TAX AND SUSTAINABILITY: A FRAMEWORK FOR BUSINESSES AND SOCIALLY RESPONSIBLE INVESTORS

POVERTY

Christian Aid wants to see an end to poverty, everywhere. One of the ways that we believe this can be achieved is through equipping developing countries to collect a fair amount of tax from the companies operating within their borders, enabling governments to pay for essential services for poor communities.

Tax, sustainability and corporate responsibility – an emerging agenda

Corporate tax payments are an increasing area of concern for civil society and companies alike. In the face of austerity measures, grassroots groups in the UK and US[1] are challenging companies on perceived tax avoidance schemes.[2]

NGOs such as Christian Aid, ActionAid and CAFOD have raised the profile of tax as a key element of development in impoverished countries. Aid dependence, they argue, is not sustainable in the long term. By collecting tax effectively, such countries not only access a sustainable source of revenue, but in doing so, they are also likely to promote accountability between state and citizen through strengthening the 'fiscal social contract'.[3]

Business tax payments are important because the contributions to some countries comprise a significant proportion of overall tax revenue,[4] and equity in the tax system is one crucial factor in shifting the culture from one of evasion to one of compliance; the perception that big players are paying their way is important.

As this issue is now firmly on the agenda, a number of investors and businesses have engaged actively in the debate, have committed to codes of conduct on taxation, and have built tax into their corporate social responsibility (CSR) framework.[5] Firms such as PricewaterhouseCoopers (PwC) and KPMG have begun advising their clients on the tax and development debate and the reputational risks involved.[6] Notably Andrew Witty, CEO of pharmaceutical company GSK, recently stated publicly that it was 'completely wrong' to redomicile to follow a lower tax rate.[7] This was despite the fact that GSK has, in the past, been involved in high profile tax disputes.[8] Meanwhile businesses such as Vodafone, Rio Tinto and Anglo American disclose their tax strategies and, in some cases, tax payments to the countries in which they work.

A 2005 survey of FTSE350 companies suggested that, at the time, most companies had not considered the link between their tax strategy and their corporate responsibility policy.[9] In 2010, when Christian Aid conducted a survey of FTSE100 companies in relation to tax and development, the picture had changed, with a majority of respondents agreeing that 'payment of tax in developing countries should form a key part of an organisation's CSR commitment'.[10]

Our experience suggests that when new issues emerge on the corporate responsibility agenda, some businesses assume that it is not relevant to them – but in time, the issue becomes mainstreamed.

Advisory firm Corporate Citizenship is eager to point out the risks of not engaging in the tax and development debate: 'It seems that many companies are sitting tight and hoping that this issue will go away. We believe that the opposite is likely. Scrutiny is increasing, demands for transparency are rising and companies that don't have a clear position will lose this debate.'[11]

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What is the business case for including tax as a corporate responsibility issue?

In the face of austerity measures in Europe, the rhetoric regarding payment of tax is changing, from one of irrelevance or something that companies and individuals should avoid if possible, to one of a contribution to society

Conventional wisdom suggests that minimising tax is always in the interests of the shareholder. However an analysis of firm-level data provided by companies, to test the extent to which tax avoidance serves shareholder interests, suggests a complex picture. The simple view of corporate tax avoidance as a transfer of resources from the state to shareholders is incomplete.[12] This complexity may result in part from the risks that tax avoidance pose to a company – most notably compliance risk (the increased likelihood of expensive and protracted disputes) and reputational risk – which come with taking aggressive tax positions.[13]

SustainAbility's 2006 report *Taxing Issues: Responsible Business and Tax* highlights three areas of risk which companies should consider:[14]

1. Reputational risk

Tax and reputation risk has clearly been on the agenda of many major companies for some time. In 2004, 97 per cent of companies surveyed by PwC said they would be concerned about negative press coverage of their tax planning, while 40 per cent mentioned corporate responsibility as the most important driver for measuring taxes paid.[15]

However these risks are increasing. In the face of austerity measures in Europe, the rhetoric regarding payment of tax is changing – from one of irrelevance or something that companies and individuals should avoid if possible, to one of a contribution to society. While this view has emerged from relatively small campaign groups such as UK Uncut, the sentiment resonates and is gaining purchase in mainstream media. Inevitably, large businesses that take aggressive tax positions have been exposed to reputational risk.

Not only are tax considerations reasonably far down companies' priority list, but the factors that are perceived as important are also closely related to revenue mobilisation in country

The *Financial Times* in 2010 reported that 'tax is becoming an important source of reputation risk'. It said: 'Increasingly, businesses are weighing up whether they are vulnerable to attack and how they should respond if they become the target of a campaign.'[16]

Yet the complexity of taxation leads to varying interpretations of what is fair. Notably, Corporate Citizenship have suggested that 'the traditional defence of compliance is dead; the distinction between evasion (illegal) and avoidance (lawful) has dissolved in the eyes of governments, NGOs and citizens'.[17]

2. Regime risk

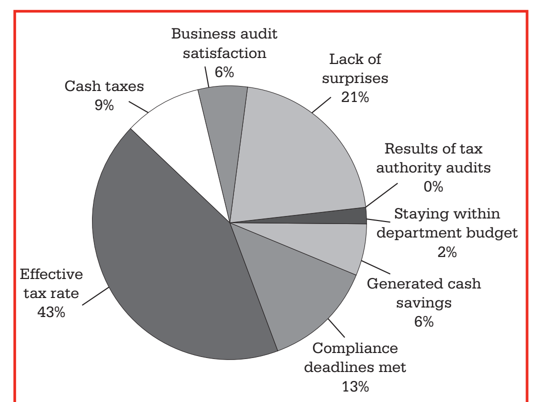
Taking aggressive or assertive tax positions can increase the risk of litigation in the event of a company's tax position being challenged by a revenue authority. This can then have a knock-on effect on reputation risk and cashflow risk. In some cases, access to government contracts (such as the UK Private Finance Initiative) depends upon the company being domiciled in the relevant country. In France, this is also tangible at the local government level, where local authority Ile de France now requires financial institutions that it works with to provide details to verify that they are not linked to tax havens listed by the State.[18]

3. Cash flow risk

Extensive tax planning can reduce certainty for a company – through uncertainties about some taxation liabilities, potential impacts on cash flow and senior staff time. Anecdotal discussions with tax directors from FTSE companies suggest that taking aggressive tax positions presents a risk to sustainable profitability, since loopholes that may be closed in the future may affect profitability and therefore shareholder returns – even if real economic activity has not been affected.

For investors, many performance indicators are based on post-tax profits, and investors place a high value on the reliability, predictability and perceived 'quality' of such earnings. Unsustainable tax practices can increase uncertainty and volatility of earnings, which could have a material impact on investor confidence.

PwC's Total Tax Contribution Survey 2008 identified that only 43 per cent of tax departments surveyed are evaluated by effective tax rate and nine per cent are evaluated on cash taxes. This means that only half of UK tax departments are evaluated on the level of tax that they pay. Notably, 21 per cent are measured according to 'lack of surprises'.



Source: *PricewaterhouseCoopers, Total Tax Contribution Survey 2008*

The business case for tax contributions to society

In addition to the risks that aggressive tax planning poses to businesses directly, it is reasonable to suggest that such behaviour reduces trust in businesses and increases complexity in the tax code, as governments legislate to close loopholes. Over time this increases complexity and compliance costs for all. In the UK for example, the tax code grew 54 per cent between 2011 and 2006.[19]

Conversely, it is widely recognised that good relationships between businesses and revenue authorities are beneficial to both parties. Here, both businesses and governments bear co-responsibility – but an aggressive and opaque tax policy is likely to undermine this relationship.

In the long term, a range of factors drive companies' overseas investment decisions. An analysis of the factors that drive investment in 11 low-income countries[20] found that the factors at the forefront of companies' minds, rather than effective tax rate, were: domestic political stability; domestic economic stability; labour productivity; a pro-investment legal system; and access to markets. While econometric analysis shows that an increase in taxes is negatively correlated with firm-level growth, the effect is much weaker than the impact of corruption and bribery.[21]

Not only are tax considerations reasonably far down companies' priority list, but the factors that are perceived as important are closely related to revenue mobilisation in-country.

Evidence suggests that revenue mobilisation is strongly correlated with policy stability and political accountability,[22] while the infrastructure and education needed to attract investment is best funded by tax revenues.

What is a fair amount of tax?

In a democratic society, a government will establish a tax code that will, in turn, be implemented by the revenue authority. Ideally, legislation will be robust and revenue authorities strong enough to determine the right amount of tax due.

However, in recent years the opportunities for companies to be legally compliant while contravening the spirit of the law have proliferated. In response, an increasing number of stakeholders in the debate argue that behaviours that contravene the spirit of the law are unethical or immoral.

The world of tax is complex. Multinational companies operate in multiple jurisdictions, each with varying tax codes, and they clearly have an incentive to minimise their effective tax rate. Some jurisdictions seek to attract business by offering legal tax incentives such as tax holidays or low tax rates; others actively seek to undermine the tax bases of other countries by providing financial secrecy (typically tax havens or secrecy jurisdictions).

In the face of such complexity, the opportunities for exploiting loopholes are many – particularly in the context of developing countries, where legislation and revenue authority capacity may be weak. The solution must therefore involve capacity building, training and stronger legislation. But businesses also have a role to play in being transparent about their approach to tax and committing to principles of corporate responsibility.

From a corporate responsibility perspective, a company's approach to tax is ultimately about risk management. SustainAbility helpfully identifies a spectrum of behaviour, from evasion to mitigation. What one individual, company or government perceives as fair will be different from another. It is therefore important that the company effectively evaluates the risks identified above in order to determine the position that it will take on this spectrum.

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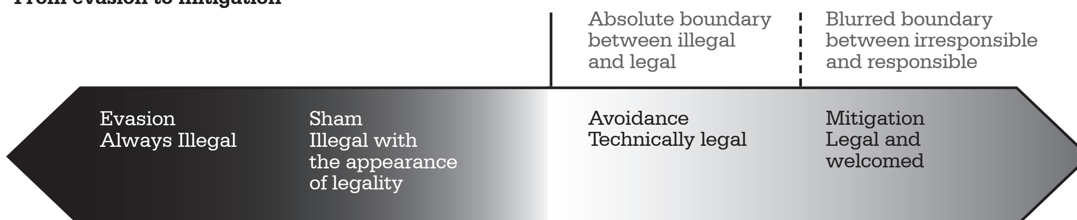

Source: SustainAbility, *Taxing Issues: Responsible Business and Tax*

What is tax avoidance?

Christian Aid co-hosted a roundtable in London in February 2010, where tax directors from FTSE companies, officials from the Big Four accounting firms, tax lawyers and government officials gathered to discuss the question, 'What is tax avoidance?'

It was defined as taking a tax position that is legally compliant but undermines the tax administration and that is not in the spirit of the law or respectful of the intentions behind it. A leading tax QC suggested that tax avoidance is a function of the tax base (defining what is taxable income), while evasion was described as undermining the mechanism used to collect tax.

Corporate responsibility plays a significant role in changing company behaviour in regards to tax. Two recent academic reports demonstrate a strong negative correlation between levels of corporate responsibility disclosure and levels of tax aggressiveness

What are principles of responsible corporate behaviour in the area of tax?

A review of literature and best practice in the tax and corporate responsibility debate suggests the following principles are commonly held:

- a company should, at all times, comply with the laws of the jurisdictions in which it operates
- the sustainability impact of the company's tax strategy should be a central consideration
- tax payments should reflect economic substance
- transparency should be a central tenet of tax policy
- certain abusive practices should be filtered from company behaviour.

More controversial proposals include those suggested by NGOs:

- a company should disclose its financial position in every country in which it operates, including details of tax payments, profits, turnover, intra-company financing, staff numbers and so on[23]
- a company should not use tax havens.[24]

What kinds of behaviours should a responsible business exhibit when it comes to tax?

The tables below provide examples of company behaviour that could be considered best practice,[25] and examples of behaviours that should be filtered out of company practice.[26] Defining which of these practices a company expects of its employees could be a requirement of its code of conduct.

Examples of responsible company behaviour
• Taxable transactions are recorded where their economic benefit can be best determined to arise
• Tax planning seeks to comply with the spirit, as well as the letter, of the law
• Tax planning seeks to reflect the economic substance of the transactions undertaken
• No steps are put into a transaction solely or mainly to secure a tax advantage
• Tax planning will be consistently disclosed to all tax authorities affected by it
• Data on a transaction will be consistently reported to all tax authorities affected by it
• Taxation reporting will reflect the whole economic substance and not just the form of transactions
• The company will settle all obligations owed by them at the time they are due for payment

Examples of abusive behaviour that should be removed from company practice
• Locating valuable intellectual property in low-tax jurisdictions (unless it was predominantly developed there or is predominantly exploited there)
• Moving tax residence to a low-tax jurisdiction without a corresponding shift in economic activity
• Moving high-value business functions out of developing countries and into low-tax jurisdictions
• Using structured tax planning techniques, such as 'double-dipping', under which tax allowances on one piece of income are claimed in two different jurisdictions

Towards a framework for socially responsible investors

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Socially responsible investors can play a role in encouraging companies to incorporate taxation into their sustainability agendas. Drawing on the FTSE4Good framework on corruption, Christian Aid has prepared a draft framework for evaluating corporate responsibility in relation to taxation. The tables below present a risk analysis tool and potential options for criteria that socially responsible investors could encourage companies to implement.

Unsustainable tax practices can increase uncertainty and volatility of earnings, which could have a material impact on investor confidence

Policy	Management	Reporting
1 Basic • Tax policy provides basic information on tax policies and payment		
2 Systematic • Tax policy defines level of aggressiveness in tax planning; provides for an assessment of tax revenue impact on all major business decisions; rules out certain tax practices; and outlines criteria for tax negotiations[28]	• Communicates policy and code of conduct to employees	• Policy and code of conduct is publicly disclosed
• Code of conduct defines acceptable and unacceptable practices, with agreed benchmarks accepted by a range of stakeholders	• Trains relevant employees	• Compliance mechanisms are publicly disclosed.
3 Extensive • Tax policy filters abusive practices	• Clear articulation of the systems used to manage the payment of tax as a corporate responsibility issue • Provides secure communication channels for employees to seek advice or voice concerns • Procedures to remedy non-compliance	• Comprehensive information on governance and management of tax • Reporting on specific levels of tax payment across different geographies • Breakdown of different types of tax including pre-tax profits; levels of current and deferred tax; opening and closing tax liabilities; payment of different types of tax including on ‘capital’ (corporation tax, irrecoverable sales tax, business rates); ‘people’ (employer tax liabilities); and on ‘product’ (custom duties, excise duties)
4 Integrated		• Reporting is systemic and extensive in coverage • Reporting provides evidence that wider business decision-making and process are coordinated to ensure that the company is integrating the corporate responsibility dimensions of tax into forward planning

High risk companies – both filters must apply to each company before they are designated 'high risk'

Sectors

- Oil and gas producers; oil equipment services and distribution; industrial metals; mining; construction and materials; aerospace and defence; general industrials; electronic and electrical equipment; industrial engineering; support services; electricity; gas; water and multi-utilities; beverages; food producers.*
- Pharmaceuticals; hotels; fixed line telecommunications; mobile telecommunications; software and computer services; technology hardware and equipment.*

Countries

- Presence in low-income countries as classified by the World Bank.[29]
- Presence in tax havens/secrecy jurisdictions: this could be defined as presence in countries identified in the Tax Justice Network's Financial Secrecy Index.[30]
- Presence in countries scoring zero or less on the World Bank Governance Indicator (regulatory quality).

* Based on Industry Classification Benchmark sectors considered to be susceptible to tax abuse

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Endnotes

1 For example, UK Uncut, Citizens for Tax Justice (US) and the Tax Justice Network (global).

2 Companies such as Barclays, Google, GE, Arcadia, SAB Miller and Vodafone have been subject to recent media campaigns alleging tax avoidance.

3 D Brautigam, O H Fjeldstad and M Moore (Eds), *Taxation and State Building in Developing Countries*, Cambridge University Press, 2008.

4 In Ghana, for example, the majority of corporate tax revenue comes from foreign-owned firms.

5 For instance Rio Tinto, Anglo American, Vodafone and Intercontinental Hotels Group

6 See T Elgood, I Paroissien and L Quimby, *Tax Risk Management*, PwC, 2004; and T Scheiwiller and S Symons, *Corporate Responsibility and Paying Tax*, OECD Observer, January 2010.

7 Witty said: 'I really believe one of the reasons we've seen an erosion of trust, broadly, in big companies is they've allowed themselves to be seen as being detached from society and they will float in and out of societies according to what the tax regime is… I think that's completely wrong.' guardian.co.uk/business/2011/mar/20/andrew-witty-glaxosmithkline-big-firms-detached-society

8 In 2006, GSK paid the IRS the biggest tax settlement in US history – US$3.4bn accountancyage.com/aa/news/1768893/gsk-pays-biggest-tax-settlement-us-history

9 Henderson Global Investors, *Tax, Risk and Corporate Governance*, February 2005.

10 D McNair, *Shifting Sands: Developments in Corporate Transparency*, Christian Aid, 2010.

11 R Hardyment, P Truesdale and M Tuffrey, *Tax as a Corporate Responsibility Issue*, Corporate Citizenship, 2011.

12 M A Desai and D Dharmapala, *Corporate Tax Avoidance and Firm Value*, Journal of Economics and Statistics 91 (3) 2009, pp537-546.

13 T Elgood, I Paroissien and L Quimby, *Tax Risk Management*, PricewaterhouseCoopers, 2004. The authors identify seven primary risks to firms in relation to tax: transactional, operational, compliance, financial accounting, portfolio, management, and reputational risk.

14 S Beloe, G Lye, K Cruickshank, R Murphy, *Taxing Issues: Responsible Business and Tax*, SustainAbility, 2006.

15 PwC, Total Tax Contribution Framework, pwc.co.uk/eng/issues/what_is_total_tax_contribution_framework.html

16 V Houlder, 'Tax Claims hit reputation as well as coffers,' *Financial Times*, 8 November 2010.

17 See note 11.

18 Hayat Gazzane, 'Paradis fiscaux: l'Ile-de-France lance la lutte,' *Le Figaro,* 3 June 2010.

19 Tax Faculty of the Institute of Chartered Accountants in England and Wales, 8 September 2005.

20 N Bhinda and M Martin, *Private Capital Flows to Low Income Countries: Dealing With Boom and Bust,* FPC CBP Series No 2, 2009.

21 R Fisman and J Svensson, *Are Corruption and Taxation Really Harmful to Growth? Firm Level Evidence,* Journal of Development Economics 83 (1), 2007, pp63-75.

22 See note 3.

23 R Murphy, *Why is Country-by-Country Financial Reporting by Multinational Companies so Important?* Tax Justice Network.

24 www.eurodad.org/whatsnew/articles.aspx?id=4272

25 R Murphy, *A Code of Conduct for Taxation*, Tax Justice Network/AABA, 2007.

26 M Hearson, *Tax Responsibility: The Business Case for Making Tax a Corporate Responsibility Issue,* ActionAid, FairFood and FairPensions, 2011.

27 G A Richardson and R Lanis, *Corporate Social Responsibility and Tax Aggressiveness,* American Accounting Association (AAA) annual meeting, 2011; L Watson, *Social Influences on Aggressive Accounting: the Impact of Corporate Social Responsibility on Tax Aggressiveness,* AAA annual meeting, 2011.

28 See note 26.

29 data.worldbank.org/about/country-classifications/country-and-lending-groups#Low_income

30 financialsecrecyindex.com/#which_jurisdictions

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Poverty is an outrage against humanity. It robs people of dignity, freedom and hope, of power over their own lives.

Christian Aid has a vision – an end to poverty – and we believe that vision can become a reality. We urge you to join us.

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