Tax Risk Management - the legal team and the tax team and their interaction in transactions to avoid tax risk

The reason why the legal department and the tax department would sometimes have different interpretations when it comes to a particular transaction is driven not so much by differences in the interpretation of the law, but in differences in the interpretation of the facts.

What that means is the tax department would sometimes be approached with a transaction and would be asked to participate in the initial planning phase of the transaction in order to give direction and guidance as to what the tax implications are going to be and ultimately what the tax result will be on conclusion of the transaction and that is done at the planning phase.

What will typically happen is the legal department, the transaction team, and the tax department will participate in the original discussions surrounding what the transaction will ultimately look like. At that point an external tax opinion, as well as other opinions, may then be obtained from tax and other specialists that have advice on aspects of the transaction.

Once the parties are comfortable with what the transaction is going to look like, the next phase is to approach the commercial lawyers, either internally or externally, who will then commence drafting the lengthy documentation to record the transaction about to be entered into and concluded. At this particular point commercial draftsmen are skilled in a broader area of law than just tax and they may in the process of drafting decide that there are issues of bankruptcy law or other legal issues that need to be more carefully addressed as the drafting process commences. The draftsmen will then inevitably involve specialists in the area of bankruptcy or banking law or whatever the particular area of concern is. As a result they will then introduce sections to the agreements to cover the concerns, legal concerns, that they have. Now the documents are then completed in their draft form and normally the transactor and the legal department of the firm in question or the organization in question will review those documents and ultimately conclude that they reflect what the transaction is supposed to achieve and the documents are then prepared for final dispersal or final round-robin between the different parties and inevitably the final conclusion signing process takes place and the documents are signed off.

What often does not happen is prior to signing off the documents, in concluding the transaction, where there have been these additional additions introduced into the documents, the tax department is in many instances not asked to comment again or to review the documents at that particular point in time, and more importantly having done that the external tax specialist council has also not been asked to review the documentation and to determine whether or not the transaction as it has now been recorded actually still reflects the position advised upon in the first place. So that being the case often a tax problem enters the picture, because these amendments that were introduced to take care of other areas of law may, in fact, have a particular impact on the tax consequences that were given an opinion on when the transaction was being planned. Now that is where the problems arise between the legal departments and in the tax departments, because the tax department will then only become aware of this difference once the transaction has been concluded and it is virtually then to late to do anything about it except to go back and to rectify the agreements, which often does not take place because the mistake or the difference is only picked up some years down the line once the transaction has already run part of its course. Then it becomes very difficult to go back and change it. So this becomes a risk area that is often not picked up and not uncovered until it is virtually too late and the problem with this potential risk, tax risk, area is that the reason why the legal department and the tax department and the organization would have obtained a tax opinion on the structure of the transaction would play a very important roll down the line in explaining to the IRS if the transaction is challenged by the IRS that this particular transaction has been the subject of careful scrutiny by specialists, who have given the green light for this particular transaction. Now if there has been amendments to what the original proposal looked like to what the final concluded agreements looked like, then the ability to rely on that opinion becomes watered down significantly and the IRS is going to try and impose negligence penalties against the organization and not allow it to rely on the opinion that was drafted in the first place. The way in which you would resolve this particular conflict between the legal teams and the tax teams, both internally and where they are external participants, is to ensure that at the time that the documentation for a transaction has been completed, but before the signing of the documentation, that that documentation together with the original tax opinion is redistributed to the parties who participated in the initial advice being given and that they are asked to comment and express their views whether or not the final drafted documentation in any way deviates from the original opinion and advice given on the tax consequences. The necessity for the transaction teams, the legal teams and the tax teams to communicate with each other on an ongoing basis during the different phases of a transaction such as a merger or acquisition will ensure that the information that needs to be commented on by each of those parties to ensure that the original tax plan that was proposed is at the end of the day executed, is the result of that communication. So the communication between those parties through ongoing committee meetings forces the parties to share the information with each other and ultimately to ensure that the uncovered tax risk, which often emanates from these transactions by lack of this communication is taken care of.

Quite separately from the risks associated with the planning and final implementation of transactions another dilemma often faces the transaction parties, the legal teams and the tax teams participating in these transactions and that is whether or not the transaction must follow the spirit of the law or the letter of the law as it has been legislated by Congress. This is a moral dilemma which really is something that can only be determined at board level and by the attitude of the board as to whether or not they are going to be an organization that will attempt to follow the spirit of the law or the letter of the law. Following the spirit of the law means that you would go beyond applying the normal rules of interpretation and that you would actually try and understand what mischief the legislation is attempting to cure as opposed to the manner in which it has been conveyed. Now it is often the case that with tax legislation the sections are so convoluted and so complex that it creates huge uncertainty between the various parties that participate in these transactions and therein often lies a defense to an organization that has taken a particular route of interpretation backed up by a very thorough opinion where the advisers have been given all the facts of the transactions. If all the facts of the transactions have been carefully considered and a plausible interpretation is given in an area of tax law that is uncertain it's going to be highly unlikely that the IRS will succeed in imposing any form of negligence penalties against the organization. And therein lies the solution that organizations may not be in any way morally obliged to follow a spirit of the law interpretation but a more technical nature of the law interpretation providing it is backed up by probably considered opinions that take into account the responsibilities and duties placed on the tax advisers by Circular 230 issued by the Department of Treasury. What this results in is that the corporation can then turn around to any critique and say that they have done what is reasonably prudent by any organization in making sure that they have obtained proper advice before embarking upon a transaction where the tax law position is uncertain. Insofar as the responsibilities of the legal departments and the tax departments go towards board members and more specifically the executive board members such as the CEO and CFO. Legislation such as Sarbanes-Oxley and more particular the SOX 404 places the CEO and the CFO in a position where once they have signed off the financial statements and those financial statements have not been properly checked in accordance with the standards put forward by Sarbanes-Oxley and had not been properly audited in order to determine whether there are any material weaknesses, those individuals can face very lengthy prison sentences and it is here that the legal departments and the tax departments play a very very important role in ensuring that each transaction and each potential uncertain and contentious tax issue has been properly researched, probably considered and finally properly implemented along the lines of what is suggested in this article. What is going to happen in the future depends, and one can seek guidance, from what Congress has discussed in the recent past. There is a growing concern that the tax gap in the United States of America is much too high for nothing to be done. At this particular point in time the IRS are reporting that 86% of the taxes that should be collected are in fact being collected and that there is a shortfall of 14%. The estimated value of that 14% is in the region of $350 billion, which is a significant sum of money, and if you consider that corporate America contributes approximately, on average, 16% of the total taxes collected, that means corporate America could be in for an additional $56 billion in missing revenues. If you take that number and you then also look at the data book report published by the IRS every year, the last one being in 2007, approximately $18.5 billion was in dispute between the IRS and corporate America on field audits that took place. So all things considered equal the amount that is missing in the coffers of the IRS and the Department of Treasury and in the Federal Government is a significant sum and that means that there are going to be increasing numbers of steps taken by the IRS to try to close that tax gap. The obvious negative sides are that there will be an increase in prosecutions, there will be an increase penalties and we are already seeing that penalties and prosecutions year on year are increasing by the rate of approximately 10% every year. But let's look at the positive side and on the positive side Congress is suggesting cooperation between the IRS, different organizations and, of course, including corporate America. Herein lies the opportunity for corporates, particularly where there is an increased amount of transparency taking place by way of SOX404 and FIN 48 that they attempt to resolve any tax issues with the IRS long before they become the question of an audit or they become a deficiency that is picked up after the tax return has been filed with the IRS. And this particular trend is also being followed by countries who are member states of the OECD of which the United States is the largest member. So there is an overall opportunity for increased cooperation to take place between corporate taxpayers and the IRS so that the IRS can focus its attention on those corporations that are known not to be compliance and that are very aggressive in the manner in which they execute tax planning. Insofar as a Sarbanes-Oxley 2 or a reworking of Sarbanes-Oxley goes it is quite possible that in light of extensive criticisms being brought to bear on Sarbanes-Oxley and that it is too onerous, that it may be very specific amendments introduced to make it more palatable. Certainly from the point of view that it causes corporations to be more transparent from a tax point of view, I don't foresee that there will be any downscaling of this and if anything, international trends and accounting standard trends are following suit by ensuring that tax liabilities, even though they may be unrealized, must be quantified and in some form expressed in the financial statements of public companies and also to a larger extent as time goes by in private companies that are subject to reports.