PERSPECTIVES

SHIFTING SANDS: WHEN TAX PLANNING MORPHS INTO TAX AVOIDANCE

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The press is rife with stories of companies and wealthy individuals engaging in transactions to minimise taxes, with media and public sentiment landing firmly on the side of the public fisc. Before the economic downturn, stories of corporations losing tax battles generally resided in the business pages and were primarily of interest to investors and other corporations using similar strategies.

But that has changed, and a dispute with tax authorities now bears the overtones of potential (or actual) public condemnation. Such public condemnation, in many cases, precedes government enforcement actions, such as in the case of leaked Luxembourg tax rulings or US congressional hearings on corporate tax saving strategies. Whistleblower actions, which can lead to a simultaneous onslaught of enforcement and media attention, are also on the rise.

Companies now find themselves facing scrutiny of transactions entered into five years earlier, or longer, that, at the time, were viewed as well within the bounds of reasonable tax planning. But as public sentiment has shifted, so too have the legal standards that apply to determine whether transactions are labelled abusive. In the United

States, for example, recent court decisions have transformed the doctrine of economic substance, such that the mere awareness of tax benefits is now argued, by the government, to constitute improper tax motivation.

Further, US courts have become wary of arguments that taxpayers should be excused from penalties based on contemporaneous advice of counsel, finding that reliance on such advice was not reasonable. What is worse, many jurisdictions, both US and non-US, have begun to turn civil audits of tax minimisation strategies into criminal inquiries, further raising the stakes for potential legal and public relations liability.

The very nature of administrative audits is also changing. The recent IRS audit of Microsoft's transfer pricing related to its intellectual property rights mirrors a major litigation more than an informal administrative audit. The IRS has hired outside counsel and has issued summons requesting not just documents but also interviews with corporate executives. The IRS and other authorities are also issuing broad document requests – administrative proceedings now involve litigation-style e-discovery efforts.

And yet, tax and finance executives have fiduciary obligations to minimise costs of all kinds, including taxes. The paradox of time is that companies seeking to meet this fiduciary obligation prior to the economic downturn by minimising tax costs may now be facing accusations of wrongdoing from the media or

government agencies. And defending against these accusations is costly, both in terms of expense and reputation. While the clock cannot be turned back now, executives should proactively review historical transactions to manage future risk of enforcement and the attendant reputational risks.

Below are a number of steps that companies should take.

Plan in advance. Identify those transactions or practices that present the most risk. As a preliminary step, determine the true statute of limitations. Many transactions or strategies affect tax years well beyond the initial transaction or adoption, running the risk that an issue that a corporation believed to be old and cold is fair game to a regulatory authority because at least some affected years are still open.

Keep critical documentation longer. Relatedly, review document-retention policies with an eye toward lingering tax years. For example, a six-year retention policy may make sense for the bulk of ordinary course business deductions, but meaningful transactions, changes in accounting methods or business policies that have ongoing tax effects should be evaluated on an item by item basis. If a company carries forward losses, this could mean that all issues from prior years giving rise to losses are open for inspection, and a general policy may need to be evaluated.

Document the whole picture. Document retention no longer relates just to accounting records, receipts and tax opinions. Often, administrative agencies seek email traffic on an issue or structure from multiple custodians, or will require all tax advice received in connection with a transaction (and not just rely on a formal, written tax opinion). Without these materials, an agency is more likely to challenge a deduction or deny abatement of penalties.

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Tell the right story. Responding to an administrative audit with minimal cooperation and stonewalling is no longer the best strategy (if ever it was). Engaging an advocate's voice at an early stage to tell the story of a transaction and lend weight to legal arguments may be the best way to be successful at an early stage and avoid drawn out, public litigation.

Develop a comprehensive strategy early. From the outset of any inquiry or the identification of a

potential hot issue, CFOs and tax directors should involve counsel (both internal and external) and public relations colleagues to craft a strategy that protects the company's legitimate tax planning. This becomes critically important when media attention precedes enforcement of a particular issue: discounting the media's version by putting forth a company's best facts could be the best strategy to avoiding an enforcement action. And even if an enforcement action follows, reducing the sting of media attention might also reduce perceived public pressure on an enforcement agency.

Change the tone of legitimate tax planning. Educating internal tax and finance professionals regarding the tone of discussions of future tax planning may be the best help to protect a company's credibility with enforcement agencies. Almost universally, casual email can be taken out of context. This means that flip references to transactions 'designed to avoid tax' or discussions about the 'presentation risk' of a tax return may be interpreted by an enforcement agency as a tax avoidance motive or tax return fraud, respectively. Educating employees to consider wording their correspondence carefully can lay the foundation for a strong defence against future inquiries.

Privilege is not sacrosanct. The legal privilege, particularly as it relates to tax advice, has eroded in recent years. Companies seeking to rely on the advice of counsel as a defence to penalties are now asked (or ordered) to release all privileged communications regarding the particular transaction or issue. This means that a company should take into consideration inconsistent or conflicting advice that exists in its records in assessing the potential application of penalties to a particular issue or transaction.

While no company can turn back time, changing course and strategy in response to the new environment can be critical to protecting a company's reputation and public goodwill. And just as regulators and the media become more aggressive, a company's best play may be to meet that aggression head on. R&C

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