Compensation and Other Sensitive Boardroom Tax Issues

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COMPENSATION AND OTHER SENSITIVE BOARDROOM TAX ISSUES

As regulatory and compliance burdens increase for many companies, the role of — and the need for the board to rely on — the in-house tax function in meeting the company's regulatory and compliance obligations is increasing. There are many factors contributing to this change and varying views on when board reliance on in-house tax departments is appropriate. It's also important for boards to determine if the in-house department has the necessary resources to fulfill its expanding responsibilities.

At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, a panel entitled "Compensation and Other Sensitive Boardroom Tax Issues" featured a discussion of the regulatory environment that is driving an increased need for boards and key board committees to rely on in-house tax departments. The discussion was moderated by Michael Woolver, partner at Foley & Lardner, and included Donald Adler, director of corporate taxes at CF Industries Holdings, Inc.; Carl Fortner, partner at Foley & Lardner; Leo Henikoff, president emeritus of Rush University and retired president and CEO of Rush University Medical Center; Norma Lauder, director of the Chicago MS Tax Program at the University of Illinois; and Bryan Slone, partner at Deloitte Tax LLP.

The Changing Role of the In-House Tax Department

In the past, many boards may have only interacted with the company's CEO, CFO, or auditors on issues with significant tax implications for the company, such as acquisitions, dispositions, determination of appropriate reserves, retirement plan funding, and executive compensation. Developments in the regulatory environment, however, are increasing the degree to which boards may feel the need for input directly from the company's in-house tax professionals.

One such development is the Sarbanes-Oxley Act of 2002 (SOX) and, in particular, the control requirements of Section 404. Income tax has been the primary source of internal control weakness identified under Section 404, and compliance with Section 404 has had a significant impact on in-house tax functions. Another more recent change is the Financial Accounting Standards Board's Interpretation No. 48 (FIN 48). FIN 48 may significantly change the way in which companies reserve for taxes. One effect of FIN 48 is to require companies to handicap to a much greater degree the chances of prevailing on income tax positions – e.g., deductions, income exclusions, and income recharacterizations – reflected on an income tax return. For example, under FIN 48, unless a company assesses its chance of prevailing as at least "more likely than not," no tax benefit can be recognized. This could require significant restatements of tax reserves at some companies. FIN 48 is complex and involves the exercise of professional judgment, so board members need to understand its impact on their companies. Appropriate steps may include direct communication between tax directors and audit committees.

One of the developments following SOX has been the realization that tax is a risk-management function, not merely a compliance function. In addition to financial risks, the tax function involves managing reputational risk to the company. An important consideration in evaluating tax risk is how a position would reflect on the company if it were scrutinized in the public media. In-house tax professionals have a uniquely comprehensive view of the overall risk profile of the company from a tax perspective, and can effectively serve the board by presenting tax risk in a manner that can be translated into business risk for the board's evaluation and judgment.

The view of in-house tax functions has shifted since the 1990s, when they were frequently viewed as profit centers and evaluated in terms of their financial contribution to a company's bottom line. In the past, when evaluating tax strategies, companies would focus on audit risk (i.e., the likelihood of detection) and frequently fail to factor in the need for reserves. Though the tax function's goal is still tax minimization, focusing on effective tax rates was no longer a reasonable management tool. In today's environment, opportunities must make sense for the business, not just from a tax minimization standpoint, or they are likely to become problematic in the future.

Tax Department Procedures and Resources

Two emerging best practices resulted from a joint study by CFO Research Services and Deloitte Tax LLP in advising companies regarding tax risk management in today's regulatory environment. First, companies should consider establishing policies governing when transactions should be elevated for tax consideration and approval by the CEO, audit committee, or board of directors. Many companies currently have not established such policies and controls. The second best practice is to continually review the resource model for today's tax departments. Many tax departments were designed in light of a previous regulatory environment and are no longer equipped to fulfill their enhanced role. Recent tax failures have often been due to a lack of tax resources – e.g., lack of systems and data, appropriate personnel or foreign tax expertise – rather than technical tax issues. Boards should be focused on the top risk items for tax departments, which are not necessarily the largest reserve items but may include items like lack of tax function resources and planning for future regulatory changes.

Specific Tax Issues

In recent years, a number of corporate practices with significant income tax implications have been subject to public scrutiny and criticism and, in some cases, may have received insufficient board oversight. These practices include use of certain "tax products" and executive compensation issues.

<u>Tax Products</u>

Tax products are methods of attempting to reduce tax liability through transactions that produce tax losses with little or no risk of economic loss to the company. Companies may purchase tax products in the hope of sheltering significant non-operating tax gains, such as gain on the sale of a division or subsidiary. Recently, the Internal Revenue Service has successfully challenged many tax products. Tax products often are complicated and may not always receive adequate board review.

In situations involving complicated and controversial tax positions, companies should be conservative in determining appropriate reserves, reserving partially or fully even, in certain cases, when a "should"-level opinion has been obtained. The in-house tax function must understand and sign off on complex tax positions, if only to be able to report them properly, even if the company relied on external tax advice. The use of tax products should come before the board even if the numbers involved are relatively small, given the reputational risk and its potential impact on the company's stock price.

Executive Compensation

Conflicts and Hidden Costs

Executive compensation can be a sensitive issue for boards for several reasons, including the inherent conflict between executives' interests and the company's interests in this area. Without adequate board understanding of the conflict and the actual after-tax cost to the company of compensation, this conflict can produce poor results. In the tax area, compensation structures designed to benefit the executive might impose hidden costs on the company through the loss of a deduction.

In one example of such a compensation structure, companies permitted an executive to sell existing options to a family partnership in exchange for a long-term balloon note. When the partnership exercised the options, no gain was recognized because the partnership's basis was purportedly the face amount of the note. In theory, the executive would not be taxed until payment was made on the note many years later. The intended effect was to convert appreciation in the value of the option shares to capital gain without the executive paying any current tax. The IRS quickly shut down transactions of this sort, but not before a number of executives entered into such sales. If these transactions had worked, they may have saved the executive the difference between ordinary income and capital gains rates but also would have cost the company its potentially more valuable, higher rate deduction, which was tied to recognition of income by the executive.

Another area where benefits to executives may entail hidden and potentially disproportionate costs to companies are payments in connection with changes in control. Section 280G of the Internal Revenue Code of 1986, as amended (the Code), limits the compensation deduction that a company may claim for amounts paid to executives due to a change in control and imposes a twenty percent excise tax on the executive who receives such payments. According to many compensation consultants, while the trend is against so called "gross up" provisions designed to cover the excise tax, a majority of public companies still fully gross up senior executives. In the event the excise tax is triggered, it is not unusual for the company to have to pay five or more non-deductible dollars in order to deliver one dollar after-tax to the executive. In many cases, these gross up provisions are adopted before the change in control, when the company does not know precisely what its payment obligation will be.

One way to limit these payments is to make sure that the board is aware of all of the tax ramifications to the company of any sort of "make whole" payments to executives. Often times, boards of directors do not understand the full after-tax impact on the company of such payments and should avoid approving such arrangements without a full understanding.

The Securities and Exchange Commission's (SEC) new disclosure rules, which require enhanced disclosure of executive compensation, may help to highlight situations where the executive is benefiting through a disproportionate cost to the company. Boards need to look beneath the disclosed numbers even under the new rules, however, as the full after-tax cost to the company is generally not required to be disclosed. In the context of change in control and severance payments, the rules only call for estimates, which may significantly understate the actual amount. For example, the assumed change in control price is the year-end closing quoted market price. In the area of option back dating, the rules applicable to companies who are required to restate their financial reports do not require disclosure of the value of the tax deductions foregone by the company with respect to money option grants.

Advising the board on executive compensation issues may not be an appropriate role for the in-house tax department. In-house tax personnel answer to the CEO or CFO, and therefore may lack the independence (or appearance of independence) that is required of an advisor on executive compensation. However, in-house tax personnel may have a role in alerting the appropriate members of the organization if they become aware that advice the board is receiving from outside advisors on compensation matters is not genuinely independent.

Make-Whole Payments under Section 409A

Section 409A is a new provision of the Code that imposes a twenty percent additional tax, and added interest charges, on executives who benefit under programs that do not comply with Section 409A's requirements. Options that were "in the money" when granted may be subject to Section 409A, even if granted before the provision was added to the Code, and thus subject to the additional tax and interest. Many of the companies being investigated by the SEC for their option practices granted a significant number of employees "in the money" options that the employees did not know were in the money at the time of the grant. If the options were exercised in 2006, none of the transitional rules under Section 409A protect the employees, and thus the employees will be subject to the twenty percent additional tax and added interest charges. The IRS recently authorized corporations to pay the excise tax on behalf of their employees, but not senior officers, who fell within the Section 409A "trap" in 2006. One company recently announced it would pay $100 million to cover the excise tax for its rank and file employees under the IRS program.

A board of directors can use the following framework when deciding whether to make an employee whole for an error of the type that was involved in granting these options:

- Did the employee have any way of knowing of the error? If the employee did not, the company should make the employee whole
- If the employee had some way of knowing, is it reasonable to expect that the employee should have known? If it is not reasonable, the company should make the employee whole
- If the employee could reasonably be expected to have known of the error, the board should consider the moral and ethical obligation of the company to its employees, and the cost of making the employees whole compared to the benefit to the company

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.