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Developing the Concept of Tax Governance

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Abstract

The paper examines the emerging concept of 'tax governance', suggesting ways in which this could helpfully be developed in order to assist directors in enhancing the value of their companies for the benefit of shareholders and other stakeholders.

After suggesting a definition of 'tax governance', it considers various principles that may underlie the decisions made by directors in this area. These are discussed under headings dealing with morality, legality, regulatory compliance, reputational issues and corporate social responsibility. The paper then considers the question 'To whom do directors have a duty?' and examines responsibilities towards shareholders, employees, customers, suppliers and the community at large. Finally it discusses how the identified principles might apply in practice to particular aspects of a company's tax affairs. These areas are grouped under four main headings dealing with: the company's relations with the state; its commercial operations; the relationship of the board to management; and relationships with third parties.

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1. Introduction

Historically, boards of directors have not always given tax the attention it deserves.[1] Instead, it has been seen as a technical matter for the tax department[2] or specialist advisers to deal with. A number of factors are now combining to change attitudes in this area: a heightened level of public debate on the ethics of tax avoidance and of companies' tax contributions in the developing world; the requirements of the Sarbanes-Oxley Act[3] as regards internal controls; the effect of globalisation in giving companies an element of choice as to where and at what rate their tax liabilities arise; and a growing realisation that, as a commercial matter, directors cannot ignore a factor which may account for a significant proportion of a company's profit. In summary, tax is now too important to be left to the tax specialist.

In addition, attitudes towards corporate governance have been changing, with increased pressure on directors to give attention to the claims of stakeholders other than shareholders. Corporate governance is generally accepted as including tax issues in the same way as other aspects of a company's operation, but as yet there has been little published work on the emerging concept of 'tax governance'. The present paper therefore seeks to examine current thinking in this area, suggesting ways in which this could helpfully be developed and areas that would benefit from further detailed consideration. The paper is intended as a contribution to an ongoing debate rather than as a detailed blueprint for change, and therefore examines various options while seeking to avoid being overly prescriptive. Underlying it is the belief that tax governance, rather than simply imposing a further compliance burden on directors, represents an opportunity for them to integrate tax into their strategic planning in order to build the value of the business for the benefit of shareholders and other stakeholders.

The paper begins with a working definition of 'tax governance', in section 2, then considers various principles that, it suggests, may underlie the decisions made by directors. These are discussed under headings dealing with morality and business ethics, legality, regulatory compliance, reputational issues and corporate social responsibility, in section 3. Section 4 deals with the question 'To whom do directors have a duty?' and considers responsibilities towards shareholders, employees, customers, suppliers and the community at large. Section 5 deals with tax governance in practice, discussing how the identified principles might apply to particular aspects of a company's tax affairs. These areas are grouped under four main headings dealing with: the company's relations with the state; its commercial operations; the relationship of the board to management; and relationships with third parties.

In general, the points made are illustrated by reference to the tax legislation and legal system of the UK, because that is the jurisdiction with which the writer is most familiar. However, the principles discussed are of general application, and the paper is intended for an international readership. For this reason, references to the UK tax regime are accompanied, where necessary, by sufficient explanation to enable the point at issue to be understood by those unfamiliar with that system.

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[1] See, for example, Henderson Global Investors, *Tax, Risk and Corporate Governance: Findings from a Survey of the FTSE 350*, February 2005, at http://www.henderson.com/global_includes/pdf/sri/tax_paper.pdf; and KPMG, *The Tax Function: Facing Up to the Changing World*, November 2006 at http://www.kpmg.co.uk/news/docs/The%20Tax%20Function%20-%20Facing%20up%20to%20the%20changing%20world%20PR.pdf.

[2] In this paper the term 'tax department' refers to whoever has responsibility within a company for the day-to-day administration of tax matters.

[3] US Public Law 107-204 of 30 July 2002, see http://www.sec.gov/about/laws.shtml#sox2002.

2. What is tax governance?

It may be helpful to begin by attempting a working definition of what is meant in this paper by 'tax governance'. This might be briefly expressed as 'corporate governance as it relates to tax'.[4] This is certainly an accurate description of the areas that are to be considered. It may however be subtly misleading if it is taken to refer only to the surprisingly small area of overlap where current literature on corporate governance issues strays into the area of tax.[5]

It is the contention of this paper that tax governance is indeed a constituent part of the wider concept of corporate governance but that, as indicated in section 1 above, it has not hitherto received the attention it deserves in that context. Accordingly, and in view also of its specialised technical basis, it is helpful at this stage of the debate to consider it as a separate issue.

An alternative way of expressing the definition, that recognises this background, might therefore be to say that tax governance is the answer, or the totality of the various answers, that the board of directors of a company gives to the questions 'What responsibilities and opportunities are we presented with in relation to the tax affairs of the company?' and 'How can we best respond to those responsibilities and opportunities for the benefit of the shareholders and of others to whom we have an obligation?'. The paper hopes to show that this answer should not merely be a series of independent responses to a variety of circumstances that present themselves, but should take the form of a coherent strategy that recognises the 'inter-connectedness' of the tax issues facing the company, and the fact that decisions in one area will affect the options available in other areas.[6]

3. Underlying principles

This paper suggests that the determination made by a board of directors of its detailed responsibilities, and its assessment of what will amount to the most effective discharge of them, will be founded upon certain basic principles as follows. These are suggested as general principles of corporate governance, by no means limited to the tax sphere, but this paper seeks to apply them to tax rather than suggesting extensions to general corporate governance design or implementation.

3.1 Morality and business ethics

One of the most fundamental of these principles, it may be argued, is that directors will wish to do what they believe to be right, and avoid doing what they believe to be wrong. This may seem so obvious, or naïve, a statement as to contribute little to the discussion. Nevertheless, individuals' moral perceptions are arguably one of the most significant determinants of their behaviour, and may influence them to do the right thing (i) for its own sake, (ii) for fear of the disapproval of others who share that moral perception, or (iii) in cases where the moral position results from religious beliefs, because of the expectation of divine approval or disapproval.

To leave the moral factor out of account may lead to distortions in the debate whereby, for example, directors are assumed to avoid aggressive tax avoidance for essentially commercial reasons, ie because the

[4] The term 'tax governance' is sometimes also used in a different sense to refer to the role of national governments and supranational organisations in devising and regulating tax systems. That subject is outside the scope of this paper.

[5] The *OECD Principles of Corporate Governance* issued in 2004 and available at http://www.oecd.org/dataoecd/32/18/31557724.pdf#search=%22oecd%20principles%20corporate%20governance%22, for example, contain only two passing references to tax in 69 pages.

[6] The European Audit Committee Leadership Network defines 'tax governance' in its newsletter 'Viewpoints' of 31 October 2005, at pages 3 and 8, as 'the oversight of tax planning, reporting and risk management'. See http://www.ey.com/global/download.nsf/South_Africa/European_ViewPoints_-_October_2005/.

adverse effects of such behaviour on the company's reputation would have a financial impact, whereas in fact they may avoid it simply because it is contrary to the moral position that they hold. Such distortions may result in legislation being seen as the only appropriate response to abuses of the tax system, with insufficient attention being given to the possibility of changing taxpayers' attitudes by means of moral debate.

Such a lack of explicit recognition of the moral factor in tax governance and in the wider corporate governance area may result partly from a general unease with moral debate in Western society, which may in turn derive from the widespread loss of confidence in the religious concepts that previously underpinned it. It may also be the case that, for many individuals, moral values are adopted and applied on an 'instinctive' basis that they would not necessarily find easy either to articulate or to justify intellectually. In general, commentators are perhaps more at ease with concepts of 'fairness' or 'equity' than with those of 'right' and 'wrong', but essentially these also involve moral judgments.

While it would arguably be wrong not to acknowledge the implicit role of morality, it is perhaps too easy for a moral debate to be 'hijacked' and made irrelevant in a business context, and indeed to provide an excuse not to discuss the importance of governance at the heart of running a business but rather to put it at the fringes as a theoretical issue. A difficulty remains therefore in making the moral debate a coherent tool to influence taxpayers that have corporate form (or indeed quasi-corporate form, such as partnerships). The individuals who make the decisions, and shape the actions, of corporates have responsibilities that impact others who expect corporate officers to take decisions on behalf of the collective. Arguably, therefore, it makes sense to seek a platform that is implicitly built on a basis of morality but is less vulnerable to extreme views. Such a business ethics framework may be more accessible to those who wish to discuss and influence the actions of corporates.

In seeking to employ such an ethical framework as one of the principles underlying tax governance, or indeed any other behaviour, the problem arises that while there may be broad agreement on fundamental ethical values there can be considerable diversity of opinion as to how those values should apply in particular cases. Members of the same board may, for example, agree that their companies must be scrupulously honest at all times, but may genuinely hold different views on whether a particular course of behaviour would, for example, amount to dishonesty or merely to putting the best possible construction on the facts. To some extent, however, such difficulties may be minimised if directors work to agreed codes of business ethics. [7]

3.2 Legality

A second principle which, it may be argued, underlies the action of the board as regards tax is that it will wish to behave in a way that is legal. There is an obvious overlap here with the principle of behaving ethically, as discussed in 3.1, as many of the actions that are prohibited by the criminal law in all jurisdictions, such as theft, fraud or perjury, are prohibited precisely because they are generally recognised as unethical. In addition, sometimes obeying the law of the land will itself be seen as an ethical or religious duty irrespective of whether the individual concerned approves of the law in question. In other cases obeying the law is a matter of pragmatism: it is done to avoid the consequences of illegality, whether these take the form of criminal sentences, reputational effects on the individual or the company, or regulatory impediments to continuing in business.

The concept of 'illegality' as it relates to tax covers a number of separate but overlapping areas as considered below. It is important to distinguish them because the term 'illegal' is sometimes used loosely in a way that can obscure the debate.

[7] For a discussion of how ethics committees may arbitrate on moral issues, see Rashkin, Michael D, *Absolute Responsibility and Corporate Tax Governance* in 'Tax Executive' March/April 2004 at http://www.allbusiness.com/periodicals/article/151533-1.html.

First, the board of a company could find themselves in breach of the general criminal law of any of the jurisdictions in which they operate if they became involved with, for example, theft, fraud or forgery in relation to tax. Many jurisdictions also include in their legal codes criminal offences specifically related to tax evasion or to more narrowly defined tax-related offences. The criminal law may also be used to penalise certain regulatory failures that might not generally be thought of as crimes, particularly in jurisdictions where the concept of using the civil law to regulate relationships between the citizen and the government is less well developed.

For directors, criminal penalties may represent a much more significant deterrent than civil penalties of the same monetary amount, because of the potential effect of criminal convictions on their reputation and employment, and also because of 'knock on' effects such as difficulties in obtaining visas or certain insurance cover. Criminal convictions will also be a matter of public record in most jurisdictions, whereas civil penalties in general will not be.

Under many national tax systems the major means by which compliance is enforced is by the imposition of civil penalties, normally on the company itself rather than on its directors. Where the level of the penalty is related to the tax due, this may place a significant burden on the company. Other penalties may be relatively small in monetary terms but may represent a significant worsening of relationships with the tax authorities which will have a cost in administrative inconvenience, and may convert to a financial cost.

In most jurisdictions failure to pay tax due will incur a cost in terms of interest, usually at above-market rates. Ultimately, if tax liabilities remain unpaid, payment will usually be enforced by seizure of assets or by court action, depending on the particular jurisdiction concerned. In the UK proceedings for recovery of tax and other debts are a civil rather than a criminal matter, but are nevertheless likely to have a reputational impact on the company.

Most jurisdictions provide for technical disputes as to tax liability to be finally settled by the courts, often by appeal from the decision of a specialist tax tribunal. At their simplest, such disputes may arise over whether a particular receipt is taxable, or whether an expense is deductible in the calculation of taxable profit. Cases often proceed to the highest court in the jurisdiction concerned because, even where the amounts in dispute are not large, they may involve principles that are of wide application. Increasingly, tax cases in the Member States of the European Union may also involve the referring of a question by one of the tribunals or courts involved for a decision by the European Court of Justice. A tax case can therefore be extremely expensive to conduct, in terms of both legal fees and management time, and may also give rise to a prolonged state of uncertainty as to the company's eventual tax liability, extending over many balance-sheet dates. These disputes are purely civil matters, and in some circumstances they provide the only way of resolving outstanding issues. In principle, therefore, no criticism attaches to a company that finds itself involved in such a case, or to its directors. Depending on the circumstances, and on the point of view of the observer, directors may be seen either as having allowed themselves to become ensnared in an unprofitable dispute that should have been resolved by negotiation, or as standing up bravely for the interests of the shareholders against the unreasonable demands of the state. Litigation is an incident of modern commercial life, and in general shareholders and other interested parties will perhaps rarely think of a dispute over a tax liability as reflecting on the competence of the directors unless either the amounts involved are so great as to have a significant effect on the financial results of the company, or it becomes clear that the dispute has arisen because the directors took inadequate advice prior to the event.[8]

[8] However, Miquël Timmers enters a note of caution. 'Recent media coverage of a number of large income tax adjustments … has potential to influence public perception. An obvious extrapolation would be that a large tax adjustment, even where disputed, implies a lack of sound governance by the board. Although this would rarely be accurate, there can be a degree of unease on behalf of directors where quality of governance oversight is linked to compliance adjustments'. Timmers, Miquël, *A Principle of Good Corporate Tax Governance*, in 'Keeping Good Companies' February 2006, see http://www.allbusiness.com/periodicals/article/874677-1.html. (Mr Timmers was here reporting the points made in a discussion forum rather than necessarily giving his own views.)

The conduct of the company may, however, come under particular scrutiny where the case concerns tax avoidance arrangements. This paper will return to the subject of tax avoidance – both how it is to be defined and the attitude that the directors should take to it: see 5.2.3. For the moment, it is important to make a distinction that is often missed in popular comment on this matter. Despite newspaper reports to the effect that the courts have found tax schemes 'illegal', tax avoidance is by definition[9] not illegal.[10] Some commentators consider that it should be, but arguably such a move would only shift the boundary between avoidance and evasion, rather than eliminating the former. Depending on the commentator's point of view, avoidance may sometimes or always be irreligious, unethical, irresponsible or unwise - or it may not be. Those issues will be discussed further below. It is certainly contentious; that is perhaps the only thing about it that is beyond dispute.

When a court gives judgment in a tax avoidance case in the UK or in any jurisdiction with a similar approach it is simply saying, as it does in any other tax case, how it considers that the taxation law applies to the particular set of facts under consideration. Indeed, it will not necessarily identify the case as a 'tax avoidance case'; that is simply a convenient term used by commentators.[11] If the court rules against the taxpayer, therefore, it is not declaring the arrangements in question to be illegal, but *ineffective*. Neither is it declaring them to be ineffective for all purposes, but simply to be ineffective for tax purposes; they continue to regulate the legal relations between the parties. That is not to deny that a board of directors will need to consider carefully its approach to the possible implementation of tax avoidance arrangements; it will be argued below that this is an important aspect of tax governance. The principles underlying such a decision will, however, be those concerned with business ethics, reputation and commerciality rather than with legality.

A parallel may be drawn with the position where the tax authorities lose a case. In this situation the court is effectively saying that the authorities have interpreted the legislation erroneously or unreasonably, or that they have based their contentions of fact on inadequate evidence. In cases heard by the European Court of Justice the decision may also be saying that the Member State concerned has enacted legislation that is not compliant with its obligations under EU law. There may be occasional extreme comment referring to governments in such cases as having been 'found guilty' of 'attempted tax theft' and as having behaved immorally in contesting the issue. However, most commentators accept that in a state governed by the rule of law the courts are the proper forum in which to settle genuine differences of opinion; accordingly, no criticism can be levelled against the authorities for taking the case to court, merely on the ground that their view has not been upheld. If there is to be criticism it must be based on an analysis of the particular facts of the case. By the same token it may be suggested that it is unreasonable to criticise companies merely on the ground that they have taken a dispute through the proper channels and have, in the event, been unsuccessful.

The law governing tax liability can also have an effect on commercial relationships with customers and suppliers, where contractual arrangements are made by reference to the tax effects of the transactions; for

[9] That is to say, by reference to the definition to which we shall return at 5.2.3.

[10] But, as Lord Simon LC said in *Latilla* v *IRC*, HL (1943) 25 TC 107, 'There is, of course, no doubt that they [the taxpayers] are within their legal rights, but that is no reason why their efforts … should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship.'

[11] One might tentatively define a UK 'tax avoidance case' (without solving the problem of how to define 'tax avoidance' itself) as any case that considers legislation which includes a reference to (i) a tax avoidance motive, purpose or scheme, (ii) a 'tax advantage', or (iii) a 'bona fide commercial' test, or any case that considers the *Ramsay* principle. The *Ramsay* principle (ie, the principle established in *WT Ramsay Ltd* v *IRC*, HL (1981) 54 TC 101 and developed in a number of subsequent cases) means, very broadly, that the courts may now apply a purposive construction of a statutory provision in order to determine the nature of the transaction to which it was intended to apply, and then decide the question of whether the actual transaction in dispute falls within that description by considering the overall effect of a number of elements intended to operate together. The definition would happily transplant to some (but not all) overseas jurisdictions.

example, providing that one party must behave in such a way that tax allowances are available to the other. Where cases are taken before the courts to deal with disputes of this nature,[12] greater criticism may be directed at the losing party than in the case of a dispute with the tax authorities, on the ground that either its behaviour or its pursuit of the case represents a commercial misjudgment.

3.3 Compliance with regulatory demands

A third principle that may underlie directors' behaviour, closely allied to that of legality, is a wish to conduct their business and to report on its results in accordance with generally accepted regulatory standards, even where these are not legally binding or where failure carries no legal penalty.

So, for example, directors will need to comply with the requirements of companies legislation. In most jurisdictions this requires accounts to present a 'true and fair' view of the company's results for the year and financial position at the balance sheet date, and extends to tax figures in the same way as to other matters. In the UK, as in many other jurisdictions, there are in fact criminal penalties for failures in this respect,[13] but the point is considered here rather than in 3.2 because it is closely allied with the regulatory matters discussed below.

There may also be codes of conduct on corporate governance such as, in the UK, the Financial Reporting Council's *Combined Code*,[14] or stock exchange listing rules such as the *United Kingdom Listing Authority Listing Rules* published by the Financial Services Authority.[15]

It will also be relevant for directors to consider the effect of accounting standards on tax reporting; for example, in the UK, FRS 16, *Current Tax*[16] and FRS 19, *Deferred Tax*;[17] in the US, Financial Accounting Standards Board statement 109, *Accounting for Income Taxes*;[18] and, at an international level, International Accounting Standard 12, *Income Taxes*.[19] If a failure to comply with an accounting standard is so significant that, as a result, the accounts fail to give a true and fair view, this will normally constitute the breach of a legal requirement, and may well be subject to penalties, depending on the jurisdiction concerned.

For fiscal years beginning after 15 December 2006, companies filing US GAAP accounts will also be obliged to comply with FASB Interpretation No 48 *Accounting for Uncertainty in Income Tax – An Interpretation of FASB Statement No 109*, which 'prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return [and] also provides guidance on de-recognition, classification, interest and penalties,

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[12] Examples from the UK are *Indofood International Finance Ltd* v *JP Morgan Chase Bank NA*, CA [2006] STC 1295 on the interpretation of the double tax treaty between Indonesia and the Netherlands, and *Crusabridge Investments Ltd* v *Casings International Ltd*, ChD (1979) 54 TC 246 on the availability of industrial buildings allowances.
[13] Section 414 Companies Act 2006.
[14] Financial Reporting Council, *The Combined Code on Corporate Governance*, June 2006, see http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf.
[15] Financial Services Authority, *United Kingdom Listing Authority Listing Rules*, apparently undated, see http://fsahandbook.info/FSA/html/handbook/LR.
[16] Accounting Standards Board, *Financial Reporting Standard 16: Current Tax*, December 1999, see http://www.frc.org.uk/asb/technical/standards/pub0160.html.
[17] Accounting Standards Board, *Financial Reporting Standard 19: Deferred Tax*, December 2000, see http://www.frc.org.uk/asb/technical/standards/pub0210.html.
[18] Financial Accounting Standards Board, *Statement of Financial Accounting Standards 109: Accounting for Income Taxes*, February 1992, see http://www.fasb.org/st/#fas125.
[19] International Accounting Standards Board, *International Accounting Standard 12: Income Taxes*, revised October 2000. The text is not available on the internet, but useful summary material is available via the ICAEW's website at http://www.icaew.co.uk/library/index.cfm?AUB=TB2I_77005,MNXI_77005.

accounting in interim returns, disclosure and transition'.[20] It is quite possible that other jurisdictions will adopt similar approaches in the future.

Directors may also wish to comply with international guidelines, which are of necessity not mandatory, such as the OECD's *Principles of Corporate Governance*[21] and *Guidelines for Multinational Enterprises*,[22] the Global Reporting Initiative's *Sustainability Reporting Guidelines*[23], which are discussed in more detail in 5.5.1, *The Ten Principles* of the United Nations Global Compact,[24] the *Guidance on Corporate Responsibility Indicators in Annual Reports* issued by the United Nations Conference on Trade and Development (UNCTAD),[25] on which again see further at 5.5.1, or with standards applying in their particular jurisdictions of operation.

The OECD's material is perhaps the most influential of these. The *Principles of Corporate Governance* contain only two passing references to tax, but the *Guidelines for Multinational Enterprises* indicate that companies should refrain from seeking or accepting tax exemptions not contemplated in the statutory or regulatory framework of the host country,[26] and in addressing the issue of bribery they indicate that companies should adopt tax accounting practices that 'prevent the establishment of "off the books" or secret accounts or the creation of documents which do not properly and fairly record the transactions to which they relate'.[27] More generally, they comment as follows:

> 'It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with the tax laws and regulations in all countries in which they operate and should exert every effort to act in accordance with both the letter and spirit of those laws and regulations. This would include such measures as providing to the relevant authorities the information necessary for the correct determination of taxes to be assessed in connection with their operations and conforming transfer pricing practices to the arm's length principle.'[28]

Companies may also be affected by legislation emanating from jurisdictions other than that in which they have their seat of operations. Section 404 of the US Sarbanes-Oxley Act of 2002 requires senior management annually to assess and report on the effectiveness of the company's internal controls over financial reporting. This extends to the systems producing tax figures, and assessing tax risk, as to other matters. It also requires a company's external auditor to report specifically on management's evaluation of these issues. The legislation applies, broadly, to any group that has shares or loans traded on US exchanges,

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[20] Financial Accounting Standards Board of the Financial Accounting Foundation, *FASB Interpretation No 48: Accounting for Uncertainty in Income Tax – An Interpretation of FASB Statement No 109*, dated June 2006 but released on 15 July 2006, see third preliminary (unnumbered) page at http://www.fasb.org/pdf/fin%2048.pdf.

[21] Organisation for Economic Co-operation and Development, *OECD Principles of Corporate Governance,* 2004 http://www.oecd.org/dataoecd/32/18/31557724.pdf#search=%22oecd%20principles%20corporate%20governance%22.

[22] Organisation for Economic Co-operation and Development, *The OECD Guidelines for Multinational Enterprises*, Revision 2000, see http://www.oecd.org/dataoecd/56/36/1922428.pdf.

[23] Global Reporting Initiative, *Sustainability Reporting Guidelines*, October 2006, see http://www.globalreporting.org/NR/rdonlyres/A1FB5501-B0DE-4B69-A900-27DD8A4C2839/0/G3_GuidelinesENG.pdf.

[24] United Nations Global Compact, *The Ten Principles*, see http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/index.html. (These make no specific mention of tax, and are only indirectly relevant to the tax sphere.)

[25] United Nations Conference on Trade and Development, *Guidance on Corporate Responsibility Indicators in Annual Reports*, 24 July 2006, see http://www.unctad.org/en/docs/c2isard34_en.pdf.

[26] 'General Policies' on page 19, para 5 and commentary at page 42, para 6.

[27] 'Combating Bribery' on page 25, para 4.

[28] 'Taxation' on page 27, and commentary on pages 54 and 55.

and thus has implications for companies based in many jurisdictions outside the US. In addition many other jurisdictions have introduced, or are considering introducing, similar legislation. It is reported that, 'Tax has been one of the top causes of material weaknesses and restatements under the Sarbanes-Oxley Act's section 404'.[29]

3.4 Preserving the reputation of the company and the directors

A fourth principle that may underlie directors' behaviour is the wish to act in a way that preserves and enhances the reputation of the company. In the UK this is specifically provided for in s172(1)(e) Companies Act 2006, which indicates that in making decisions directors should bear in mind 'the desirability of the company maintaining a reputation for high standards of business conduct'. For further discussion of s172 see section 4 below.

A recent survey indicated that three fifths of chief executive officers believe that 40 per cent or more of their company's market capitalisation is represented by 'brand/reputation'.[30] Similarly, a survey of the chairmen of large UK-based corporates conducted by HMRC indicated that, 'UK tax rates and policies are the most important issues facing boards, but reputational and other risks rank a close second.'[31]

There is an overlap here with the preceding principles of business ethics, legality and regulatory compliance considered in 3.1 to 3.3. As already discussed, one of the incentives for behaving in a way that is ethical and legal is that to do otherwise may well have deleterious effects on the company's reputation. In addition, however, there may be occasions when a course of action that the directors know to be legal, and consider to be ethical, will nevertheless be considered unwise because of reputational issues. A company might, for example, fear that press coverage would be unfavourable and that there would be no opportunity for it to put forward to the public the very credible defence that it believed it had. Similarly, its defence might involve technical complexities that it was not confident would be widely understood. The directors might consider that the important question in these circumstances was not whether the expected criticism would be fair, but whether it would be made at all.

Reputational impact is a significant issue in determining, in particular, a company's attitude to tax avoidance. Some directors may make this decision on purely ethical grounds, so that no separate consideration need then be given to the reputational effect. Others may not see this as an ethical issue - not because they do not share the high ethical standards of those who do, but because of an honestly held view on how those standards apply to this subject: see further at 5.2.3 below. In such a case the reputational effects may have a more significant place in their thinking.

For example, in the UK the 'retailers scheme' declared ineffective by the Court of Appeal in *HMRC* v *Debenhams Retail plc*[32] involved a contention by the taxpayer company that it was only liable to account for VAT on 97.5 per cent of the amount paid by customers, the remaining 2.5 per cent being a payment for VAT-exempt card handling services, as indicated on the till receipt. Companies using this scheme might have mounted a defence in ethical terms, as opposed to a legal argument, against accusations of artificiality on the basis that the arrangements were merely an attempt to bring the tax consequences of the transactions into line with the economic consequences, under which the customer paid the stated price and received in return a package of benefits which included the services of the credit card company as well as the goods

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[29] European Audit Committee Leadership Network, *Tax Governance* in 'Viewpoints', 31 October 2005, page 9, see http://www.ey.com/global/download.nsf/South_Africa/European_ViewPoints_-_October_2005/. This refers to further sources.
[30] 'Voice of Leaders Survey', World Economic Forum, January 2004, quoted in Sanghar, Balviner, *Tax Risk and Strong Corporate Governance*, in 'Tax Executive' of 3 January 2004, see http://www.highbeam.com/library/docFree.asp?DOCID=1G1:117526440.
[31] HM Revenue & Customs, *Tax on the Boardroom Agenda: The Views of Business*, February 2006, see http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_025452, page 4.
[32] CA [2005] STC 1155.

purchased. This paper offers no comment on whether that is a correct conclusion, as distinct from an arguable case However, particular companies might have decided to forego this opportunity in the belief that this defence, though in their opinion sound, would not be widely understood.

Directors may also be concerned to enhance, rather than merely protect, the reputation of the company. A company that declines an aggressive tax avoidance scheme that is offered to it may thereby avoid damaging its reputation with those who disapprove of such schemes, but it is unlikely to enhance it – partly because the facts may not be widely known, and partly because that will be no more than is expected of it by that constituency. A public announcement of the facts would overcome the first problem, but not the second; it might perhaps also be suspected that the company had declined on commercial rather than ethical grounds, and that it would have been willing in other circumstances to adopt a more reliable scheme. However, a formal policy that the company would not employ such schemes, adopted and publicly announced in advance of the availability of particular schemes, might well be seen as a positively reputation-enhancing move.

To adopt a policy on this or any other matter and either formally to abandon it or simply to fail to abide by it would in general have a more harmful effect on a company's reputation than if it had not adopted the policy in the first place. A company may therefore be well advised to consider a number of factors carefully before adopting a policy: *viz*, the extent to which it will impose constraints on its actions, and what the costs of those constraints will be; whether it is indeed committed to that policy in principle, rather than adopting it as a 'knee-jerk' reaction to criticism; whether the policy has been defined in sufficiently precise terms; and how easy it will be to measure compliance with it. A policy of not engaging in tax avoidance, for example, may be of little help to a company's reputation if it then has to become involved in protracted debates as to whether or not particular courses of action that it has undertaken do in fact constitute tax avoidance. Similarly, a policy of full geographical analysis of tax payments, as to which see further at 5.5.1, may be of little help if it is overshadowed by a debate as to whether particular mineral royalties paid to a Third World government should properly be classified as a tax or as a production cost.

A company's reputation is not a homogenous characteristic that varies in only two directions: 'better' and 'worse'. A company can have a reputation for having certain particular qualities, and for lacking others. It may, for example, have a reputation for probity, for aggression, for quality, for speed of reaction, or for their opposites. In some cases these attributes are incompatible; a company may choose whether it wishes to be seen as conservative or radical, neither of which is a self-evident virtue, but it cannot be both.

Similarly, reputation is a subjective matter; a company may have a good reputation, or a reputation for particular characteristics, in the eyes of shareholders but not of customers, or in the eyes of the public at large but not of the tax authorities. However, it is not in the interests of shareholders for the company to have a bad reputation with other parties if this may impinge on financial results or share price, and thus all reputational issues are of relevance to shareholders to a greater or a lesser extent. In the case of the company's reputation with the tax authorities, an unfavourable movement may have costs in terms of an increased administrative burden but this will normally be much less significant than, for example, a loss of reputation with customers. Some shareholders may consider that it is more than compensated for by the tax savings resulting from taking a more aggressive approach in the tax area.

The discussion above relates to the reputation of the company rather than of the directors themselves. Nevertheless, it might be argued that it is impossible for directors to exclude from consideration the effect of their actions on their personal reputations both for probity and for competence. Indeed, it might equally be maintained that there is no reason why they should attempt to exclude those factors.

In general, reputational issues work in parallel to questions of business ethics and legality, because in taking actions that observers disapprove of on ethical grounds the company will normally also damage its reputation. There can, however, be cases where there is a tension. If the company has acted in such a way as to attract disapproval on ethical grounds, its reputation may be preserved provided the facts do not become generally known. If, for example, it has misrepresented its circumstances to the tax authorities in such a way as to reduce its tax liability but subsequently makes a full disclosure and incurs a civil penalty as a result, should it make the facts public? Arguably it is under no obligation to do so on grounds of business ethics: it has acted inappropriately and incurred the corresponding penalty; there is no reason that it should bring further punishment upon itself by making an unnecessary disclosure. If this is correct, which is a matter on which opinions will no doubt differ, then there is no self-evident general principle of 'openness' in corporate behaviour as regards tax. Tax is a private matter between the taxpayer and the state,[33] and a company is under no obligation to disclose private matters except as required by law. Openness must, however, be distinguished from honesty, which is part of the ethical requirements discussed in 3.1 above. The two issues overlap if there is any risk that the company may be questioned about the relevant matter, in which case to deny it would be dishonest and to decline to comment would virtually be to admit to it. In such cases openness may be seen as the preferable course on pragmatic grounds, because the admission of a wrongdoing under questioning may well have more serious effects than the disclosure of the same wrongdoing at the time, and in the manner, of the company's choosing.

Some commentators may, contrary to the above, see openness as a principle that should be applied on ethical rather than pragmatic grounds in the tax arena, but in order to make that case it would be necessary to establish why tax should be distinguished in this respect from any other commercial matter. That is not to deny that openness is in many ways desirable; simply to suggest that it falls short of being a self-evident obligation.

3.5 Commerciality

A fifth principle that directors may wish to observe is that of commerciality. Arguably, businesses exist to make money. 'The business of business is business.'[34] If they fail to make money they will eventually cease to exist, to the disadvantage of employees, customers and suppliers as well as shareholders, and indeed to the economy as a whole. That is by no means to suggest that commercial considerations should take precedence over questions of business ethics and legality. However, it might be argued that making money is the *purpose* for which the directors are engaged in the particular commercial activities with which the company is concerned, while business ethics and legality prescribe the *manner* in which they are to do it. If this is so, the question facing the directors is not for example, 'Shall we be ethical or commercial?' but 'How can we be commercial in an ethical way?'

On this analysis, the vast majority of decisions taken by the directors in the course of running the company will be taken primarily from a commercial standpoint, but informed by the other principles discussed above; in general these will not be choices between right and wrong or legal and illegal, but choices as to which otherwise neutral course of action will, on balance, be most to the commercial advantage of the company. The question of whether the commercial interests of the company are to be identified solely with those of shareholders, and of whether the directors have responsibilities to interest groups other than shareholders, are discussed in section 4 below.

Applying the principle of commerciality will involve consideration of the commercial effect of the other principles; for example the financial impact of actions that adversely affect the company's reputation. In the UK s172 Companies Act 2006, discussed more fully in section 4 below, requires a director to act in the way he considers would be most likely to promote the success of the company and, in so doing, to have regard to the likely consequences of any decision in the long term. This clearly justifies directors in forgoing an immediate financial benefit, for example a reduced tax liability, if they consider that securing that benefit would have disadvantageous, but less easily quantifiable, effects on the company's performance in the future. Similar principles will normally apply in other jurisdictions, with some local variation, despite differences in the applicable legislation.

[33] As borne out by the significant penalties in the UK (including imprisonment) for employees of the state who disclose details of taxpayers' affairs without good cause, see s19 Commissioners for Revenue and Customs Act 2005.
[34] A maxim variously ascribed to Milton Friedman and to Alfred Pritchard Sloan, Jr (1875 to 1966), President of General Motors.

The importance of commerciality as a decision-making principle is matched by its visibility. If the company is paying high or low amounts of tax, that will be obvious to shareholders and to all other users of the accounts. In very broad terms, a high charge relative to profits may be seen as representing a commercial failure, and a low charge a commercial success. Questions as to whether that result has been obtained by ethical or legal means, and without damage to the company's reputation, may be harder to answer, and even when the information is available it will not necessarily appear on the face of the accounts.

There may be questions in any particular case over how the figures for the tax charge are to be interpreted, but these do not affect the general point that commerciality is normally the easiest of the relevant principles to measure, because its results are expressed in the company's accounts in quantitative rather than qualitative terms and the law provides for this to be done annually or, depending on the relevant jurisdiction and the status of the company, at more frequent intervals. It is true that a course of action can give a temporary reduction in tax, to be paid for by a later increase, or *vice versa* but in general normal accounting principles will see these variations 'smoothed' through the deferred tax account. Ways of giving a fuller picture of the company's total tax position through a 'statement of total tax paid', covering for example PAYE and VAT in addition to corporation tax, are discussed at 5.5.1 below.

The importance of commerciality as a guiding principle, and the relative ease of measuring its results compared to those of the other principles discussed above, mean that there is a risk of its being allowed to override other factors completely. In such cases the making of money may come to take precedence over business ethics and legality, as in recent corporate scandals. Personal greed may also play its part where the income of directors is directly or indirectly dependent on the results of the company, as to some extent it must always be - at least in the sense that if the company ceases business there will be no income at all.

Nevertheless, corporate collapse as a result of serious breaches of the law will represent a complete commercial failure as well as an ethical and legal one. Similarly, ethical and legal failures that become known will almost inevitably have an effect on a company's commercial success, even where that falls short of the catastrophic. There is, therefore, a sense in which the principles of business ethics and legality are reinforced rather than prejudiced by commercial considerations.

Arguably, in the tax arena the desirable commercial outcome is to pay as little tax as legally possible. However, other factors can militate against concentration on this objective. An aggressive approach to artificial tax avoidance may be rejected by some directors on ethical grounds; others may reject it on grounds of general reputation, or on the basis of the effect it will have on dealings with the tax authorities: see further at 5.2.3 below. If the objection is essentially pragmatic rather than one of principle, it will then be necessary to identify a cut-off point at which the administrative and reputational cost of an aggressive approach, which may be spread over many years, outweighs the immediate advantage in terms of reduced tax liability.

3.6 Corporate social responsibility

Some commentators would see responsibility to the society within which a company operates as a further principle that should guide its behaviour on tax as on other issues. The approach taken in this paper by contrast is to consider corporate social responsibility, at 4.4 below, not as a separate principle of behaviour but as part of the question, 'In whose interests should directors apply the principles that have been identified as governing their behaviour?' It is to that question that we now turn.

4 To whom do the directors have a duty?

4.1 The model of s172 of the UK Companies Act 2006

In most jurisdictions it is accepted that the directors' primary duty is to manage the affairs of the company for the benefit of the shareholders. However, there may also be other 'stakeholders' affected by the actions of the company whose interests the directors will need to take into consideration.

Depending on the jurisdiction concerned, these duties may arise under statutory provisions or under custom or case law. In the UK the position is codified by s172(1) Companies Act 2006 as follows:

> 'A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
>
> (a) the likely consequences of any decision in the long term,
>
> (b) the interests of the company's employees,
>
> (c) the need to foster the company's business relationships with suppliers, customers and others,
>
> (d) the impact of the company's operations on the community and the environment,
>
> (e) the desirability of the company maintaining a reputation for high standards of business conduct … .'

Clearly, different provisions will apply in other jurisdictions, but this legislation provides a convenient template for considering the directors' obligations to various groups of stakeholders. This concept of taking into account the impact of the directors' decisions on other parties in addition to shareholders is sometimes referred to as having regard to 'enlightened shareholder value'.

4.2 Customers and suppliers

It will be seen that the level of responsibility prescribed varies depending on the stakeholder group concerned. Section 172(1)(c), for example, does not impose a responsibility on directors for the well being of customers, suppliers and others with whom the company has business relationships; rather it recognises that the need to foster those relationships in order to promote the success of the company may require the directors to take actions that are of immediate financial disadvantage to it such as paying suppliers more quickly or charging lower prices to customers, because that is of long term benefit, for example in securing sources of supply for raw materials or expanding the customer base. In the tax arena this principle might cover, for example, settling a dispute with the tax authorities on less favourable terms than those the company believes to be justified under the law in order to avoid putting a strain on the relationship that may result in increased administrative costs in the future. While this will be a matter of judgment in every case, the section imposes a duty on directors to have regard to such issues rather than merely permitting them to do so.

4.3 Employees

In the case of employees, there is a requirement in s172(1)(b) to have regard to their interests *per se* rather than simply to the need to foster the company's relationship with them. In the tax arena this might involve, for example, ensuring that remuneration was paid in a tax-efficient manner. It might, however, also involve ensuring that this was not done in a way that left employees exposed to the risk of disputes with the tax authorities and long periods of uncertainty.

This requirement to have regard to the interests of employees still arises in the context of the directors' duty to act in the way they consider would be most likely to promote the success of the company for the benefit of its members as a whole.[35] Accordingly, it does not give them the authority for acts of pure bounty towards employees, such as paying them greatly in excess of the market rate for their services. So, in the tax arena, it might be difficult for a company to justify, for example, meeting all employees' tax liabilities on company cars, but it could be easier to justify meeting tax liabilities on Christmas parties[36] or on emergency call-out payments in circumstances where leaving employees to bear these costs would have a deleterious effect on staff morale in general, and not merely on the morale of the particular individuals affected.

4.4 The community and the environment

Similar considerations apply to the obligation in s172(1)(d) to have regard to the impact of the company's operations on the community and the environment. This dictates the *manner in which* directors are to pursue the company's interests, for example in an environmentally conscious way; it does not give them a separate and additional responsibility to the environment as directors. These obligation are usually considered under the categories of 'corporate social responsibility' (CSR) and 'sustainable development', with the latter sometimes being regarded as a sub-category of the former. There is an extensive literature dealing with this subject, but as yet little attention has been given to how the principles apply in the tax field.[37] What follows can only be a brief introduction to this area.

It may be argued on the basis of s172(1)(d) that responsibility to the community is a legitimate ground for making an operating decision with adverse tax implications. So, for example, a company in the UK may wish to expend £5 million to build a factory on land it already owns, with £1.3 million of that amount relating to office areas. Only the £3.7 million relating to the factory area will qualify for industrial buildings allowances. If the company extends the factory over an adjoining area that a local housing association had hoped to acquire it will incur additional expenditure of £0.3 million. In this case, somewhat anomalously, industrial buildings allowances will be available for the office area as well as the factory area because the expenditure on the office area will then constitute less than 25 per cent of the increased £5.3 million total.[38]

Arguably the directors would be justified in deciding to forgo the allowances on the £1.3 million in order not to obstruct the housing association's plans: they would then have achieved the company's commercial objectives in community-friendly way. Nevertheless, some shareholders might be unhappy with the decision, unless they were persuaded that in fact there was commercial advantage to the company in the goodwill thereby gained with the local community. If taken on that basis, however, the decision would be a purely commercial one; the directors would not be basing their decision on considerations of responsibility to the community but on commercial considerations that took into account their knowledge of *other people's* attitudes to such considerations.

If the figures involved were ten or twenty times those given in the example, perhaps more shareholders would be unhappy. In practice, there may come a point where shareholder concerns outweigh community considerations in the minds of the directors. A company might, for example, readily forgo a tax advantage of £1,000 rather than interfere with a community project. It would perhaps be unlikely to forgo an

[35] They must have regard to the interests of employees 'in doing so' (ie, in acting 'in the way … most likely to promote the success of the company') not '*while* doing so'. The interests of employees must be considered as part of the process of promoting the success of the company, rather than as a completely separate matter.
[36] See, in the UK, s264 ITEPA 2003 (and, previously, extra-statutory concession A70).
[37] But see, for example, SustainAbility Ltd, *Taxing Issues: Responsible Business and Tax*, March 2006 at http://www.taxresearch.org.uk/Documents/taxing_issues.pdf; and Baker, Mallen, *In Search of the Business Case for Responsible Tax* in 'Business Respect – CSR Dispatches' No 91, 26 March 2006 at http://www.mallenbaker.net/csr/nl/91.html#anchor1556.
[38] See s283 CAA 2001.

advantage of £1 billion for the same reason. Somewhere in between the two figures it would have to draw the line.

How is the 'community' to be identified?

Questions arise as to how the 'community' referred to in s172(1)(d) is to be identified. Does this consist of people living or working near the company's place of operations, or of all the people in the country in question, or in the world at large? Arguably the answer is that if people are in a position to be affected by the decisions that the company makes, then they are part of the community to which it has a responsibility. That does not completely solve all the definitional problems, because a company may affect people's lives by omissions; for example, by deciding to set up a new base of operations in one place rather than in any one of a host of others that are thereby disadvantaged. Such decisions may involve tax considerations where, for example, there are tax incentives for investment in different areas[39] or where the decisions to be made determine in which national jurisdiction tax will be paid.

In some cases at least it may be legitimate to identify the 'the community' with society at large; ie, with the totality of people living in the nation. The question then arises as to how far that society can be identified with the state; ie, the apparatus of government. If the identification were an absolute one, then it could simply be said that to pay tax is to benefit the community and that to fail to pay it, for whatever reason, is to disadvantage the community. However, the identification is, in fact, by no means absolute; much of the economic, cultural, social and welfare activity of society is organised and conducted either completely without reference to the state or independently within broad parameters established by the state. It is true that, for example, welfare payments are financed by taxation, but it does not follow from this either that a company paying more tax thereby automatically improves welfare payments to needy members of the community, or that a company reducing its tax payments thereby disadvantages those individuals. In the former case the government may choose not to use the additional revenue in this way, and in the latter it may find the necessary revenue by increasing taxes on other members of the community.

Nevertheless, there may be circumstances in which a company considers that it must discharge its obligations to the community by ensuring that it pays a certain minimum amount of tax to the state, even where it could arrange matters to produce a lower liability.[40] The importance of such a policy is obvious in situations where companies need government approval to continue to operate in the countries concerned, but such an approach may also be motivated by reputational concerns, or simply by considerations of corporate responsibility.

Some companies may look to governments not only for a licence to operate but also for a significant part of their revenue. The SustainAbility report *Taxing Issues: Responsible Business and Tax* makes the point that companies may lose access to government contracts if they undertake their activities through tax haven vehicles or engage in other forms of avoidance. It indicates that a major element in the US presidential campaign of Senator John Kerry in 2004 was a proposal to restrict access to government contracts for companies that had 'inverted'; ie, moved their headquarters outside the US for tax purposes.[41]

The appropriation of funds to good causes

The requirement of s172(1)(d), and of similar provisions in other jurisdictions, to have regard to the impact of the company's operations on the community and the environment does not, it may be argued, justify the *appropriation* of funds to good causes. So, for example, in choosing between two sites to build a depot a company may justifiably take into account the fact that the local community would like to purchase one of

[39] For example, in the UK an incentive for investment in 'disadvantaged areas' is given by the 'community investment tax relief' of s57 and Sch 16 FA 2002.
[40] A particular example is quoted in Henderson Global Investors, *Responsible Tax*, October 2005, page 6 at http://www.henderson.com/global_includes/pdf/corporate_governance/ResponsibleTax.pdf.
[41] SustainAbility Ltd, *Taxing Issues: Responsible Business and Tax*, March 2006, see http://www.taxresearch.org.uk/Documents/taxing_issues.pdf, page 17.

them rather than the other for use as a children's playground. It is a different matter if it decides to donate money for the construction of a playground. Arguably this will need to be justified on commercial grounds by reference to the benefit to the company of maintaining good relations with the local community, which may well include members of its own workforce. The donation cannot, as a legal matter, be justified on purely altruistic grounds.

If it is justified on commercial grounds, it forms a legitimate business expense and may be allowable in calculating the taxable profits, depending upon the jurisdiction concerned. If it is made on altruistic grounds it effectively represents an appropriation from post-tax profits, though not represented in the accounts as such. It is money that could otherwise have been distributed to the shareholders or retained in the business for their benefit. Once it reached the shareholders' hands they would have been free either to use it for their own purposes or to give it away to charitable or social causes, whether those involved the building of children's playgrounds or other matters that they considered more deserving. However, where the company itself makes the donation the directors' judgment has effectively been substituted for that of the individual shareholders. They may have acted with the best of intentions, but there is also a risk that they may have been influenced in their decisions by the gratitude and deference frequently accorded to those who have the opportunity to be generous in public. Effectively, they may be spending money which they hold in a fiduciary capacity without regard to the views of, or any possible benefit to, the persons for whom they hold it.

Shareholders might perhaps consider small donations reasonable and large donations unreasonable, but it is difficult to suggest criteria that might indicate where the line should be drawn. Arguably, therefore, the issue of whether the directors should make donations with the shareholders' money can only be judged as a point of principle; once that is done the principle would apply to any donation, large or small.

What is the equivalent in the tax arena of the directors' decision to build a children's playground? It seems that it can only be the payment of more tax. Given that the tax authorities will not normally accept more tax than is legally due, additional tax can only be paid by forgoing artificial but legal tax avoidance, by forgoing legitimate tax planning, however defined, or by deliberately structuring the company's commercial affairs in a way that will give rise to a greater tax liability than necessary. Directors may consider that it is not a proper exercise of their responsibility effectively to appropriate funds in this way to make unnecessary tax payments. Their reluctance may be greater than in the example of the children's playground, because the payment of more tax is not a direct equivalent of a donation to a good cause. A company cannot give to the *community* via the tax system; it can only give to the state. As discussed above, the state can act as a proxy for the community to some extent, and certainly the community would suffer if the state were completely deprived of funds, but the two are not identical. Some directors will consider, rightly or wrongly, that they can do more good for the community by charitable giving, social projects, or the economic effects of their normal business activities than the state will do with any funds that they pass to it beyond the minimum taxation required by law. Even if they have more confidence than this in the ability of the state to use funds wisely, or less confidence in their own abilities outside their normal business sphere, they may still feel that there is no ethical or legal justification for substituting their own judgment for that of the shareholders in the disposition of funds that would otherwise go to enhance dividends or, by reinvestment, to increase the value of the company to shareholders. In either case they may then feel free, in principle, to use every legal avenue to reduce their tax liability. If, despite feeling no constraint on CSR grounds, they do not in fact use every such avenue, this may be the result of other considerations of reputation or practicality, or of business ethics. While arguably there are significant areas of overlap between CSR and business ethics, they are not the same thing. Directors may feel no community responsibility to give more money to a government with whose priorities they are out of sympathy, but may nevertheless feel, as a separate matter, that artificiality is unethical.

4.5 Alternative models in different jurisdictions

As indicated above, while the discussion has been conducted here by reference to the statutory provisions of s172 of the UK Companies Act 2006, the principles are readily transferable to other jurisdictions. Even in those jurisdictions where the legal responsibility of the directors is restricted to the interests of the shareholders, in practice other legislation such as employment law, health and safety law and environment law, and the prevailing climate of public opinion, will usually make it necessary to have some regard to the interests of customers, suppliers, employees and society at large. Strictly, these latter obligation may be more reliant in principle on the reputational effects of the actions concerned, and thus on the way they affect the company, rather than on how they affect the other stakeholders directly concerned, but in practice any difference that this makes to the company's actions is unlikely to be great.

4.6 The interests of directors themselves

Directors may also wish to bear in mind the effect on themselves of the decisions they make in running the company. In many cases their interests will be exactly aligned with those of the company. For example, considerations of business ethics and legality will apply to them in exactly the same way. Similarly, actions that damage or enhance the reputation of the company will often have a parallel effect on the reputation of the directors, with consequent effects on their employment prospects and remuneration. Arguably, however, directors also need to be conscious of the areas where what is good for them personally may not be in the best interests of the company. In such cases they may wish to guard against the temptation to put their own interests first and may manage conflicts of interest by, for example, taking independent professional advice or carefully documenting the decision-making process.

In the tax arena such conflicts of interest are perhaps most likely to arise in connection with directors' remuneration. They might, for example, have to make decisions about the introduction of employee share schemes in which they would themselves participate.[42] There may also be significant elements of their remuneration that are related to the company's financial results. If the figure used for this purpose is that of post-tax profits, there could be a temptation to manipulate the figures to reduce tax or to take an aggressive approach to tax avoidance which would not be justified on the basis of the company's own best interests. There might also be a temptation to take steps to bring forward tax relief, for example by accelerating capital expenditure programmes, but normal principles of accounting for deferred tax would often remove the benefit of such manoeuvres. This might extend to taking an immediate relief at the cost of a higher tax charge later.

All these conflicts of interest relating to the determination of post-tax profits could be avoided by making remuneration dependent on pre-tax profits, as is often the case for managers below board level.[43] However, directors would then have no personal incentive, as distinct from their duty to the company, to manage tax effectively. A similar issue can arise when the boards of individual subsidiaries within a group of companies have responsibility for operational matters but all tax issues are managed on a group basis. Consideration of tax at the group level allows account to be taken of any statutory provisions that recognise a group of companies as one economic unit, such as group relief of losses, but directors of subsidiaries will also need to be aware of the tax effects of commercial decisions that they take if they are to discharge their legal duties in relation to the company. For further discussion of group relationships, see 5.5.4.

The position is complicated by the fact that many tax-efficient arrangements derive their efficiency from the acceleration of relief or the deferment of liability rather than from a permanent reduction in the tax burden. The 'smoothing' effect of the deferred tax charge may mean that reported profits take no account of these efficiencies, though cash flow will of course benefit. However, using a measure of performance based on

[42] In most jurisdictions, decisions regarding 'executive schemes' would probably be the responsibility of a remuneration committee, but even all-employee schemes can often give significant benefits to the higher paid.
[43] KPMG International, *Tax in the Boardroom*, 2004, p4, see http://www.kpmg.co.uk/services/t/cts/tcs/tmas.cfm.

pre-tax profits less actual tax charged, leaving the deferred tax charge out of account, might bring its own problems, particularly in relation to the volatility of the figures and the risk of decisions being made on a short-term basis at the expense of increased costs in the future.

5 Tax governance in practice

5.1 General

Once directors have considered the principles underlying good tax governance, as discussed in section 3 above, and the identity of the parties for whose benefit they have an obligation to apply those principles, as discussed in section 4 above, it will remain for them to determine how to apply them to particular aspects of the company's business. Such application might involve the formal adoption of relevant policies together with the institution of systems to: keep those policies under review; ensure that they are complied with; monitor such compliance, including external monitoring if appropriate; and deal with breaches of policy.

5.2 Relations with the state

5.2.1 Compliance with the criminal law

All companies will, it is to be hoped, adopt a policy of compliance with the criminal law. Thus, in the tax arena, they will resolve to avoid any behaviour that fraudulently conceals or misrepresents to the tax authorities the facts relating to their tax liabilities, or which is specifically forbidden by the tax code or by the more general criminal law. It might be argued that compliance with the criminal law is a 'default' behaviour that may reasonably be assumed, and that making a specific commitment to this position is superfluous, or even counter-productive if it suggests that compliance is a matter of choice rather than an obligation. In some jurisdictions, however, there is a perception that 'big business' sees itself as above the law; in such cases a formal commitment to compliance may be effective in making the company's stance clear.

If a company wishes to promulgate a general policy of compliance with the law, the question then arises of whether this should make specific reference to tax or, indeed, whether there should be a separate policy statement that the company will not involve itself in tax evasion. Arguably a general commitment is sufficient; if a special case is made for tax, then this could be taken as suggesting that the commitment is not so great in other areas. However, in jurisdictions where tax evasion is endemic, there may be a case for making it clear that the company's policy is one of complete compliance with the law in this area. This might be particularly appropriate where, for whatever reasons, a company feels justified in adopting an aggressive policy on tax avoidance or tax planning and therefore wishes to place it on record that this does not extend to the countenancing of any illegal activity.

Some commentators imply that there is a continuum of tax minimisation activity that begins with evasion and shades off through aggressive avoidance and less aggressive avoidance to the planning of commercial activities with tax in mind, and ends with the utilisation of reliefs specifically enacted by governments to encourage certain activities. Somewhere along this line, it is suggested, the activity becomes 'acceptable'. This may be a correct analysis from the point of view of business ethics or social responsibility, though if it is it leaves significant problems of definition and demarcation to be resolved, as to which see further at 5.2.3. It is not, however, a sound legal analysis. The difference between evasion and avoidance, in the UK and other jurisdictions with similar legal backgrounds, is not one of degree but one of kind. Evasion involves the misrepresentation of the facts to the tax authorities by deliberate or reckless misstatement, concealment or omission. Avoidance involves the arrangement of a taxpayer's affairs in such a way that, when all the facts are known, the taxpayer can still contend, however worthily or unworthily, for the reduced tax liability that the arrangements are intended to achieve. The blurring of this distinction may not facilitate a reasoned debate as to what behaviour is acceptable.

5.2.2 Compliance with the civil law

Directors may also wish to formalise their policy on compliance with the administrative requirements of the tax system, which in the UK and many other jurisdictions are enforced by a system of civil penalties. To some extent this is a matter of business ethics or social responsibility. In addition, the practical effect of failure can be to increase the administrative costs of dealing with the tax authorities, and in more extreme cases to damage the company's wider reputation. At its most basic level such a policy may be simply a matter of stewardship or 'good housekeeping'. A company or group with many tax returns or claims in arrears, or with countless open computations in dispute, cannot say with precision what its tax liabilities are, or what the tax background is against which it has to plan its commercial ventures. Neither can it be sure that it will not be surprised at any time by the surfacing of an unexpected liability, or challenged on the effectiveness for a past year of arrangements that it has continued to implement in subsequent years.

Somewhat different considerations apply to interest on overdue tax, as distinct from penalties. Arguably, less criticism attaches to a company for incurring interest than for incurring a penalty, because financing operations by debt is a feature of normal business activity. Arguably, too, a company can always make the effort to comply with its administrative obligations if it takes them seriously enough but it cannot always pay debts as they become due, particularly if they arise unexpectedly, simply because of the unavailability of funds. Interest therefore arises, at least sometimes, through force of circumstances rather than through a failure of will. Even where there is a formal policy of compliance with administrative requirements in order to avoid penalties, therefore, it might be argued that interest should be considered according to different criteria as part of the company's or group's treasury management function.

5.2.3 Attitude to legal tax avoidance

Perhaps one of the most significant, and high profile, decisions that a board of directors will have to take as regards tax governance will be that concerning its attitude to legal tax avoidance, and how aggressive a stance it is prepared to take in this area. Research indicates that attitudes have become more conservative in this area in recent years.[44]

For the purposes of this debate perhaps most commentators would wish to draw a distinction between tax avoidance and tax planning, though some would wish to use different terminology. For the purposes of this paper a distinction between tax avoidance and tax planning is assumed, while recognising that there are difficult issues of definition, and of demarcation at the margins, that cannot be addressed in any detail here. Working definitions of the two terms are borrowed from the address of Professor David Ulph, then Director of the Analysis and Research Division of HMRC,[45] in speaking at a symposium organised by KPMG in May 2005.[46] To quote the report of that occasion:[47]

> 'He defined "tax planning" as a taxpayer's adjusting his real social, economic or organisational affairs to obtain the "best outcome" in response to the tax system. This did not necessarily mean paying the smallest possible amount of tax; if the price of earning additional profits was to pay additional tax this might still be advantageous. "Tax avoidance" he defined as using artificial or contrived methods of adjusting taxpayers' social, economic or

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[44] KPMG International, Tax in the Boardroom, 2004, pages 4 and 5 at http://www.kpmg.co.uk/services/t/cts/tcs/tmas.cfm; Timmers, Miquël, *A Principle of Good Corporate Tax Governance*, in 'Keeping Good Companies' February 2006, at http://www.allbusiness.com/periodicals/article/874677-1.html.

[45] And now Professor of Economics and Head of the School of Economics and Finance at the University of St Andrews.

[46] Williams, David F, *From Debate to Action: Drawing the Lines and Finding the Balance*, a report of a symposium held by KPMG's Tax Business School® on 25 May 2006, see http://www.kpmg.co.uk/pubs/beforepdf.cfm?PubID=1744.

[47] At pages 6 and 7.

organisational affairs to reduce their tax liability in accordance with the law while not affecting the economic substance of the transactions.'

The present section of this paper deals with attitudes to tax avoidance, as defined in the quotation above; the following section, 5.2.4, deals with tax planning, as so defined.

The distinction between what directors in any particular case regard as appropriate and inappropriate behaviour for their company as regards tax minimisation will not necessarily be the same as the distinction between avoidance and planning. Some directors may regard as acceptable not only planning but also the less aggressive forms of avoidance. Often the degree of artificiality is a major criterion in determining what is 'too' aggressive, but there may be other factors, such as the amounts of tax involved, and the subject matter of the scheme. Some taxpayers and advisers, for example, have specifically stated that they will not be involved in schemes that involve the exploitation of reliefs intended to benefit charities.

For many directors, the objection to arrangements that are in their view 'too' artificial may be framed largely in terms of business ethics. Other directors, equally determined to behave in an ethical way, may consider that the degree of artificiality is not an ethical issue provided no attempt is made to misrepresent the facts or to hide them from the tax authorities. They may argue that the tax system is entirely a creature of statute, though amplified by decisions of the courts, that it is full of anomalies and oddities, based on no universal principles, and its object is simply to raise tax. The system is itself artificial and arbitrary, they would argue, so there is no 'right' amount of tax except in the sense of what is arithmetically correct. The only pertinent question is whether the transactions in issue fall inside or outside the wording of the legislation that imposes the particular tax liability under consideration.[48] Just as there is no scope for a company to contest its tax liability in cases where the taxable profit exceeds the economic profit so, proponents of this view would argue, the company should not hesitate to reduce its taxable profits below its economic profits where it can legally do so. The only ethical obligation on taxpayers, they would say, is to comply with the law.

At one time such a view would perhaps have been more widely held than now.[49] At the present time it represents one end of a range of views in a debate where probably most commentators would hold that within the compass of what is legal there is some behaviour that is acceptable and some that is not. What they differ on is precisely where the line between the two is to be drawn and, perhaps more importantly, what criteria are to be used to determine the distinction.

This paper adopts the view that if debate on these issues is to proceed in a helpful way, it is important that participants be careful not to impugn the motives of those with whom they disagree. Those who see certain forms of tax avoidance as clear moral evils may need to recognise that those who, by contrast, see those particular activities as perfectly acceptable do not necessarily do so because they lack ethical sense, or because they have deliberately disregarded what they know to be right. They may simply differ on how ethical principles which are held in common by all the parties, for example honesty and consideration for other people, apply to the particular circumstances. If they are happy to debate the issues on the basis of such a shared ethical framework then they are not enemies of the first group, but friends with whom they disagree.

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[48] '… in taxation you have to look simply at what is clearly said [in the legislation]. There is no room for any intendment; there is no equity about a tax: there is no presumption as to a tax; you read nothing in; you imply nothing, but you look fairly at what is said and at what is said clearly and that is the tax.' Rowlatt J in *The Cape Brandy Syndicate* v *The Commissioners of Inland Revenue*, KB (1920) 12 TC 358**.**

[49] This was, in effect, the view underlying the decision of the House of Lords in *IRC* v *Duke of Westminster* HL, (1935) 19 TC 490, which contained Lord Tomlin's famous dictum that, 'Every man is entitled if he can to order his affairs so that the tax attracted under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.'

The directors' view of what is acceptable or 'proper', as considered above, is not the only determinant of the policy that they will adopt for the company. They may consider a certain degree of artificiality perfectly consistent with their ethical obligations but may nevertheless decide that a more cautious approach is required on pragmatic grounds, relating either to the effect on the company's reputation or on its relationship with the tax authorities. They may also consider that the prolonged period of uncertainty involved in determining the effectiveness of any tax avoidance scheme, whether through litigation or otherwise, will be disruptive to the proper functioning of the business and will engage too much management time.

A further practical matter that may influence the decision of the directors is the possibility of changes in the law. Particularly in countries, such as the UK, where there are rules requiring the disclosure of tax avoidance schemes to the tax authorities prior to submission of the tax return,[50] there is a risk that legislation to counter an artificial tax avoidance scheme may be introduced before the scheme can be fully implemented, and that the company may be left bearing not only the purchase costs but also the costs of dismantling the structures it has set up for the purpose. In one particular area, employee remuneration, the UK Government has announced that changes in the law made at any time in the future may be backdated to 2 December 2004, the date when it made the announcement in question,[51] and this was in fact done with legislation enacted in 2006.[52]

Similarly, while statutory general anti-avoidance rules are perhaps unlikely to be introduced retrospectively in most jurisdictions, their introduction for the future may nevertheless mean that expenditure incurred by a company in expectation of continuing tax savings is wasted; in addition, the structures put in place for this purpose may be difficult, or expensive, to dismantle. A further risk results from changing judicial attitudes to tax avoidance. Because in most legal systems the courts do not, in theory, change the law as set out in legislation, but only elucidate what it has always meant, their decisions can have retrospective effect over a very long period. In the UK case of *WT Ramsay* v *IRC*,[53] for example, which marked a major change in the approach of the courts to tax avoidance, the transactions that formed the subject matter of the decision of the House of Lords in 1981 had taken place eight years previously in 1973.

Where directors decide, having considered all these factors, that it is appropriate in any particular case to engage in avoidance that could be viewed as aggressive, they may wish to consider the importance of documenting carefully the decisions made and the reasons underlying them. In particular they may wish to make it absolutely clear that the board is not giving its approval to any illegal action, nor to any attempt to misrepresent the arrangements to the authorities or to withhold information from them. In the same way they may wish to ensure that adequate evidence exists of the professional advice taken and that this too contains no suggestion of illegality or impropriety in what is envisaged.

5.2.4 Attitude to tax planning

Tax planning, as distinct from avoidance, was defined in 5.2.3 as, broadly, the organising of genuine commercial transactions in such as way as to give the lowest possible tax charge or, strictly, the highest possible after-tax profit. In many cases the judgments involved in determining whether transactions amount to avoidance or planning will be straightforward, but there may be some middle ground where they are difficult, even where there is agreement on the principles to be employed in making the judgment.

In any policy adopted by the board of directors in this area, therefore, it may be helpful to lay down the principles on which in their judgement avoidance and planning are to be distinguished, perhaps expanding

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[50] Sections 306 to 319 FA 2004.
[51] Parliamentary written statement by the Paymaster General, Dawn Primarolo, Hansard 2 December 2004, col 44WS, see http://www.publications.parliament.uk/pa/cm200405/cmhansrd/vo041202/wmstext/41202m02.htm#41202m02.html_spmin0.
[52] Section 92 FA 2006, 'Avoidance using options, etc'.
[53] HL (1981) 54 TC 101.

on the basic definition set out in 5.2.3. They may also wish to put in place procedures to determine who is to make the decision in particular cases. Having dealt with the problems of definition, there may perhaps still be arrangements within the category of planning rather than avoidance which the directors nevertheless consider it prudent not to engage in for reputational reasons. This is less likely to arise if reputational impact is itself one of the factors that the directors take into account in formulating their definitions.

Despite these notes of caution, it may be argued that in formulating a policy on tax planning directors should seek to balance risks and opportunities. In order to reduce the possibility of opportunities being overlooked the directors might, for example, agree a policy that no major commercial transactions should be implemented without the tax department or external tax advisers being asked to give an opinion on them.

5.2.5 Relationships with tax authorities

Directors may wish to establish a policy or internal code of conduct governing relationships with the tax authorities. A policy might cover matters such as honesty, openness, courtesy and promptness in dealings with the authorities.[54]

The requirement for honesty and openness largely follows from a company's commitment to comply with the law, see 3.2, and from ethical and reputational considerations, see 3.1 and 3.4, but the company may need to make decisions about the extent to which it will meet requests for information from the tax authorities for which there is no legal basis, as for example under HMRC's experimental 'Interventions' initiative.[55] A case might be argued for placing no limit on what is disclosed, except to exclude exercises that would give rise to a completely unreasonable administrative burden or that would put commercial information at risk. Against this, companies might object that almost every piece of information disclosed has the potential to give rise to further questions, thus multiplying the administrative burden. While this is indeed a real risk, where the tax authorities know that a company is committed to a policy of openness they may in practice take a more relaxed view on the extent of enquiries necessary. Similarly, companies may wish to consider that an attitude to the tax authorities that is perceived, rightly or wrongly, as obstructive may be counter-productive, irrespective of the strict legal position.

At the time of writing the suggestion has been put forward that a tripartite code of conduct should be introduced governing the behaviour of taxpayer companies, tax advisers and HMRC.[56] If such a code is introduced in the UK and gains any significant degree of support, directors will need to address the question of whether they wish their company to subscribe to it. Similar considerations will apply if corresponding codes are introduced in other jurisdictions.

In seeking to foster good relationships with individual tax officials, a company will often wish to offer modest hospitality, such as lunch or dinner following meetings. In doing so it will be aware that the sort of reciprocity often present in business relationships is not possible here. This may mean that extravagant hospitality by the company is best avoided. Such issues present more of a problem in some jurisdictions than they do in the UK, where the standards of conduct of public officials are very high. Those dealing with the tax authorities in jurisdictions where standards are lower may find it of benefit to have a clear company policy on what is and is not permissible, and on how they should respond to any suggestion that amounts to a request for a bribe. While these issues may be covered by a general company policy on bribery,[57] there may also be a need for specific guidance on tax issues, because of the fact that the quantum

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[54] Such issues are included in HM Revenue & Customs, *Tax in the Boardroom*, undated, see http://www.hmrc.gov.uk/lbo/tax-in-the-boardroom.htm.

[55] This involves requests by HMRC for information, without using their formal enquiry powers, for a trial period from July 2006. See http://www.hmrc.gov.uk/news/compliance-interventions.htm.

[56] See, *inter alia*, Hickey, Loughlin, *If the Trust Gap Widens Can the Tax Gap Be Narrowed?* ICAEW Tax Faculty Hardman Memorial Lecture, 17 November 2005.

[57] See, for example, *The OECD Guidelines for Multinational Enterprises*, revised 2000, at http://www.oecd.org/dataoecd/56/36/1922428.pdf.

of tax liability is in certain cases a legitimate matter for negotiation rather than simply a matter of arithmetic calculation; for example, where transfer pricing is in point.

5.2.6 Relationships with governments

This discussion under this heading relates to relationships with elected policymakers, or non-elected policy advisers, rather than to officials responsible for the assessment and collection of tax as in 5.2.5. In the UK this would normally mean Treasury Ministers and advisers at the tax policy group of HM Treasury, as distinct from officials of HMRC. Depending on the particular jurisdiction concerned there may be a greater or lesser degree of overlap between these groups.

Companies may wish to lobby governments, either directly or through participation in trade bodies, for changes in the law to remove perceived inequities or to introduce special regimes applying to particular classes of taxpayer. Such regimes might operate by reference to location[58] or particular industries.[59] Probably most commentators would regard such lobbying as legitimate, provided it does not involve bribery or other inappropriate inducements to comply with the company's wishes.

Companies or groups operating in overseas jurisdictions may on occasion wish to indicate to governments that without improvements to the tax regime they will not feel able to continue their activities. While they may see this as a statement of commercial reality, governments may see it as a threat. Much may depend upon the tone of the discussion. As a safeguard against allegations of impropriety, directors may wish to have a formal policy for contacts with governments over tax issues. This might involve requirements for: approval by the board or delegated directors before such contacts are made; at least two company representatives to be present at all meetings to help prevent misunderstanding or misrepresentation; minutes to be kept of all meetings; and at least a summary of the main points to be forwarded to officials after the meeting.

In some jurisdictions it is possible to negotiate special rates of tax for particular organisations, or special treatment of items of income and expenditure that are peculiar to the particular company's activities. Such negotiations may be with governments or with tax authorities depending, in the main, on whether the results are seen as policy decisions preceding the enactment of appropriate legislation or as technical decisions on how the existing law applies in particular cases. While a company may not consider that there is any objection in principle to its seeking to negotiate the most advantageous terms that it can, it may nevertheless wish to have a policy in place to prevent staff engaging in any impropriety, and to assist it in defending itself against any unjustified allegations that it has done so.

5.2.7 Participation in consultation exercises

One particular aspect of a company's relationship with government is the company's participation in consultation exercises on developments in the tax system. A company may wish to have a formal policy in place to govern its responses to such exercises, and various factors may influence the stance adopted. Contributing to public debate about changes to national tax systems may be seen by some as an ethical issue relating to responsible citizenship. In addition, if a company is likely to be affected by any changes made, it may be in its commercial interests to make its views known, and to do all it can to ensure that the issues are clearly understood by policymakers.

In the UK most consultations take the form of papers issued by HM Treasury or HMRC setting out proposals for change and inviting comments from interested parties, either in general or in response to specific questions. Less often the government will simply announce that it is considering whether any changes are required in a particular area and that it would welcome comments. Such cases shade into the more general lobbying discussed at 5.2.6. Responses made to the Government are normally regarded by it

[58] For example, in the UK, 'enterprise zones' (ss298 to 304 CAA 2001) or 'disadvantaged areas' (s57 and Sch 16 FA 2002).
[59] For example, in the UK, the tonnage tax for shipping companies (s82 and Sch 22 FA 2000).

as being in the public arena,[60] so there are reputational issues to be considered by the company, both as regards the views adopted and as regards the standard of writing and presentation of the response.

A policy adopted by the board may cover the question of who is empowered to draft and approve any response. It may also be helpful to provide for a central register of submissions, and perhaps a co-ordinator, in order to avoid the situation where representations drafted by one individual in connection with one issue contradict those drafted by another individual on a different matter. A policy might also contain a mechanism for deciding whether or not representations should be made in any particular case, given the time and resources that will normally be required to prepare any worthwhile response.

From time to time consultation exercises on tax issues will be carried out by supra-national bodies such as the European Union or the OECD. Similar considerations apply, but it may also be appropriate for any policy adopted to provide for liaison as appropriate with overseas companies within the same group, as they may be affected in different ways and therefore have different interests.

5.3 The commercial management of the company

5.3.1 The suitability of accounting systems for tax purposes

It may be argued that one of the directors' primary responsibilities in the tax field is to ensure that the company's accounting systems provide accurate figures in a form in which they can be used for the preparation of the tax computation and the tax figures for the accounts. Even where the relevant legal system does not directly address the responsibility for such systems, this follows from the reporting obligations imposed by law. As a practical matter, many difficulties may be avoided if the figures in the tax computation can readily be reconciled to those in the published accounts. This may simplify negotiations with the tax authorities, and also enable discussion of the computation to be engaged in more readily by members of staff who have not been involved in the detailed work of preparing it. It may therefore be helpful to involve tax personnel in the design and modification of accounting systems.

5.3.2 Taking tax into account in commercial decisions

As discussed at 5.2.4 in the context of tax planning, directors may find it helpful to have formal procedures in place to ensure that the tax department is consulted in the planning of commercial transactions, both to aid tax efficiency and to avoid the unnecessary creation of artificial tax liabilities by inappropriate structuring of transactions. There are particular risks of in the area of VAT, where tax liabilities are calculated by reference to turnover rather than profit, so that an unexpected liability can eliminate rather than simply reduce the profit. Similarly, liaison between accounting and tax specialists may help to ensure that transactions entered into for tax purposes do not cause difficulties from the accounting point of view; for example, in preventing or deferring the recognition of profit.

Two particular issues arise in the context of a company's efforts to avoid expensive mistakes in the tax area. One is the need to ensure the competence of the staff involved by appropriate recruitment and training procedures, as to which see further at 5.3.5. The other relates to the interaction between staff in different specialist areas within tax, and in particular between direct and indirect tax specialists. It may be helpful for staff to develop an 'awareness' of taxes outside their specialist areas. So, for example, the corporate tax specialist may need to know that the transaction he or she is proposing will have VAT effects, but may not need to be aware of precisely what those effects are; for that, reference can be made to an indirect tax specialist. It may also be beneficial to cultivate a 'habit of communication' such that, even in a case where the corporate specialist does not realise that there will be VAT effects, it is nevertheless second nature to

[60] See, for example, the statement on this point at paras 1.8 and 1.9 of the HMRC consultative document, *HM Revenue & Customs and the Taxpayer: Modernising Powers, Deterrents and Safeguards - A Consultation on the Developing Programme of Work*, issued on 30 March 2006, at http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_025429.

him or her to communicate proposals to VAT colleagues at an early stage, and then to keep them informed of any changes as the arrangements are developed.

5.3.3 Planning to accommodate changes in tax law

Directors may wish to consider whether the procedures for taking tax issues into account in the assessment of commercial proposals as discussed at 5.3.2 should extend to a consideration of the likelihood and possible impact of future changes in tax law, both in the home country and, where relevant, overseas. If so, it may be helpful for the tax department to keep abreast not only of technical developments, but of the various issues under public debate, whether formally or informally, in the tax arena. It will be for the directors to determine the level of risk that it is prudent for the company to expose itself to in this area, and also how such risk is to be assessed. In addition to the possibility of specific legislative changes, directors may wish to consider the extent to which the decisions made by the company should take into account the potential impact of more general measures such as the introduction in the relevant jurisdictions of general anti-avoidance rules, or of changes in the attitude of the courts to the interpretation of tax statutes, as discussed at 5.2.3 in the context of tax avoidance.

5.3.4 Attitude to risk

In making any decisions relating to tax avoidance or tax planning the directors may wish to weigh the likelihood of achieving the desired outcome against the effect of failure. The use of formal risk management tools may help to ensure some consistency of approach, but the assessment of risk will perhaps inevitably include a subjective element. Other risks that the directors may wish to consider include the possibility of disputes over the correct tax treatment of items of income or expenditure unrelated to tax planning and the possibility that uncontentious items of expenditure, or agreed losses brought forward, will not give rise to the expected tax relief simply because there are insufficient profits against which to set them. It may not always be possible to reduce such risks, but it may be possible to ‘manage’ them in the sense of recognising the exposure and making other commercial decisions accordingly.

5.3.5 Recruitment, training and qualification of tax professionals

A company’s policy for the recruitment of tax professionals might include various procedural points, such as a requirement that a tax professional must always be involved in the interview, or that the discussion should not only cover the applicant’s experience but should specifically test his knowledge on technical issues. It might also require that a relevant qualification be held on appointment, or provide for the company to encourage staff to obtain such qualifications, perhaps by paying for courses, giving time off for study, or rewarding examination success. It may also be appropriate to provide, or pay for, sufficient training courses to enable qualified members of staff to comply with the continuing professional development requirements of the bodies to which they belong.

The directors might also wish to provide ‘tax awareness’ training to members of the finance staff at large, not with the objective of enabling them to make decisions on tax issues but so that they would recognise commercial matters that had tax implications, and would be in a position to ensure that these were referred to the tax department. This would complement the requirement for such staff to consult the tax department as discussed in 5.3.2.

5.3.6 The buying of tax advice and services

A policy might also be established to govern the buying of tax advice and services. This could involve matters such as: obtaining competitive proposals for projects in excess of a certain value; using a pool of approved advisers; or, indeed, always using one particular firm. It might also involve protocols on how advisers would interact with the company’s own tax staff; for example, the issues on which outside advice could be sought, the level of seniority at which such contacts had to be approved, and procedures for putting in writing the results of such contacts.

5.4 The relationship of the board to management

5.4.1 Where responsibility for tax lies within the company

The board may wish to have policies in place making it clear where responsibility for the company's tax issues lies. As a legal matter, responsibility for all the company's affairs ultimately rests with the board, but such a policy may make clear what functions it has delegated and to whom. For example, it might make clear whether the responsibilities of the tax department extended only to compliance or also embraced planning; who was permitted to commission external tax advice; who had responsibility for reviewing any computations produced by external advisers; and who was required to approve the terms on which points in dispute with the tax authorities were resolved.

5.4.2 The reporting of tax issues to the board

As indicated in section 1 above there is evidence to suggest that, historically, many boards of directors have taken insufficient interest in tax matters. This may result in legitimate opportunities to reduce tax being neglected, in mistakes being made, in a build-up of open computations that have not been agreed with the tax authorities, and in significant problems coming to the attention of the board only at a late stage, when the range of options available to them to resolve the issue has been significantly narrowed. Directors may therefore wish to lay down a policy on regular reporting of open issues, at an appropriate level of detail, either to the board as a whole or to a director or sub-committee charged with monitoring such issues and reporting to the full board where necessary. For some of these issues it may be a simple matter to specify what should be reported; for example, to require a list of all years for which corporation tax liabilities have not been agreed and the factors that are preventing this. For other issues it will perhaps be more difficult to identify what is required, and directors may wish to establish criteria based on their knowledge of the company's particular circumstances, perhaps seeking to identify not only major issues, but also issues that have the potential to become so.

5.4.3 Tax awareness of the board

Directors might also wish to have in place a system of 'tax awareness' training for the board. If that was considered to place onerous demands on directors whose primary responsibilities lay elsewhere, an alternative might be a system for the board to obtain 'high level' advice on tax issues, independently of the recommendations coming to them as part of particular commercial proposals. This might give the directors the opportunity to be satisfied that they understood the significance of the issues on which they were being asked to make the final decision, without seeking to substitute one set of professional advice for another. HMRC's statement *Tax in the Boardroom* summarises the point as follows: 'Whilst we acknowledge that not all directors need to understand the complexities, we consider that it is in their interest to understand whether any tax matters present significant issues for their business.'[61]

[61] HM Revenue & Customs, *Tax in the Boardroom*, undated, see http://www.hmrc.gov.uk/lbo/tax-in-the-boardroom.htm. See also Timmers, Miquël, *A Principle of Good Corporate Tax Governance* in 'Keeping Good Companies' February 2006at http://www.allbusiness.com/periodicals/article/874677-1.html; Australian Commissioner of Taxation, *Questions to be Asked of Tax Advisors to Assist Boards in Assessing and Managing Tax Risks for Corporations* (with covering letter), 29 January 2004 at http://www.ato.gov.au/content/downloads/CommishLetter_4pp.pdf#search=%2229%20January%202004%20Australia%20Commissioner%20Taxation%; Australian Taxation Office Practice Statement Law Administration PS LA 2004/14, *Access to Corporate Board Documents on Tax Compliance Risk*, 23 December 2004 at http://law.ato.gov.au/atolaw/print.htm?DocID=PSR%2FPS200414%2FNAT%2FATO%2F00001; and Australian Tax Office media release Nat 04/089, *Tax Office Approach to Accessing Corporate Documents*, 22 December 2004 at http://www.ato.gov.au/corporate/content.asp?doc=/content/mr2004089.htm. These three ATO documents were discussed in Ferrers, Tony, *Governance and Tax: Australian Tax Compliance* in 'Tax Journal', 4 April 2005 and in Mackenzie, Gordon, *Letter from Australia* in 'Tax Journal', 14 February 2005.

5.5 Relationships with third parties

5.5.1 The reporting of tax figures in the accounts

In all jurisdictions with well developed systems of company law, directors must take responsibility for the tax figures reported in the company's published accounts, just as they must for all the figures included. Sometimes it may be necessary for them to take professional advice in order to establish those figures, for example to form a view on the likely outcome of a disputed matter, but in general the decision must be made by them in the light of all relevant facts and the weight they give to the advice they have received; it cannot normally be delegated to a third party.

In large measure the level of disclosure in the accounts is likely to be determined by the statutory regime applying in the country of incorporation or in other countries where the company has a stock exchange listing. Directors may wish to consider whether to make more detailed disclosure in cases where they consider the statutory level inadequate, either in general or in the company's particular circumstances. In cases where there has been adverse criticism of the company in the past the directors might perhaps decide on a high level of disclosure simply to deflect criticism. They might also decide on voluntary disclosure of certain matters in order to show that they had behaved in a socially responsible way, for example in paying an adequate level of tax in developing countries. Additional information might also be given in order to forestall criticism of apparent anomalies; for example, where an apparently low rate of tax on profits could be explained by disclosure of one particularly large receipt of a non-taxable nature in the year, or of an enhanced relief for certain expenditure.

Reasons that might militate against making disclosure beyond that required by law might be the cost of extracting the information and the risk of making public commercially sensitive details, for example about the company's pattern of trading in different parts of the world. An arguably less worthy motive might be the suspicion that increased disclosure could give rise to criticism over issues where the company was confident that its behaviour was appropriate, but did not relish the prospect of spending time and money debating the point with those who took a different view. While such an approach could be defended, it might prove unwise if the relevant information ever became public in any form. In that case the directors might wish that they had made further disclosure in the accounts for the relevant year, and had been seen to have done so, rather than having to deal with a partial or inaccurate disclosure in the press at a time not of their choosing.

In considering such issues directors may wish to bear in mind that if they make increased disclosure in one or more years and then revert for whatever reason to a lower level of disclosure, they may face more criticism than if they had simply restricted themselves to the statutory minimum throughout. They might also consider that the implications of the additional information they could reasonably give would not be readily understandable without including still further information in such quantity as to be disproportionate to the treatment of other items in the accounts. They might also fear that additional disclosure would generate demands for more and more detail until meeting these demands became impracticable.

One particular area where companies may wish to consider the merits of additional disclosure is the inclusion of a 'statement of total tax paid'; ie, including items such as payroll taxes, VAT and excise duties as well as tax on the profits of the company. Opinions on the merits of such statements are sharply divided, and this paper cannot attempt a full discussion.[62]

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[62] See Williams, David F, *From Debate to Action: Drawing the Lines and Finding the Balance*, at http://www.kpmg.co.uk/pubs/beforepdf.cfm?PubID=1744, pages 23 to 27. See also a discussion by PricewaterhouoseCoopers on their website at http://www.pwc.com/Extweb/insights.nsf/docid/75D58AF8B3774A3C80256F8800586AC6 and an article, very critical of PwC's approach, by McIntyre, Robert S, *Transparently Dishonest* in 'The American Prospect – Online Edition', 30 August 2006 at http://www.prospect.org/web/page.ww?section=root&name=ViewWeb&articleId=11936.

Another area where additional disclosure is often recommended is the analysis of tax charged, and paid, on a country-by-country basis. At the time this paper was being written this was a matter on which the International Accounting Standards Board was being pressed to take action as regards reporting in the extractive industries by the 'Publish What You Pay' coalition.[63] Country-by-country reporting of tax and many other figures was also recommended in the 2005 report by Global Witness, *Extracting Transparency: The Need for an International Financial Reporting Standard for the Extractive Industries*,[64] and similar principles were put forward in the 'Extractive Industries Transparency Initiative' announced by Tony Blair, the UK Prime Minister, at the World Summit on Sustainable Development held in Johannesburg in September 2002.[65]

The *Sustainability Reporting Guidelines* published in October 2006 by the Global Reporting Initiative[66] apply to 'organisations of any size, sector or location',[67] and not simply to the extractive industries. They include in their protocol for *Economic Performance Indicators* details of the information that should appear in a table of 'Economic Value Generated and Distributed'. This includes 'all company taxes (corporate, income, property, etc) and related penalties paid at the international, national and local levels. This figure should not include deferred taxes because they may not be paid.'[68] The protocol adds, 'For organisations operating in more than one country, report taxes paid by country'.[69] Very similar requirements appear in the *Guidance on Corporate Responsibility Indicators in Annual Reports* issued by the United Nations Conference on Trade and Development (UNCTAD).[70] In the 2006 report *Taxing Issues*, prepared by SustainAbility, part of the proposed programme for moving 'from passive to active tax responsibility' involved moving from segmental disclosure of tax paid to 'full disclosure of all taxes paid by country with relevant supporting data'.[71]

5.5.2 Communication of tax policies

Directors may also wish to consider to what extent they will make public, whether through the medium of the company's annual accounts or otherwise, the policies mentioned in the other sections of this paper. For example, they might wish to report the company's policy on tax avoidance or on disclosure of figures beyond the statutory requirements, because of the reputational benefits this could bring. However, they may wish to bear in mind that failure to abide by such a disclosed policy could expose them to more criticism, and arguably more justified criticism, than if they had followed the same course of action without having previously committed themselves to a contrary policy. So, for example, a company might engage in

[63] The website of 'Publish What You Pay' is at http://www.publishwhatyoupay.org/english/index.shtml.
[64] Global Witness, *Extracting Transparency: The Need for an International Financial Reporting Standard for the Extractive Industries*, 2005. http://www.globalwitness.org/reports/download.php/00245.pdf.
[65] Department for International Development (UK), *Extractive Industries Transparency Initiative – Core Script*, 28 July 2004, at http://www2.dfid.gov.uk/pubs/files/eiticorescript.pdf. See also EITI *Statement of Principles and Agreed Actions*, 29 July 2004 at http://www2.dfid.gov.uk/pubs/files/eitidraftreportstatement.pdf and EITI *Revised Draft Reporting Guidelines*, 23 May 2003 at http://www2.dfid.gov.uk/pubs/files/eitidraftreportguidelines.pdf.
[66] Global Reporting Initiative, *Sustainability Reporting Guidelines*, October 2006, see http://www.globalreporting.org/NR/rdonlyres/A1FB5501-B0DE-4B69-A900-27DD8A4C2839/0/G3_GuidelinesENG.pdf.
[67] Page 2.
[68] Global Reporting Initiative, *Economic Performance Indicators*, October 2006, paragraph 2.2(e), page 5, see http://www.globalreporting.org/NR/rdonlyres/A4C5FA04-3BD3-4A02-B083-6B3B00DEAF61/0/G3_IP_Economic.pdf.
[69] Paragraph 2.2(e), page 5.
[70] United Nations Conference on Trade and Development (UNCTAD), *Guidance on Corporate Responsibility Indicators in Annual Reports*, 24 July 2006, paragraphs 30, 32 and 33, see http://www.unctad.org/en/docs/c2isard34_en.pdf.
[71] SustainAbility Ltd, *Taxing Issues: Responsible Business and Tax*, March 2006, see http://www.taxresearch.org.uk/Documents/taxing_issues.pdf, pages 5 and 24, and comments of Richard Murphy on page 20.

an artificial but legal tax avoidance arrangement. That would expose it to criticism from some quarters, but not from others. However, if it announced a policy of not engaging in artificial arrangements and then did so, it might open itself to criticism from a much wider constituency. Similarly, a subsequently announced change of policy, or one inferred from silence in a subsequent year's accounts, might open it to more criticism than if it had never announced its original policy.

5.5.3 Relationships with shareholders, press and lobbying organisations

From time to time a company may have tax issues which it wishes to communicate to shareholders or third parties by means of a circular letter or statement, or a press release. In addition, the press or lobbying organisations may ask for information, either in response to events or in connection with research projects, and may sometimes have their own agendas to promote, which are not necessarily aligned with the interests of the company. Companies may find it helpful to give advance consideration to the various information needs of different stakeholders, so that the relevant details are available in an appropriate format when required and statements made in different contexts give an accurate and consistent message that is difficult to misunderstand, conveys the company's point of view fairly yet persuasively, and can readily be supported. Tax poses particular challenges in this area because of the technical nature of the subject matter and the complexity of many tax systems.

Companies may already have non-tax-specific procedures in place for approval of press releases, circulars, etc, and also rules as to who can speak to the press. As regards tax issues, they may consider it appropriate to provide that written statements cannot be made unless both a tax professional and an appropriate non-tax director or member of staff have approved the wording. This may help to avoid situations where a statement couched in technical terms is misunderstood or cannot be understood, or where a summary in layman's terms is simply wrong. Those responsible for drafting statements may wish to bear in mind the climate of opinion into which the statement is to be released and the fact that statements intended for shareholders may also be seen by third parties. Where that climate is potentially hostile, this may require additional background information to be given that might be overlooked by a tax professional because he or she considered it so obvious as not to need to be stated.

5.5.4 The company and the group

The HMRC document *Tax on the Boardroom Agenda: The Views of Business*, issued in February 2006, reported, *inter alia*, on the results of a survey of the chairmen of large UK-based corporates conducted by HMRC. This indicated that 'Although only 44 respondents [out of 161] indicated that they operated as global groups, half of these found the policies of their parent company's tax authority to be very influential. The remainder felt these policies to be of some influence.'[72]

Nevertheless, in setting policies directors may wish to bear in mind that legal responsibility for the affairs of a subsidiary rests with its own directors, and not with those of the parent. A parent company's directors may decide on policies that they intend to be applied across the group, but the responsibility for adopting them, and for ensuring that they are adhered to, rests with the boards of each individual company – and it is by them that the consequences of any legal or commercial failure on the part of the company will initially be felt.

[72] HM Revenue & Customs, *Tax on the Boardroom Agenda: The Views of Business*, February 2006, see http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_025452, page 4.

6 Conclusion

This paper has sought to examine the principles that directors may consider it appropriate to apply to their corporate governance decisions, the various stakeholder groups to which they have an obligation, and the way in which those principles might be applied to some specific areas of responsibility within the emerging field of tax governance.

It does not seek to offer conclusions of universal application, but rather to establish that tax governance is a subject with wide implications, and to encourage directors to consider critically how they can fulfil their responsibilities in this area in such a way as to enhance the value of their company for the benefit of all stakeholder groups.

In examining the principles, and how they might apply in the particular areas considered in section 5 above, the aim has been to stimulate readers to further discussion and debate. If that follows, then this paper will have served its purpose.

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