Corporate Tax - USA

The tax planner's tightrope: morality and politics now in play

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Introduction

In 1934 distinguished US jurist Judge Learned Hand famously opined that "one may so arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes". In light of recent developments in tax planning, government enforcement and domestic and global politics, a serious question exists as to whether this remains the case.

This update discusses the mounting pressure on tax planners, who increasingly face the delicate and sensitive task of determining whether a contemplated tax reduction strategy is "going too far".

Avoidance versus evasion

The distinction between legal tax avoidance and illegal tax evasion is well-ploughed turf. In general, legal avoidance becomes illegal evasion if the structure involves some kind of deception, fraud, false statement or sham in fact. Some cases are obvious – a wilful misrepresentation or concealment of fact on a return or series of returns (eg, underreporting income on a tax return or misrepresenting a transaction as having occurred when it did not).

Others involve what US authorities call a 'Klein conspiracy' (named after a landmark 1950s criminal case), where the government alleges a concerted effort to impair, impede and obstruct Internal Revenue Service (IRS) tax enforcement, such as through mischaracterised transactions, false book entries or other documents or even false statements made during tax examinations.

To some, US authorities pushed the edge of the avoidance versus evasion issue in prosecuting tax practitioners beginning early in the last decade for structuring, marketing and opining on large tax shelter transactions that, with a few signatures, wiped away vast amounts of income.

While defence lawyers urged that the transactions were a series of legal steps that were properly documented, federal prosecutors argued that the architects of these shelters wilfully lied about their purpose. In one line of cases judges and juries were persuaded that what some practitioners might have characterised as investing in certain foreign currency options and hedges was in fact purely a well-papered ruse to generate massive and sham tax losses. The wilful mischaracterisation of a transaction's business purpose (although sometimes accompanied by other badges of fraud or ill-conceived emails) was deemed to be a criminal act of evasion, not an honest disagreement over a tax avoidance strategy. Practitioners went to jail and taxpayers paid heavy penalties.

Legal avoidance versus abusive avoidance

Of course, fact patterns can be complicated and distinguishable, and fitting a transaction into legal 'tax avoidance' is, like most tax work, best analysed on a case-by-case basis. However, if a deal fits this label, it is legal because every aspect of the transaction literally complies with the text of the law. At the corporate level, such tax planning can obviously increase earnings and enhance shareholder value.

But the analysis does not stop with the notion that each aspect of a transaction is 'legal'.

Various judicial and legislative anti-abuse doctrines can nonetheless undermine whether such a transaction works for tax purposes. Such concepts are generally well known in the United States, where courts apply the step transaction doctrine, economic substance, sham in substance and other markers to draw lines between the deals that work from those that do not. These analytical tools are largely objective, but the outcome of applying such tools nonetheless often turns on whether a transaction was solely for tax avoidance or whether it held a non-tax purpose, and courts are increasingly less tolerant of taxpayer arguments.

Until recently, tax planners looked almost entirely to these doctrines as providing sufficiently reliable and objective guideposts in drawing the line between acceptable and unacceptable tax. But decisions under such anti-abuse doctrines are beginning to venture into a normative and legal judgement that planners generally should not engage in tax reduction strategies solely for that purpose, even if the structure is legally sound, and a transaction increasingly has become abusive because the taxing authority decrees it. The language in court decisions is beginning to reflect added considerations having little to do with the finer points of statutes, regulations or cases.

Enter morals and politics

Even arguably legal tax avoidance transactions may now be viewed as too aggressive based on a perceived violation of some larger and more diffuse set of values. For example, in *Salem Financial, Inc v United States* (2013) a complex but legal loan and trust transaction – commonly known as the 'STARS' transaction – was struck down by the US Court of Federal Claims as "economically meaningless" under the economic substance doctrine. However, the court also voiced a strong moral basis for its decision against the taxpayer and all parties involved in the scheme by calling their conduct "nothing short of reprehensible". More recently, the media and the political establishment have applied yet another test – one based, contrary to Hand's pronouncement, on patriotism and a more absolute and moralistic view of corporate behaviour under the Tax Code.

One clear example arises from the debate over corporate inversions, which is a transaction in which a US-based multinational corporation replaces its US parent with a foreign parent through a restructuring merger, effectively becoming domiciled in the new foreign parent's jurisdiction of incorporation (usually with a lower corporate income tax rate than that of the United States). The transaction works unless the inverted corporation fails to meet certain ownership-related criteria laid out in the Internal Revenue Code, in which case the entity will still be treated as US for US tax purposes.

Whatever other reasons there may be for an inversion, the most important is obvious to any shareholder – the post-inversion foreign corporation would no longer be subject to the uniquely harsh 35% US corporate income tax rate and the inclusion of certain foreign-sourced earnings of the corporation into the corporation's pot of US taxable income.

The US Treasury acknowledges that genuine cross-border mergers, based on non-tax reasons such as increased access to foreign markets and reduction of manufacturing costs, may strengthen the US economy by enabling overseas investment of US companies and attracting foreign investment into the United States. However, it also takes the view that inversions driven solely by a desire to avoid US taxes are improper, implying that a tax-motivated inversion is not genuine, even if technically within the law.

Whatever the legalities, political figures – including congressional leaders and President Obama – have denounced inversions as unpatriotic. Companies contemplating perfectly sensible inversions are subject to political and moral pressure to refrain from tax-motivated expatriation after having operated as a US company for many years and derived large benefits from the US markets and infrastructure. in 2014 Walgreens, a major US drug store company, terminated its inversion plans to merge with Alliance Boots, a European retailer, because of the potential for customer backlash, loss of government contracts and a likely protracted legal dispute with the IRS.

Thus, US tax planners are increasingly forced to look far beyond the legal risks that a tax plan entails and consider political and reputational risks in reviewing a given transaction.

Such an analysis requires not just the ordinary tools of the tax trade (eg, detailed code and regulatory analysis and professional advice and outside opinions), but even the input of media consultants and corporate lobbyists.

To complicate the matter further, in the international arena the dividing line between sustainable and non-sustainable deals is even more ambiguous, due to the lack of a coherent international tax system where all constituents abide by a single agreed legal doctrine that is effectively enforced by a centralised authority. The existence of different sets of domestic law, with a complex network of tax treaties and other international agreements, provide a fertile environment to engage in tax avoidance transactions.

But such anarchy also leads to difficulty in generating a formal doctrine to police international tax planning transactions in general, as each country has its own anti-abuse rules that may or may not apply in a given case.

The lack of a unified legal regime for labelling certain transactions as inappropriate has caused further confusion and created inefficiencies in international business operations. Companies must face the risk that, even if their legal tax avoidance transactions may work in one country, another affected tax authority may challenge and reject them after implementation. To the extent that such a review will now embody any notion of morality, one can only imagine the legal and cross-cultural complexities.

One recent example of a tax avoidance structure that the international community has condemned as immoral is known as the 'double Irish Dutch sandwich' technique – a structure used by many large multinational corporations, including Google and Apple. The transaction involves funnelling profits through an Irish company, then to a Dutch company and finally to a second Irish company that is headquartered in a low-tax jurisdiction.

By in effect arbitraging the differing tax residency rules under Irish and Dutch domestic law, the EU free trade regime forbidding withholding tax on inter-EU transactions, and the income tax treaty between Ireland and the Netherlands allowing taxation of royalties only in the country of residence, a corporation can ultimately achieve a dramatic reduction in its tax liabilities. This complex structure can be meticulously planned so that it violates none of the numerous anti-abuse doctrines and is thus legal.

But enter the concept of morality. Critics argue that companies embarking on this approach are exploiting unintended gaps in the criss-crossing web of different laws and reducing their effective global tax rates to single-digit figures, despite the fact that they generate billions of profits around the world. This is viewed as unfair in that the corporate taxpayers are shirking their social responsibility to contribute to society in the form of tax dollars in exchange for their shareholders profiting from the social infrastructure, markets and economic activities in various jurisdictions. From a political perspective, this argument resonates strongly not just in the media, but with many ordinary businesses and taxpayers which do not have the means to engage in such complex global tax structuring and must pay a substantially higher rate of tax.

The launch of the recent Organisation for Economic Cooperation and Development base erosion and profit shifting (BEPS) project, which aims to curb tax practices that result in base erosion and profit shifting, could be seen as an attempt to construct a relatively unified legal front against such aggressive tax avoidance structures and certain illegitimate tax avoidance behaviours to prevent corporate profits from escaping tax. BEPS has gained momentum, in part because of a great increase in public awareness and scrutiny of tax avoidance transactions (eg, the protests against and boycotting of Starbucks by the UK public and the controversy resulting from leaked documents out of Luxembourg). Recently, the European Union announced that it may expand its push towards making tax rulings transparent among member governments on a quarterly basis to include disclosure of such developments retroactive for the past 10 years. Corporations must now worry about brands becoming tainted as immoral and unethical because of an attempted tax strategy even a decade ago.

Next steps

Taxpayers and their advisers who must navigate the murky international waters between tax avoidance and tax evasion are well advised to ensure, at a minimum, that the tax-planning process is procedurally and ethically sound by:

- seeking the professional advice of tax experts;
- making full disclosure of all pertinent facts relevant to the tax plan; and
- ensuring that the actual tax avoidance transaction as carried out conforms to the transaction as planned and documented.

But planners must now develop methods to buffer allegations of immorality or a lack of patriotism, perhaps by:

- engaging with tax authorities in advance;
- developing messaging strategies to defend the increase in shareholder value; and
- preparing for what appears to be an eventual push towards greater transparency, even to the public, of tax rulings and determinations.

For instance, it may become routine practice for tax planners to engage strategic public relations or political consultants to gauge and evaluate the non-legal (ie, reputational) repercussions that a seemingly aggressive tax avoidance structure may bring about, such as a drop in company share value, short-term and long-term loss of revenue and negative impact on the corporate brand. Lobbyists might be engaged to interface with politicians; media talking points may be required.

Indeed, for years advertisers and litigators have made presentations before mock sample audiences under confidentiality arrangements to gauge possible reactions. It is not too farfetched to imagine this practice coming to the tax-planning world soon.

The practice of tax has always been intellectually challenging and lawfully reducing one's tax liability as much as possible was, consistent with Hand's view, what many tax practitioners signed up to do for their clients and employers. However, the world has changed and planners must take note that there are larger, global and more serious undercurrents having little to do with the merits of a tax issue to challenge this long-held view.

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