Maximum benefits, minimum risk

Developing a strategy for tax risk is difficult but achievable – and can deliver significant benefits. Debbie Anthony of Arthur Andersen looks at risk appraisal.

Tax-driven structuring or funding opportunities can deliver significant benefits, however, various judgements about risk are required. Risk appraisal does not just relate to the technical analysis of the transaction. There are other key questions that have a bearing on whether the balance of risk and reward is optimal.

Figure 1 shows a critical thought process for categorising risk. This process is a useful tool for categorising tax risk and aiding the decision-making process. In this article, we will identify some of the risks that should provide a platform from which to derive an optimal risk/reward position.

With a simple transaction, it is more likely that all risks will be identified and understood. This will be the case not only for the corporate undertaking the transaction, but also potentially for the tax authorities reviewing the transaction. On the other hand, where a transaction is more complex, even though it may involve more initial scrutiny from the tax authorities, the rarity of the transaction may reduce tax authority fears that it will be replicated elsewhere.

Risk appraisal factors

Change in law – a tax-driven transaction should be viewed in terms of its potential for long- term returns. A transaction that is subject to tax legislation which is in a state of flux will make it very difficult to be relied on. Additionally, certainly in the UK in the past few years, the Inland Revenue has reacted with increasing speed to introduce legislation where a perceived tax advantage is available, particularly where the transaction is fairly simple and can be replicated with relative ease.

A recent example was the introduction of legislation to combat the discounted convertible financing technique. In this case the introduction of a discounted convertible loan note in an intergroup situation to finance, for example, an acquisition, enabled the borrower to obtain an interest deduction on an accruals basis, whereas the lender would only be taxed on the accrued interest element at maturity of the note, or indeed any taxation on the lender could be further deferred if the loan note was converted into equity.

This example is an important one in the context of tax risk because not only did the final legislation, introduced by the 1999 Finance Act, provide that the lender would in future be taxed on an accruals basis, but also brought into charge to tax that element of interest which had previously accrued but been untaxed, albeit on redemption. This is one of the first cases in which retrospective legislation has been used to negate the accrued tax benefits of a financing technique. Whether or not this approach to financing transactions, where there is asymmetry of tax treatment between borrower and lender, is used in other cases remains to be seen.

Damage to reputation – in many instances, a corporate may undertake a detailed technical analysis of a tax-based transaction. However, despite having confidence in the transaction and its technical merits, often, in our experience, corporates have not been prepared to litigate when the transaction was challenged – irrespective of the confidence of success – for fear of the effect on the group's reputation. A significant amount of cost and management time can often be avoided by recognising this at the outset and building this into the risk analysis.

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In general terms the overall risk profile of the business should act as an important signpost in determining the extent to which an organisation is willing to accept some tax risk on its transactions. Some cherish a straightforward corporate reputation, while others may feel that aggressive tax planning could actually enhance their reputation. In practice, very often either the individuals calculating the tax risk are not aware of the corporate's risk appetite, or individuals with knowledge of the risk appetite do not understand tax risk.

Time and cost – the costs of creating and implementing any tax planning are a clear risk. Costs include management time and expense as well as the opportunity cost of not participating in other projects due to the level of capital allocated to the tax opportunity. Further, costs can escalate if litigation is required to secure a tax ruling. Most contentious tax issues are in fact resolved by negotiation, not litigation.

In considering costs, the corporate should also always ask the question whether it is possible to indemnify itself against any tax risks. A few years ago it was almost unheard of for a banking counterparty to accept any of the risk associated with the tax-based products which were being widely marketed. However, following the recent (but temporarily aborted) plans to introduce a general anti-avoidance rule (GAAR) and the reduction in the corporate appetite for such products, to win new business, banks are currently much more amenable to discussing the allocation of tax risk with a counterparty.

Tax authority scrutiny – often tax authorities dislike some types of structure more than others, for reasons that have little to do with tax merits. However, increased scrutiny may well extend beyond the transaction or planning opportunity.

The aggressiveness of the structure entered into may cause the revenue authorities to re-evaluate the group's tax affairs. This would be of concern to a group that has a 'gentlemanly' relationship with the tax authorities, although such instances are less common nowadays. Particular care needs to be taken, for example, if the group has previously received various concessionary treatments from any revenue authority that could be revoked.

Portfolio approach – historically, some corporates with significant appetites for risk have employed methods of diversification, a portfolio approach, as part of their process for managing tax risk. The theory is that it is unlikely that all tax-driven transactions would be attacked by the revenue authorities, and if a small number are successful, the benefits which accrue outweigh any costs. While historically this may have been an appropriate risk management tool, the stakes are getting higher as revenue authorities have become more focused and have devoted more resources to targeting corporate activity in this area.

Disclosure requirements – where there is a significant financial risk associated with derivatives and other financial instruments, this should now be disclosed in the group's financial accounts in the UK under financial reporting standard 13 (FRS 13). Significant financial risk includes tax risk where it is related to specific contractual arrangements. Consequently, the risk of gross-up clauses being invoked, where significant, would, for example, need to be disclosed. Also, the UK corporation tax self-assessment (CTSA) regime places an increased burden on corporates with regard to full disclosure and support for the position adopted in their tax return.

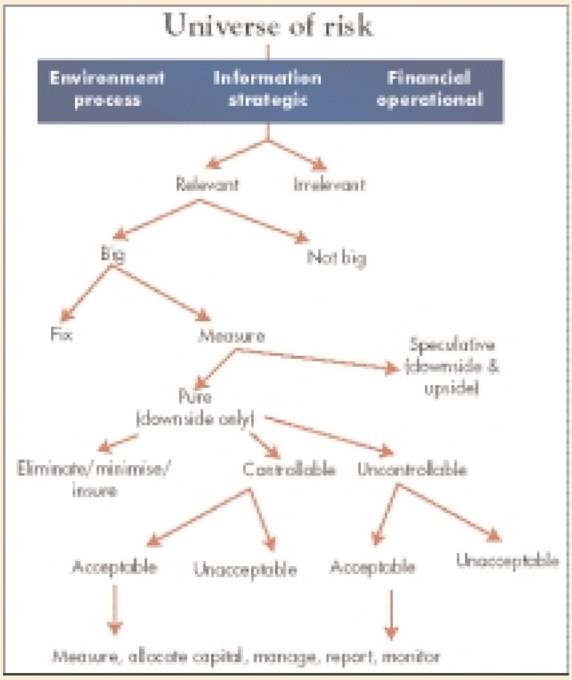
Prolonged uncertainty – the main objective of any tax planning should be in most cases to improve results, both in terms of cash flow and earnings per share. However, on many occasions the corporate has had to provide for tax in its accounts on a 'worst case' basis, effectively losing the benefit of the structure in reported EPS terms. This is of more concern when the potential benefits arise based on the tax treatment of the final cash flows when the structure is unwound. The time lag between implementation and the benefits accruing increases the uncertainty and the likelihood of legislative or other changes. Opportunities where the benefits accrue steadily over time or upfront are generally preferable in this context.

Likelihood of challenges – an arbitrage between two different tax jurisdictions is likely to be more robust than a strategy that exploits a loophole in one country. However, even here it should be noted that the Inland Revenue, in a recent letter to the British Bankers Association dated 28 July 1999, has suggested that it has concerns when financing structures exploit cross-border tax asymmetries. While the particular letter in question relates to the issue of innovative tier 1 capital by banks, the letter specifically states that the Inland Revenue offers no comfort as to the deductibility of the interest, nor will it comment on arrangements which are designed to exploit cross-border asymmetries. The letter continues: "This same policy would, of course, apply for any similar tax deductible structure that might be proposed by non banks".

Further examples are available across Europe where member states, as a result of the pressure placed on them by the drive to eliminate "harmful tax competition" throughout the EU, have taken measures designed to protect another member state's exchequer. An example of this is the Irish tax authority's refusal to grant IFSC licences to dual UK/Irish holding company structures.

These changes mean that any benefits from financing structures across the EU must be evaluated in the short term, and careful monitoring of European developments should take place. Developing a clear exit strategy is critical in this regard.

FIGURE 1



Policies and procedures

As the pace of tax change increases, policies and procedures to monitor risk become increasingly important. In particular, they should cover:

- a transfer pricing risk assessment programme for loans/intragroup services;
- trigger points for transactions where advance rulings are required;
- key factors in determining tax residence in the management of a group's investments;
- a tax risk checklist for use in assessment of bank tax-based products;
- the debt : equity ratios permitted in the key borrowing territories to satisfy 'thin capitalisation' rules;
- withholding tax rates applicable to payment of dividends, interest and royalties where appropriate for the group's overseas companies; and
- impact of tax residency and controlled foreign company (CFC) regulations on investment of surplus cash offshore and in low tax territories.

An achievable task

As with all business risks, if we seek to remove them fully, returns are also diminished. By properly understanding tax risks, the likelihood of the risk event occurring can be minimised, or its impact reduced by effective management. Developing a proper strategy for tax risk is not an easy task, but it is achievable and should enhance shareholder value. ■

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