Hope for the best, prepare for the audit

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Against the backdrop of Budget 2012 delivering a $78.4 million mandate to improve tax auditing and compliance functions, Inland Revenue is about to make significant changes to the risk review process. The changes will apply to reviews of the 2012 income year onwards, and will result in a more visible and co-ordinated approach by Inland Revenue to risk assessing a materially larger population of taxpayers.

This is consistent with tax authorities internationally moving to impose additional reporting and disclosure requirements. It means that, more than ever, taxpayers must be "audit ready" from the outset and, throughout a transaction's life cycle, regularly re-test facts or assumptions underpinning tax positions.

What are the changes, and who is affected?

For around 60 groups already treated by Inland Revenue as major taxpayers or "high risk", the current full risk review process will remain unaffected. However, compliance managers for these taxpayers may be changed, with managers going forward having a less extensive role in terms of taxpayers' interaction with Inland Revenue. Compliance managers will still run the risk review process, but will not necessarily be involved in investigations/disputes or in providing indicative views (except in an oversight role).

A further (approximately) 120 "large enterprises" taxpayers currently undertake a full risk review process and have an Inland Revenue compliance manager. This will no longer be the case. Instead, Inland Revenue will employ an analytics tool in relation to "basic compliance package" (BCP) data that will be provided by these taxpayers and then subjected to manual review. The BCP will consist of group structure information, financial statements and tax reconciliations, and will be submitted electronically at the start of a review process. The intention is to assist in identifying compliance risks more effectively and efficiently.

Most significantly, the new BCP requirement will be extended to an additional 380 taxpayers with turnover greater than $80 million. The intention is to drop this threshold to turnover greater than $30 million in the second year of the new regime. Inland Revenue's thinking is that the BCP information should already be prepared and readily available, and that risk reviews will be more straightforward and less time-consuming – having been fully informed through the early provision of key information and the application of modern analytics.

While it remains to be seen whether that will be the case, what is certain is that many taxpayers currently unaccustomed to providing risk assessment information will shortly be required to do so on an annual basis. It follows that many taxpayers presently "under the radar" – particularly in the mid-market space – can expect to have more regular and targeted contact with Inland Revenue. Letters were to be sent to affected taxpayers early this month to explain the new process, with further information to follow in February 2013 regarding the electronic provision of BCP information.

What does it mean to be "audit ready"?

In our **July Tax Alert,** we discussed Inland Revenue's wide-ranging information-gathering powers. In practice those powers are often used to probe far beyond transaction documents and board minutes, into gigabytes of email correspondence, for statements or facts from which Inland Revenue will seek to draw adverse inferences – or to seize upon the proverbial "smoking gun" supporting Inland Revenue's case theory. This is particularly so in an anti-avoidance context, where Inland Revenue is undoubtedly looking to notch up further wins and thereby extend the avoidance boundary.

Combined with the broader, more co-ordinated and (nearly) real time approach to risk assessment by Inland Revenue, this brings into sharp focus the need for taxpayers to plan and prepare for audit scrutiny from the outset.

Such preparation needs to involve documentation both supporting and peripheral to a transaction (whether the transaction is internal/intra-group or with a third party). Documents should accurately and properly reflect transactions, related background and drivers. This particularly includes explicitly identifying commercial drivers that may seem obvious to those close to the transaction, but which can be easily overlooked or understated.

Transaction design and implementation should also identify and robustly test, up-front, the key facts and assumptions (including commercial rationale) on which a transaction has been based. This discipline will ensure that contemporaneous documentation is complete, accurate and of evidential value should an Inland Revenue investigation or dispute eventuate.

In addition, having an "audit file" prepared at the outset should decrease compliance costs associated with Inland Revenue enquiry. It should also mitigate other risks such as personnel change – bearing in mind that the lag between implementing transactions and an investigation or dispute commencing can be several years (although the modified risk review process may reduce that delay to some extent). In this sense, it becomes a 'time capsule' of sorts.

Traps for the unwary

In an ideal world, taxpayers and their advisers would formulate and implement appropriate document and correspondence protocols. These would seek to mitigate, to the greatest extent possible, the risk of potentially damaging statements or statements from which potentially damaging inferences could be drawn.

However, in the real world, transaction workstreams usually move at a frenetic pace. This means that it simply is not possible in practice to insist on the behavioural changes that are required to ensure that the integrity of documentation/correspondence protocols is maintained.

That said, some basic rules of thumb can be applied to encourage best practice in this regard:

- Ensure that relevant communications to/from tax advisers (including the internal tax function) are clearly advice-related.

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- Do not mix tax advice-related and "commercial" or other business-related correspondence in emails. As noted above, keep the advice component separate.
- Be wary of using the "forward" or "reply-to-all" function. The former can risk waiving legal privilege or losing confidentiality for tax advice documents (ie potentially prejudicing non-disclosure rights). The latter can give rise to the same issues, and can result in "chains" of emails essentially comprising a dialogue that would more usefully be encapsulated in a brief conference call. A message to multiple recipients also makes it more difficult to have any degree of control over who has access to the content.
- Think twice before sending any message from a smartphone. These are usually the most hastily constructed and the least contextualised – ie the most susceptible to having adverse inferences drawn by Inland Revenue.
- Ensure that all aspects of documentation, including "subject" lines in emails, and document headers/footers, have been carefully considered (the latter having been the subject of judicial comment in the Alesco judgment).

As disputes are often won or lost on their facts – or, at the very least, the bargaining position in settlement negotiations can be seriously impacted upon by 'unhelpful' facts, statements or documents – these and other protocols should be given serious consideration as a valuable risk management tool.

Managing risk is not a set-and-forget exercise

A key part of audit readiness involves a meaningful testing of relevant facts, assumptions and legal analysis at commencement (as discussed above) and, equally as importantly, over the life cycle of a transaction.

Risk is not a static concept. The delay between transaction design/implementation, Inland Revenue audit and (where relevant) an eventual court hearing can involve many years. Changes over that period in the economic environment (eg the GFC), the justice system (eg abolition of the Privy Council and establishment of the Supreme Court), the judiciary (eg Sir Ivor Richardson retiring, and Justice Glazebrook recently having been promoted to the Supreme Court) and case law authority (eg the evolution of the "Parliamentary contemplation" concept) can have a material bearing on risk profile.

Undertaking regular 'health checks' in respect of a transaction and its factual or other underpinnings is therefore critical to ensuring that tax risk is appropriately managed. Inland Revenue's clear aim to become more current in its audit activity in itself increases risk profile.

In summary

Inland Revenue is making significant changes to the risk assessment process, which will have imminent effect. The net is being cast wider, and will catch many taxpayers in the mid-market bracket who to date have not been required to regularly provide risk assessment information.

- As a consequence, "audit readiness" assumes an even greater significance for a materially larger population of taxpayers. This concept includes carefully documenting transactions and their commercial rationale, robustly testing key facts/assumptions at inception and through a transaction's life cycle, and introducing appropriate protocol around documentation/correspondence (particularly emails and smartphones).

If you have any questions regarding changes to the risk review process, or if you would like to discuss your audit readiness, please contact your usual Deloitte adviser.