Corporate Tax Risks: A Call for Greater Audit Committee Involvement

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May 4, 2012
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This paper considers issues and events with the intent to propose changes to current behavior and duties of the audit committee. First, Part I will address reasons for greater audit committee involvement with tax risks specifically public, government, and shareholder issues. Part II will discuss both the historical approach to tax risk taken by the audit committee and its recent evolution. Part III will discuss recent regulatory roadblocks and subsequent behavior that necessitates greater audit committee involvement. In Part IV, it will discuss current duties of the audit committee and how it relates to tax risk in general. Part V highlights proposed changes to audit committee behavior that could adequately solve the issues cited without undue burden. Last, Part VI addresses why worries of increased personal liability for audit committees are real but perhaps unwarranted.

I. Introduction: Reasons for Greater Audit Committee Involvement

Due to the increased publicity of corporate tax returns in the media and required increased transparency with government agencies, tax risks have become an essential component in corporate governance. In 1986, about 24 percent of corporations paid no federal income tax; that number has increased significantly over the past quarter-century to 69 percent in 2008.¹ This has caused a public backlash across many sections of the country and has caused some in the public to view some corporations in a less than flattering light. One commonly held view is that, “[in] practice, though, it's common for big businesses to pay much less, thanks to a cornucopia of tax-code loopholes and exemptions won by lobbyists.”² Often one cannot hold a serious conversation on tax risk without catchphrases such as “loopholes”, “tax-shelters”, and “lobbyists” surfacing. This often repeated news item could have significant adverse effects on

² Id.
publicly criticized corporations. Negative publicity has become an important and even quantifiable focus for corporations.³ Goldman Sachs now includes negative publicity as a risk factor in its 10-K financial statement.⁴ The reason for this heightened attention is that negative publicity can sometimes bring about a fresh round of lawsuits and regulatory, legislative or even law enforcement investigation.⁵ All these factors can be quite costly for corporations in the long-run.

In addition, government agencies have placed a steadily increasing focus on the perceived tax risks taken by corporations. The situation has quickly evolved since the turn of the century in the post Sarbanes-Oxley corporate world. In 2006, Financial Accounting Standards Board Interpretation No. 48 (FIN 48) was issued.⁶ This interpretation brought clarity and strict compliance standards to the accepted accounting procedures for documenting uncertain tax positions in corporate financial statements.⁷ A few short years after the implementation of FIN 48, the Internal Revenue Service announced the arrival of Schedule UTP in 2010.⁸ The agency now requires corporations to annually disclose any and all uncertain tax positions, with a certain level of specificity, to be included with their corporate tax returns.⁹ One commentator, in reference to the increase in new regulation of uncertain tax positions, coined present times as the “age of transparency.”¹⁰

⁴ Id.
⁵ Id.
⁷ Id.
⁹ Id.
In recent years, even shareholders have taken affirmative action toward an increased recognition of tax risks.\(^{11}\) In 2011, select shareholders of Boeing requested that the company annually disclose the effects of tax policy on shareholder value in a report disclosed in the proxy statement.\(^{12}\) While the Securities and Exchange Commission (S.E.C.) allowed Boeing to exclude such information from the proxy statement, it does show increased concern of tax risk at the shareholder level.\(^{13}\) Concerns at the shareholder, government and public level indicate an issue ripe for increased understanding and scrutiny of tax risks at the board level.

II. Evolution of the Approach to Tax Risk Taken by the Audit Committee

Prior to the implementation of corporate governance provisions in the Sarbanes-Oxley Act (SOX), audit committee involvement with tax strategies was quite limited.\(^{14}\) Before the enactment of SOX, audit committee meetings often were short presentations by executives to the committee members who were asked to receive the information and inquire with pre-fabricated questions.\(^{15}\) Often the head of tax or the chief financial officer met with the audit committee only once at the end of each year to discuss tax issues and this was all that was required.\(^{16}\) This type of reporting, known as exception based reporting, did not give audit committee members sufficient background or context of the tax issues presented to them.\(^{17}\) As a result of SOX, there has been some change in this behavior.\(^{18}\) Major corporate governance and tax shelter scandals have increased the awareness of the significance of tax risk throughout corporate management,

\(^{12}\) Id.
\(^{13}\) Id.
\(^{16}\) Levin, supra note 14, at 2.
\(^{17}\) Id. at 3.
\(^{18}\) Id. at 2.
independent auditors, and federal regulatory agencies.\textsuperscript{19} Overall, audit committees are reported to spend 50% more time in association with their duties.\textsuperscript{20} After SOX regulation, independent auditors began to discover significant levels of material weaknesses in tax related internal controls.\textsuperscript{21} In 2005, 22 percent of all material weaknesses in companies with $500 million plus in revenues resulted from tax policies.\textsuperscript{22} These reported material weaknesses resulted from increased scrutiny in the accuracy of income tax accounting, specifically in regard to deferred tax positions and tax reserves.\textsuperscript{23} In current audit meetings, there is considerable communication pertaining to risks associated with different accounting techniques.\textsuperscript{24} However, at this time most heads of tax still approached the audit committee based on exception based reporting.\textsuperscript{25} In 2005, trends showed that the focus of the audit committee on these issues was increasing.\textsuperscript{26} An alternative approach to tax risk began circulating due to the historical approach being deemed by some heads of tax as being insufficient.\textsuperscript{27} Reporting on only exceptions such as tax reserves and essential transactions to corporate performance is insufficient.\textsuperscript{28}

The alternative approach relies on increased communication in regards to the context of tax issues.\textsuperscript{29} This approach should accomplish two results.\textsuperscript{30} First, overall tax strategy being employed by tax departments should be more fully shared with the audit committee in order to

\begin{itemize}
  \item \textsuperscript{19} Id.
  \item \textsuperscript{20} McGrane, supra note 15, at 578.
  \item \textsuperscript{21} Levin, supra note 14, at 2.
  \item \textsuperscript{22} Id.
  \item \textsuperscript{23} Id.
  \item \textsuperscript{24} McGrane, supra note 15, at 577.
  \item \textsuperscript{25} Levin, supra note 14, at 3.
  \item \textsuperscript{26} Id.
  \item \textsuperscript{27} Id.
  \item \textsuperscript{28} Id.
  \item \textsuperscript{29} Id.
  \item \textsuperscript{30} Id.
\end{itemize}
provide a reference point so that significant transactions can be better analyzed.\textsuperscript{31} Second, continued communication between the tax department and audit committees could possibly provide a shared and explicit understanding of what level of tax risk is appropriate.\textsuperscript{32} While this alternative approach is an encouraging improvement, it falls short for many reasons based on what is needed.

Overbearing regulation in recent years has presented significant unforeseen dangers to corporations that require more detailed audit committee attention and approval in respect to tax risk. Tax risk strategy needs to be recommended at the board level through negotiation with management and not the other way around. In addition, management could be more closely monitored and scrutinized. This can be accomplished through internal controls and communication with the independent auditor. The audit committee needs to specifically discuss existing FIN 48 reserves and Schedule UTP disclosures to ensure that they reconcile with an overall tax risk strategy implemented by the audit committee.

III. Recent Significant Changes in Tax Risk Laws & Standards

In the development of the so-called age of transparency, there have been two significant changes in the financial accounting and reporting of corporate tax risks. Even prior to the first significant change, evidence indicated that tax reporting had begun to evolve as a result of previous regulatory requirements implemented by SOX.\textsuperscript{33} This act was the first independent federal statutory provision to require an audit committee and governed considerable new duties

\begin{itemize}
\item \textsuperscript{31} Id.
\item \textsuperscript{32} Id.
\end{itemize}
put on the committee. 34 Recently, federal agencies have reacted strongly to behavior that in their opinion has been left under-regulated by SOX. These changes have specifically addressed uncertain tax positions. Uncertain tax positions result from the application of unclear or unsettled tax laws to specific facts and circumstances. 35 While addressing the problem of an ambiguous tax code would be the logical solution, without a great deal of reform and cooperation from Congress this is unlikely.

The first change was implemented in 2007 which called for increased scrutiny to accounting procedures regarding tax reserves. 36 FIN 48 requires corporations to account for all tax positions that are less than certain in their financial statements, known as tax reserves. 37 These tax reserves indicate in the books a monetary value of the inherent tax risk in a corporation. 38 Various studies indicate that perhaps FIN 48 has been inadequate since its initial enforcement to discourage inappropriate corporate tax practices and behavior. To some degree, this may have caused the I.R.S. to step in and address tax risk through further regulation. This second significant change was implemented for the 2010 tax year which brought increased reporting requirements for corporations when filing their corporate tax returns. 39 Schedule UTP requires corporations to directly disclose to the Internal Revenue Service any and all uncertain tax positions on a detailed specific item by item basis. 40 This will bring increased costs of tax compliance in both time and money.

A. Implementation of FIN 48 Accounting Standards

34 McGrane, supra note 15, at 575.
35 Lisowsky, supra note 33, at 6.
36 Id. at 11.
37 Id. at 6.
39 Danielle E. Rolfes, Schedule UTP: Ready or Not, Here It Comes, 26 TAX MGMT. REAL. EST. J. 267, 269 (2010).
40 Id.
The Financial Accounting Standards Board (FASB) implemented Financial Interpretation No. 48 (FIN 48) in order to bring general acceptable standards to the financial accounting of uncertainty in income taxes, known as tax reserves.\textsuperscript{41} Prior to its issuance, corporations employed a multitude of methods to determine its tax reserves.\textsuperscript{42} The legislative reason for FIN 48 was to “eliminate inconsistency in accounting for uncertain tax positions in financial statements in accordance with U.S. [General Accepted Accounting Principles] GAAP.”\textsuperscript{43} These inconsistencies led to S.E.C. concerns over corporations using tax reserves to overstate net income on financial statements.\textsuperscript{44} In order to limit this behavior, the FASB implemented FIN 48 to regulate accepted standards to the recognition, treatment, measurement, and disclosure of the tax reserves.\textsuperscript{45} These accepted standards result in more heavily regulated allowable figures, than under previous guidance, which are required to be included in the footnotes of the financial statement.\textsuperscript{46} The assessment of FIN 48 positions is done by managers, auditors, and legal counsel.\textsuperscript{47} The disclosure of such FIN 48 positions are required to be audited by the independent auditors and certified in accordance with GAAP.\textsuperscript{48}

Tax reserves are formed when a corporation is uncertain whether its proposed tax position will cause an increase in future tax liability upon any possible audits, settlements, or litigation with taxing authorities.\textsuperscript{49} A tax position can be an array of things according to the

\textsuperscript{42}Lisowsky, supra note 33, at 11.
\textsuperscript{44}Lisowsky, supra note 33, at 11.
\textsuperscript{45}Id. at 1.
\textsuperscript{46}Id. at 11.
\textsuperscript{47}Id. at 12.
\textsuperscript{48}Lipin, supra note 43, at 670.
\textsuperscript{49}Lisowsky, supra note 33, at 1.
FASB and is specifically defined; however, they further maintain that their given examples are illustrative. A tax position is:

A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets.

Under FIN 48, tax reserves are known as the unrecognized tax benefit (UTB). In general terms, UTB is a contingent liability that measures the amount of tax benefits a corporation has accrued in previously filed tax returns through uncertain tax positions that may ultimately be denied. The procedure for evaluating an uncertain tax position under FIN 48 rules involves a two-step process, recognition and measurement. In the recognition stage, the benefit must pass a more likely than not threshold in order for the benefit to be claimed. Any uncertainty to the amount of benefit is sorted out at the measurement stage.

Proposed tax benefits will only reduce tax expenses to its full extent when the position taken by the corporation has a 50.1 percent plus chance of being upheld by a court of law on the merits at trial. Simply, if a taxpayer believes that the tax position is more likely than not to be upheld, then the taxpayer can account for the full tax benefit without holding any corresponding UTB liability reserves to cover such benefit in the future. In the alternative, if the more likely than not standard is not met then no tax benefit is realized and a UTB liability reserve is formed.

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51 Id.
52 Lisowsky, supra note 33, at 11.
53 Id.
54 Lipin, supra note 43, at 671.
55 Rolles, supra note 39, at 269.
56 Id.
57 Lisowsky, supra note 33, at 11.
on the full amount.\textsuperscript{59} It becomes more difficult to calculate the effects of an uncertain tax position on tax reserves when the recognition threshold is met but there is considerable ambiguity of how much benefit will actually be received.

If some amount of benefit is more likely than not to be recognized but no individual outcome is more likely than not to occur then the benefit will be measured according to the probability of the likely amounts realized upon settlement with the I.R.S.\textsuperscript{60} Under this cumulative probability approach, all possible outcomes are ranked from largest tax benefit to smallest tax benefit.\textsuperscript{61} Then the probability of each outcome starting with the largest tax benefit is cumulated until the cumulative likelihood reaches more than 50.1 percent.\textsuperscript{62} To illustrate this concept: Assume the uncertain tax position is more likely than not to provide some tax benefit but has three possible outcomes of $100, $60, and $30. Each outcome has a one-third chance of being the benefit sustained. The $100 benefit would have a cumulative probability of 33.3%, the $60 benefit would have a cumulative probability of 66.7%, and the $30 benefit would have a cumulative probability of 100%. As a result, the tax benefit of $60 is the accepted benefit because it is the largest possible outcome with a cumulative likelihood above the more likely than not standard.\textsuperscript{63} The company will realize a $60 tax benefit and will also record a $40 UTB tax liability on its financial statements.\textsuperscript{64} The company will presumably claim the $100 benefit on its corporate tax return when in reality it is unclear whether the benefit will be $30, $60, or $100. The UTB liability reflects this economic uncertainty to some degree.

\textsuperscript{59} Lipin, supra note 43, at 672.
\textsuperscript{60} Lisowsky, supra note 33, at 12.
\textsuperscript{61} Rolles, supra note 39, at 269.
\textsuperscript{62} Id.
\textsuperscript{63} Id.
\textsuperscript{64} Id.
The intended effect of the interpretation is to limit allowable tax benefits reported in the financial statements to reflect the economic reality those tax positions will have on the financial condition of the corporation. In spite of the increased valuation and disclosure requirements, the largest corporations still maintain staggering tax reserves. As of 2011, the five largest tax reserves included: GE at $8.7 billion, Pfizer at $7.7 billion, AT&T at $7.5 billion, JP Morgan Chase at $6.6 billion, and GM at $5.4 billion. These numbers are at unacceptable levels when talking about the contingent liabilities of a corporation. The corporation could ultimately receive zero, some, or all of the tax benefit claimed. It is hard for an investor to truly understand the economic impact of such volatile and ambiguous liabilities. In addition, there are studies that indicate the interpretation has been less effective than hoped in effectively eradicating undesired behavior, namely the continued use of tax shelters and abusing tax reserves to overstate net income. The obligation is on the management of the corporation to properly determine and report a reasonable likelihood for each uncertain tax position through their inherent powers.

B. FIN 48 – Management of Tax Reserves Study

In one study of S & P 500 and S & P 400 companies over the 2007 and 2008 fiscal years, researchers in analyzing FIN 48 footnote disclosures found something of interest. Companies in opposite situations had a large disparity in behavior in relation to their treatment of tax reserves. The researchers compared corporate earnings before (“pre-reserve changed earnings”) and after the annual fiscal year changes in the FIN 48 tax reserves. Since tax accrual is usually one of the last accounts closed prior to the end of the fiscal year, it may

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67 Cazier, *supra* note 41, at abstract.
68 *Id.*
69 *Id.* at 4.
provide management with a temptation to use unethical discretion when accounting for tax reserves.\textsuperscript{70}

The results of this study found that 70.7 percent of companies with pre-reserve changed earnings below expected forecasts decreased their tax reserves, thus their liability, which resulted in an increase in net income.\textsuperscript{71} Of the companies with earnings below expected forecasts, 37 percent were able to meet expected earnings forecasts when tax reserves were reduced.\textsuperscript{72} In the opposite situation, only 20.9 percent of companies with pre-reserve changed earnings above expected forecasts decreased tax reserves.\textsuperscript{73} Of the companies with earnings above expected forecasts, only 9.8 percent increased tax reserves resulting in the companies falling short of expected earnings forecasts.\textsuperscript{74} The publishers of the study found that this large disparity in behavior in the differing situations was a result of corporate managers using tax reserves to meet expected forecasts of company performance.\textsuperscript{75}

Another finding of this study was that companies that exceeded expected forecasts by large margins were more inclined to accumulate larger tax reserves than those who exceeded expected forecasts by smaller margins.\textsuperscript{76} Of the companies with pre-reserved changed earnings far above expected forecasts, 77.3 percent increased their tax reserves while only 49.5 percent of companies with earnings just above forecasts increased their tax reserves.\textsuperscript{77} The researchers attributed this to the desire of management to temper earnings and to create “cookie jar” reserves
for the future.78 The term cookie jar reserves refers to the use of inappropriate accounting procedures to overstate reserves in a year with excess income in order to gain the ability to inflate income in future years by reducing those same reserves.79 This practice distorts the economic reality of a company from year to year.

In the first findings, the discrepancy of nearly 50 percent between the two situations definitely raises some questions on management behavior. In the second findings, the numbers again raise questions of behavior if such use of improper accounting practices is as rampant as the researchers believe. “Cookie jar reserves” are completely unacceptable due to their dangerous effects of distortion. This was an important issue for former S.E.C. chairman, Arthur Levitt.80 The S.E.C. has gone after many accounting executives for using this practice including Bristol-Myers Squibb, Sunbeam, and Dell resulting in substantial punitive settlements with the agency.81 The significance of these punitive settlements which come out of corporate coffers should raise the level of concern of the audit committee. Unfortunately, without more extensive research all one can do is draw an inference from the numbers provided. While the evidence certainly indicates “managed earnings”, it is a question best asked and answered on a corporation by corporation inquiry. The I.R.S. has held the position that FIN 48 disclosures will be reviewed and analyzed when deciding who to audit.82 So misbehavior in compiling the financial statements could lead to increased scrutiny and higher incidents of audit, resulting in increased compliance costs. The audit committee is in the best position to monitor executives and ensure that managers are not managing earnings to meet certain benchmarks.

78 Id.
79 “Motivations for Managed Earnings”, 5137-2d: Earnings per Share, Tax & Accounting Center (BNA).
82 Lipin, supra note 43, at 675.
C. FIN 48 – Tax Shelter Use Study

In another study published in 2011, researchers found evidence that a larger size of tax reserves was positively correlated to an increased use of tax shelters. The researchers also found that tax shelters attributed to a substantial percentage of the tax reserves in the sample, 48 percent. The use of tax shelters was gleaned from looking at listed transactions that must be reported to the I.R.S. and temporary book-tax differences.

Of note, the study did indicate some improvement in corporate behavior as a result of the implementation of FIN 48. The percentage of unrecognized tax benefits attributed to tax shelters decreased from 68 percent in 2006 to 48 percent in 2009. Furthermore, one survey indicated that 57% of corporate executives were less willing to employ aggressive tax positions as result of the new requirements of FIN 48.

Tax shelters are aggressive tax positions taken by taxpayers that have a negligible business purpose and result in no economic risk or loss to the taxpayer. These positions have little chance of being sustained in the occurrence of a tax audit by federal authorities. Although risky, research indicates that the use of tax shelters causes corporations to suffer from fewer repercussions from investors in the market than other corporate misconduct.

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83 Lisowsky, supra note 33, at abstract.
84 Id. at 30.
85 Id. at 15.
86 Id. at 17.
87 Id.
88 Id. at 1.
89 Id.
90 Id. at 2.
corporations that employ tax shelters obviously receive higher tax benefits but surprisingly they also enjoy lower interest rates from creditors.\(^{91}\)

On the negative side, the use of tax shelters could indicate rent extraction and aggressive accounting practices which could hide poor company performance or heightened risk in a company.\(^{92}\) The use of tax shelters can interest certain investors who want a company to be aggressive in spite of its substantial benefits and costs.\(^{93}\) The permitted use of “tax shelters” is a critical element tax strategy that should be determined at the board level. Since the audit committee represents the shareholder interest to management, it should be the audit committee and not management that recommend the level of aggressiveness shareholders find appropriate when dealing with taxing authorities and resulting public displeasure.

**D. Implementation of Schedule UTP Disclosures**

A few short years after FIN 48 was implemented, the development of Schedule UTP was announced in January of 2010.\(^{94}\) The schedule was developed with the objective of providing information to I.R.S. about uncertain tax positions that affected federal income tax liability.\(^{95}\) The announcement stated that corporate taxpayers must disclose all current FIN 48 tax reserves in addition to those tax reserves not recorded due to the anticipation of litigating the issue.\(^{96}\) The agency required that the schedule be included with the corporate tax return, Form 1120.\(^{97}\) As to the contents, the schedule must contain “a concise description of each uncertain tax position for which the taxpayer or a related entity has recorded a reserve in its financial statement and the

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\(^{91}\) Id.

\(^{92}\) Id.

\(^{93}\) Id.

\(^{94}\) I.R.S. Ann 2010-9, supra note 8.

\(^{95}\) Id.

\(^{96}\) Id.

\(^{97}\) Id.
maximum amount of potential federal tax liability to each uncertain tax positions [regardless of its likelihood of prevailing on the merits].” These uncertain tax positions must be individually ranked from highest to lowest based on possible federal tax liability plus interest and penalties, known as the federal tax reserve. In addition, if any uncertain tax position exceeds 10% of the total amount of the federal tax reserves on the schedule, it must be designated as such.

These requirements put a considerable new burden on corporations. Corporations will be required to spend more time and money on tax compliance when the average cost of compliance of Fortune 500 companies is already at about $5 million. The increased disclosure requirements could increase the costs of the audit process and any subsequent litigation due to the increased amount of information delivered to I.R.S. Subsequent fear of the audit process may cause a reactionary overly conservative approach which could result in a reduction of competitiveness and negatively affect the bottom line of corporations. Pressure from the board of directors to improve the bottom line may result in disagreement with more conservative heads of tax and vice versa. This possible tension makes it increasingly important for boards to recommend an acceptable tax strategy for the corporation through negotiations with management and to enforce this strategy on management through monitoring.

IV. Existing Duties of the Audit Committee

Before one can propose changes to existing committee behavior, there must be an analysis of existing duties of the audit committee and the customary behavior employed in
furtherance of those duties. Proper acknowledgement of these duties and the requisite due diligence in implementing these duties are essential to a good corporate governance policy regarding tax risks. However, as they currently, they are not currently sufficient to properly deal with tax risks.

A. Statutory & Regulatory Requirements

The duties of the audit committee are largely governed by the legal regimes of both the Sarbanes-Oxley Act of 2002 (SOX) and its counter-part regulations found in Exchange Act Rule 10A. SOX defines an audit committee as “a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of financial statements of the issuer…” 105 Accordingly, some the primary duties of the audit committee are to review and evaluate the financial statements of a corporation and to review the external audit of such financial statements provided by the independent auditor. 106 Other primary duties of the audit committee include: pre-approval of the independent auditors, review of the overall audit plan, review of the internal audit and review of internal controls. 107 While these other primary duties relate to tax risks in some significant manner, the previously mentioned two duties bear extreme importance in the area of tax risk assessment.

The first major duty of the audit committee in relation to tax risks involves the review and evaluation of financial statements. 108 This review will generally occur at the post-audit

105 15 U.S.C. § 78(c)(a)(58)
106 “Six Primary Functions”, Audit Committees, Corporate Governance Library (BNA).
107 Id.
108 Id.
meeting with the independent auditors and members of management.\textsuperscript{109} The primary objective of the review is to gain knowledge and understanding of significant financial reporting issues, how these issues were resolved, and to judge the effectiveness of such resolutions.\textsuperscript{110} Another objective is to gain sufficient communication with its shareholders.\textsuperscript{111} The audit committee must decide whether information presented in the financial statements is presented fairly and in a complete, accurate, and understandable method.\textsuperscript{112} This duty goes hand in hand with its duties in relation to the independent auditor. Proper communication with the independent auditor is crucial in ensuring that the financial statements are presented in a fair and accurate manner.

The regulations establish certain standards of conduct and responsibilities for the audit committee relating to the independent auditor.\textsuperscript{113} The audit committee is required to be “directly responsible for the appointment, compensation, retention and oversight” of the independent auditor.\textsuperscript{114} This includes resolving differences between the independent auditor and management involving any disagreements with the execution and finalization of the financial statements.\textsuperscript{115}

These auditors are required to report to the audit committee of a company: “…all alternative treatments within Generally Accepted Accounting Principles for policies and practices related to material items with management of the issuer…including: ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the registered public accounting firm…”\textsuperscript{116} Thus, in light of the recent implementation of FIN 48 and Schedule UTP, tax risk behavior and strategy come directly into the purview of the audit

\textsuperscript{109} Id.  
\textsuperscript{110} Id.  
\textsuperscript{111} Id.  
\textsuperscript{112} Id.  
\textsuperscript{113} 17 C.F.R. § 240.10A-3(b)(2)  
\textsuperscript{114} Id.  
\textsuperscript{115} Id.  
\textsuperscript{116} 17 C.F.R. § 210.2-07(a)
committee because of their mandated oversight of the independent auditor. The evolution of tax risk regulation and government oversight makes a strong argument for the increased involvement by the audit committee when the independent auditor raises questions about aggressive tax risk strategy, generally, and positions taken on certain transactions, specifically.

The review of the independent audit is usually a two-fold process. In the first stage, the audit committee will meet with the independent auditors to discuss the status and progress of the audit and the results of an interim audit. Some specific items they may discuss at this meeting include: the occurrence of any unanticipated problems, the possible existence of any improper or illegal transactions or activities, and the development of new accounting, legal, or regulatory principles which may affect the audit. At this point, any aggressive or uncertain tax positions that are covered by the audit should come to the attention of the audit committee. The independent auditor is required by law to disclose any surfacing improprieties to the committee if found in the process of audit.

Later in the final step of the process, the audit committee will meet with the independent auditors to discuss the full findings of the total audit at some certain time after its completion. At this meeting, some specific items that may be discussed include: cooperation level received from management and any differences of opinion with management regarding financial and reporting matters and their subsequent resolution, and also future recommendations in relation to accounting practices and financial reporting.

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117 “Six Primary Functions”, supra note 106.
118 Id.
119 Id.
120 Id.
121 Id.
122 Id.
The regulation mandating independent auditor oversight was adopted with the intent to align the interest of the shareholder with the independent auditor.\textsuperscript{123} In the alternative, the auditing process itself becomes compromised when the independent auditor’s interest aligns with the interest of management.\textsuperscript{124} Thus, the overarching responsibility of the audit committee is to ensure that the audit process is conducted in the best interests of the shareholder.

In completion of these tasks, the audit committee is required to be allowed the authority and appropriate funding to accomplish these standards through the engagement of independent counsel.\textsuperscript{125} Specifically, authorizing the help of outside counsel ensures that the audit committee can circumvent the means used by management and any inherent conflict of interest that could result from the advice of corporate counsel or management’s outside counsel. Furthermore, there is a need to independently investigate on the part of the audit committee any issues that may arise regarding financial reporting and compliance.\textsuperscript{126} While this imposes no strict duty on the audit committee to proactively investigate, it may indicate a certain level of inquiry required on the part of the audit committee.

B. Stock Exchange Listing Requirements of the Audit Committee

In addition to the federal legal regime, publicly traded corporations are subject to the listing requirements of the NYSE, NASDAQ, and other relevant exchanges. The listing requirements are contractual obligations between the exchange and corporations.\textsuperscript{127} The various stock exchanges are required by federal regulations to have certain minimum requirements of an

\begin{footnotesize}
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\item[124] Id.
\item[125] 17 C.F.R. §240.10A-3(b)(4-5)
\item[126] In re Standards Relating to Listed Company Audit, supra note 123.
\item[127] McGrane, supra note , at 582.
\end{enumerate}
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The audit committee requirements of the various stock exchanges elaborate in more detail than SOX and the regulations on both the physical consistency of the audit committee and its required behavior. The NYSE requires a minimum of three members who must satisfy independence requirements. All members must be financially literate and additionally one member must have accounting or financial management expertise. They are required to have periodic, separate meetings with each the management, independent auditors, and the internal auditors of a corporation individually. The audit committee is required to discuss, with management and the independent auditors, the annual audited financial statements and quarterly statements.

Specifically, of stark importance and relevance to tax risk, there is a provision included in the listing requirements that the committee must discuss guidelines and policies for risk management and risk assessment. While the requirements realize that the exposure of risk is a management issue, the audit committee is charged with governing the process of managing risk. Tax risks are frequently cited as being within the scope of this duty imposed on the committee. While the exchange listing requirements do not mandate the need for increased scrutiny in specific transactions with an aggressive tint, overall, it is the duty of the audit committee to ensure that the propensity for tax risk taken by management is subject to oversight.

V. Proposed Changes to Committee Behavior in Relation to Tax Risk

128 17 C.F.R. §240.10A-3(b)(1)
130 Id. at (b)(iii)(A).
131 Id. at (b)(iii)(E).
132 Id. at (b)(iii)(B).
133 Id. at (b)(iii)(D).
134 Id.
135 Levin, supra note 14.
In October of 2009, the I.R.S. Commissioner announced, in the lead up to Schedule UTP, a corporate governance initiative to emphasize the need for corporations to establish mechanisms that properly assess tax risk.\textsuperscript{136} The audit committee was singled out as being critical in this regard.\textsuperscript{137} This initiative serves as a guideline for the proposed changes of this paper to audit committee behavior and duties. The Commissioner further emphasized the importance for boards to first hold management responsible and second to understand corporate risk strategies in relation to tax.\textsuperscript{138} The Commissioner cited some reasons for this position that deserve consideration: taxes account for a significant amount of the expenses of corporations, these expenses need to be managed responsibly, and aggressive tax risk can lead to public relations issues and more significant expenses.\textsuperscript{139} He greatly emphasized the need for a mechanism to oversee tax risks.\textsuperscript{140}

Committee members should have total discretion in recommending the level of aggressiveness of tax-risk strategies. Some critics may see this as taking too much power over issues that belong to management. In the alternative, shareholders, at a minimum, should have disclosure reports in the annual proxy of both the present and future level of aggressiveness of tax-risk strategies. Aggressive tax risk strategy should be approved by the shareholders in some capacity at least tacitly through the election of the board but can be less sufficiently addressed through proxy proposals. Whether tacit approval through the election of the board is sufficient to satisfy their interest would depend largely on a corporation by corporation determination.

**A. Overall Corporate Tax Risk Strategy**

\textsuperscript{136} IR 2009-95, supra note 38.
\textsuperscript{137} Id.
\textsuperscript{138} Id.
\textsuperscript{139} Id.
\textsuperscript{140} Id.
It is a historical principle of corporate governance that the role of the board should be to monitor and oversee management and let the officers manage the day to day affairs of the company.\textsuperscript{141} The I.R.S. Commissioner’s proposition that boards of directors need the means not to involve themselves with tax planning but to ultimately oversee tax strategies and risks is perfectly aligned with this well-founded principle.\textsuperscript{142} However, boards should be responsible not just for discussing tax risk strategies but to be the ones recommending such strategy. The compensation of management usually hinges on the degree of success or failure they have, while an independent director is free to make responsible decisions because his compensation merely arises through being a director.\textsuperscript{143} Having the audit committee set guidelines of acceptable behavior is the best way to effectuate change without constant interference with the decisions of management and causing undue physical hardship on the committee. Overly discretionary tax matters need to be reeled in a bit. The independent audit committee is the most appropriate way to accomplish this task.

The most suitable method of incorporating tax strategy from the board level is through negotiation with management instead of overbearing commands and subsequent monitoring.\textsuperscript{144} By giving management a considerable input to the tax risk strategy, it will foster trust and increased cooperation with the board.\textsuperscript{145} Otherwise, mandating tax risk strategy to management could lead to adversity and distrust causing executives to withhold information from the audit

\textsuperscript{141} Kevin Iurato, \textit{Warning! A Position on the Audit Committee Could Mean Greater Exposure to Liability: The Problems with Applying a Heightened Standard of Care to the Corporate Audit Committee}, 30 STETSON L. REV. 977, 1000 (2001).
\textsuperscript{142} IR 2009-95, \textit{supra} note 38.
\textsuperscript{144} Harvard Law Review Association, \textit{II. And Now, the Independent Director! Have Congress, the NYSE, and NASDAQ Finally Figured Out How to Make the Independent Director Actually Work?}, 117 HARV. L. REV. 2181, 2200 (2004).
\textsuperscript{145} \textit{Id.}
committee. Without the trust and cooperation of executives, the audit committee will be forced into a primarily monitoring board which is insufficient to solve current issues pertaining to tax risk.

In accordance with the Commissioner’s suggestion, boards should set threshold confidence levels for uncertain tax positions. The threshold confidence levels should be conservative or aggressive depending on each corporation’s priorities and needs. In implementing threshold levels, certain factors should be considered including: shareholder values, management input, overall compliance costs, the market in which the corporation exists both geographically and in nature, and the degree of reputational concerns. Furthermore, all listed I.R.S. transactions should be approved by the board before their implementation due to their highly aggressive nature. Especially, since managers currently have so much discretion in this regard. More conservative managers may include a transaction as reportable or be more likely to record reserves while other managers may think neither is necessary. There needs to be more adequate checks and balances on this behavior.

The changes to who implements tax risk policy should not be in the form of more unneeded regulations. It should be borne from the stock exchange listing requirements due to the private contractual nature of such requirements and also because these proposed requirements are much more suited for larger publicly held corporations rather than smaller private corporations. Smaller companies already have increased difficulty in finding qualified audit committee

146 Id.
147 IR 2009-95, supra note 38.
148 Lisowsky, supra note 33, at 5.
candidates and as a result suffer larger proportional expenses in finding qualified candidates.\textsuperscript{149} Proper tax risk strategy should only be recommended from a committee that is qualified to do so.

**B. Monitoring Management**

A substantial increase in monitoring is inappropriate because it would force the board into an unproductive role. Former S.E.C. commissioner, Roberta S. Karmel, referred to the post-SOX audit committee as an “executive committee” that was more adversarial to management in contradiction with the board’s historical “collegial” approach to management.\textsuperscript{150} A substantial increase in monitoring could lead to an alarmingly defensive management and a relationship that disvalues cooperation with the committee.\textsuperscript{151} The committee needs substantial information from management to effectively do its job. However, financial statements are very important because they are management’s main communication with the shareholders.\textsuperscript{152} Setting tax risk strategy at the board level should sufficiently alleviate concerns of management using accounting and tax procedures to misrepresent the books. Management would have to act within certain parameters. However, shareholder interest would be better protected through a minimal increase in the supervising and monitoring role over the independent auditor.

Poor manager behavior often stems from a split in loyalties and not the intent to commit a crime or breach their fiduciary duty.\textsuperscript{153} Due to performance incentives, management may be tempted use their day to day control in order to implement unwanted accounting procedures and

\textsuperscript{149} Harvard Law Review Association, \textit{supra} note 144, at 2198.  
\textsuperscript{151} Harvard Law Review Association, \textit{supra} note 144, at 2201.  
\textsuperscript{152} McGrane, \textit{supra} note 15, at 579.  
\textsuperscript{153} Harvard Law Review Association, \textit{supra} note 144, at 2201.
tax transactions to distort corporate performance in the financial statements to their favor.\textsuperscript{154} The interaction with the independent auditor is essential in monitoring management. Any proposed increase in monitoring by the committee should come from its relationship with the independent auditors. This will keep adversity and distrust towards the audit committee from management at acceptable levels.

The I.R.S. Commissioner encouraged boards to maintain increased levels of communication on tax matters with independent auditors.\textsuperscript{155} In relation to tax risk, compliance with the required oversight of the independent auditor must be done with the shareholder in mind. One way to properly monitor in the long-run is to require that the independent auditor provide an annual report to the audit committee on management’s compliance with the overall tax strategy implemented through the examination of FIN 48 reserves and Schedule UTP disclosures. This report, in accordance with the Commissioner’s recommendations, should specifically address issues such as: the process used to identify uncertain tax positions, how agreeable they are with management on the assessment of the positions, the process used to determine the sustainable likelihood of each position, and the possibility of potential penalties for these positions.\textsuperscript{156} This report would allow the audit committee to better effectuate proper internal controls that could possibly bring the policy of the committee and management in harmony and also provide valuable feedback on the effectiveness of its recommended strategy.

C. Alternatives

If the proposed ability of the committee setting overall tax strategy is deemed inappropriate for any reason, in the alternative, the S.E.C. should reverse its policy on

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\item \textsuperscript{154} McGrane, \textit{supra} note, at 579.
\item \textsuperscript{155} IR 2009-95, \textit{supra} note 38.
\item \textsuperscript{156} \textit{Id.}
\end{enumerate}
\end{footnotesize}
disallowing a report on tax strategy and its effects in the proxy statement. As previously mentioned, the S.E.C. granted a no-action letter to Boeing on this issue. Specifically, the proxy proposal asked the board to include an annual report on the financial, reputational, and commercial effects that tax had on shareholder value in the proxy materials. Boeing was allowed to exclude the material under Rule 14a-8(i)(7) because it interfered with the company’s ordinary business operations. This general position has been upheld numerous times in the instances of Amazon, Home Depot, Wal-Mart, Pfizer, and many others.

The corporate strategy on tax risk greatly affects shareholder interests. Certain strategies can distort financial information and blind them to economic realities of the corporation. Thus, it transcends ordinary business operations and should cause the S.E.C. to institute actions against corporations who refuse to include this information in the proxy. This alternative position is insufficient. Shareholders will be more informed but will effectuate insignificant change in regards to tax risk. If they find proposed strategies imprudent, they can change management behavior through selling their shares. Otherwise, they are forced into a reactive position rather than a proactive position. This reactive position will allow them to act in their own interest only after something has happened. Historically, shareholders are a largely ineffective means of holding management accountable.

VI. Concerns of Subsequent Increased Liability for Committee Members

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157 The Boeing Company, supra note 3.
158 Id.
159 Id.
161 Borowski, supra note 143, at 457.
162 Id. at 457-58.
163 Id. at 458.
Liability is a substantial concern for board members and thus needs to be recognized when making changes in duties and behavior. It is always important to keep in mind the $13 million Enron settlement and the $18 million WorldCom settlement paid out of the own pocket of board members. In the post-SOX world, Roberta Karmel worried that the nature of the regulations placed on the audit committee would cause the audit committee to lose its independent status because it was now required to become intertwined in the inside affairs of the corporation. Independence is necessary in keeping liability risks down. Her worries while valid are a little misguided. While these recommendations will cause the committee members to become even more “intertwined” with the company affairs than she feared, they do not encourage behavior that the independence requirements were implemented to end.

The federal regulations require stock exchange listing requirements to mandate at least minimal independence provisions. It states that an audit committee member may not “accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary…unless the rules of [the exchange] provide otherwise …or be an affiliated person of the issuer or any subsidiary thereof.” The NYSE audit committee requirements go a step further. The board of directors must not elect an audit committee member if it is determined that the director has a “material relationship” with the company. A director will be disqualified, if the director was an employee of the company in the past three years or a family member was an executive officer in the past three years. The director will also be disqualified, if the director or an immediate family has received, in any of the past three years, direct compensation of more

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164 McGrane, supra note 15, at 578.
165 Karmel, supra note 150, at 111.
166 See, 17 C.F.R. §240.10A-3(b)(1)
167 17 C.F.R. §240.10A-3(b)(1)(ii)
169 Id. at (b)(i).
than $120,000.\textsuperscript{170} The independence requirements do not as much concern the level of involvement within corporate affairs but more the financial incentive and loyalty a board member would have with the company. Increased involvement in the day to day affairs and the intimate knowledge gained from such involvement could challenge the independence of the audit committee.

The Commissioner of the I.R.S. clarified that the wanted changes to board behavior did not intend to interfere with warranted business decision making by the board.\textsuperscript{171} Thus, it is agreeable that the business judgment rule is very much still controlling. The business judgment rule is “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”\textsuperscript{172} In accordance with this jurisprudential rule, as long as the board implements tax risk policy through sufficient communications with independent auditors, heads of tax, and outside counsel it should be a near insurmountable presumption of good faith in the actions they have taken. Committee members are allowed to rely in good faith on the information provided by management.\textsuperscript{173}

According to Regulation S-K item 407(d), the audit committee must, based on its communications with management and the independent auditor, recommend to the Board of Directors that the audited financial statements be included in the annual report on Form-10K.\textsuperscript{174} In addition, the name of each member of the audit committee must be affixed below such

\textsuperscript{170} Id. at (b)(i)-(ii).
\textsuperscript{171} IR 2009-95, supra note 38.
\textsuperscript{172} William Meade Fletcher, Business Judgment Rule – In General, 3A FLETCHER CYC. CORP. § 1036 (2012).
\textsuperscript{173} McGrane, supra note 15, at 588-89.
\textsuperscript{174} 17 C.F.R. § 229.407(d)(3)(i).
When this provision was originally proposed it required that the committee affirmatively state whether it “believes that the company’s financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material aspects.”

It was proposed again requiring the audit committee to state whether “based on its discussions with management and the auditors, its members became aware of any material misstatements or omissions in the financial statements.”

There was much controversy over these provisions because critics and commentators worried about increased liability to the audit committee and it was finalized in its current form.

The S.E.C. claims that it in its current form it will not normally subject the audit committee to increased liability and scrutiny because if the audit committee are properly informed through communications with management and the independent auditors then they will be availed to the protections of the business judgment rule.

Thus, regulatory provisions should not present new issues of liability to committee members unless they violate the business judgment rule.

The concern of increased liability in accordance with the board implementing tax strategy and more so increased monitoring could be an issue in terms of the possible application of previous case law. In *In re AM International, Incorporated Securities Litigation*, the shareholders alleged fraud to misrepresentations and omissions in the company’s annual financial statements and Form 10-Ks. The audit committee although independent was held

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177 *Id.*
178 *Id.*
liable to the same standard as management due to its status with the corporation.\textsuperscript{181} An inside status was inferred because of the large privity of knowledge they had regarding the financial condition of the company, awareness of internal control problems in the corporation, and the responsibility to review the independent audits.\textsuperscript{182} In \textit{Greenfield v. Professional Care, Incorporated}, the audit committee’s motion to dismiss was denied on charges of actual knowledge or reckless disregard of the existence of ongoing fraud at the company.\textsuperscript{183} The court left open the possibility that the audit committee members could be held to inside director status due to its responsibility to monitor the audit process and the financial accounting and reporting.\textsuperscript{184} An increased monitoring role would open up the audit committee to more liability due to the increased amount of information they receive and the increased expectation that improper behavior should have been seen. Also, insufficient internal controls relating to corporate tax strategy could lead to an increased amount of litigation. However, the applicability of these cases is questionable in light of the fact that they were all decided prior to the implementation of SOX. If the audit committee acts with sound judgment with the information they are given, there should be considerable protection under the business judgment rule.

\section*{VII. Conclusion}

In conclusion, the audit committee should take control of implementing overall tax strategy within the company. Overly aggressive tax strategy can seriously affect shareholder communication through the financial statements. Such a policy if implemented will put perhaps overly discretionary matters of management into the hands of an independent committee with

\begin{footnotesize}
\textsuperscript{181} \textit{Id.} at 605.
\textsuperscript{182} \textit{Id.} at 605-06.
\textsuperscript{184} \textit{Id.}
\end{footnotesize}
less incentive for misbehavior. This should be effectuated through considerate negotiation with management and acknowledgement of shareholder, independent auditor, and outside counsel opinions. Any increased level of monitoring should be carefully considered due to worries of an increased workload and increased liability risks on the audit committee.