Is tax avoidance worth the cost?

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- Instances of digital technology companies using cross border structures to avoid tax has attracted recent condemnation.
- The interests of the general community in which a company operates can be, and to an extent should be, taken into account by board members when considering who constitutes stakeholders.
- A change in the way boards think and operate may be even more prudent considering the pejorative view governments and international bodies are taking towards aggressive tax avoiders.

The global tax environment has become a complex labyrinth and its navigation for company boards and directors is fraught with danger. Though companies might seek to lawfully pay as little tax as possible the pertinent question is how far should they go in this endeavour?

Introduction

It is generally accepted that boards should attempt to maximise profits for shareholders but the use of certain lawful tax structures which ultimately facilitate tax avoidance (as opposed to tax mitigation) is hotly debated. Even if a company can legally minimise tax they must consider whether such conduct does more harm than good to their reputation and ultimately shareholder value. This article briefly outlines the nature of international tax structures with particular focus on double tax agreements, gives an example of how they have become one of many tools used in actively avoiding tax and discusses the tension that exists between maximising profits for shareholders and being a responsible corporate citizen.

Background to international taxation

It is helpful to have an understanding of the taxing regime employed across the world for taxing multinational corporations. The basic principle is to share taxing rights between countries and to avoid double taxation, that is, a company being taxed by two countries in relation to the same income.[1] This is achieved via Double Taxation Agreements (DTAs). DTAs are not a recent phenomenon and date back to the early twentieth century when the League of Nations first made a commitment to solving the problem of double taxation and facilitating tax sharing. There were various iterations of DTAs developed, some predicated on taxing rights belonging to the country where the income was sourced and others with a focus on the enterprise's country of origin.[2] Subsequently, both the Organisation for Economic Cooperation and Development (OECD) and the United Nations developed and continue to develop model tax treaties which have been adopted by member nations.[3] These model tax treaties have some variations. Those focusing on income source are used more often by developing countries, while those based upon origin are used by developed countries. Australia's first DTA was entered into with the United Kingdom in 1945 and was heavily negotiated by Australia to promote source based taxation but ultimately some concessions were made by both sides to facilitate the agreement.[4]

Importantly, DTAs were developed in an era where the physical manufacturing of products was the norm. Within this context countries were able to identify the source of income and clearly differentiate it from the enterprise's origin. This meant that countries could formulate suitable DTAs based on a clear picture of a company's operations, allowing for effective income sharing between jurisdictions and the mitigation of double taxation. Digital economies have put a strain on traditional DTA frameworks, exposing various limitations. For example, it is currently possible for a company residing in one jurisdiction to have a significant digital presence in another jurisdiction without being liable to taxation in the latter. This is due to the inability of current treaties to construe a nexus between the two.[5] Further, the way in which proceeds derived from the realisation of intellectual and digital property rights, can vary across jurisdictions. This creates a disconnect that facilitates 'treaty shopping'. That is where an enterprise uses DTAs to channel profits into low tax jurisdictions. Therefore, the effectiveness of DTAs has been eroded and the tax revenue of Australia and myriad other countries is being threatened.

Mitigation, avoidance, evasion

An understanding of the concepts and distinctions of 'tax mitigation', 'tax avoidance' and 'tax evasion' is also important for these purposes. Tax evasion is illegal and generally refers to the non-payment or under payment of a tax liability that would otherwise be imposed on a taxpayer.[6] Tax avoidance, which will be the focus of this article, refers to the use of lawful means to reduce a taxpayer's tax liabilities. This could involve the creation of certain legal tax structures or arrangements used to exploit what are regarded as 'loopholes' in tax laws.[7] Avoidance, while legal, may however not be consistent with underlying tax policy. The Australian Taxation Office (ATO) identifies a number of arrangements involving tax avoidance each year that are antithetical to the policy of Australian taxation laws and that the ATO regards as having little or no economic substance. In the ATO's view they are created predominantly to obtain a tax benefit for the participant.[8] To combat tax avoidance both general and specific anti-avoidance provisions (Part IVA of the *Income Tax Assessment Act 1936*) exist in Australian taxation legislation. These are designed to negate the exploitation of perceived loopholes and maintain the integrity and policy of the Australian taxation system.[9] Tax mitigation is where a taxpayer complies with both the form and substance of tax laws in order to pay the least tax allowed by law.

Not only must companies grapple with questions of tax avoidance when considering certain tax structures but they must also consider what constitutes good corporate governance and how to best attain a balance between the interests of shareholders and stakeholders.

Digital technology companies — a modern day example

Examples of multinational companies using cross border structures to avoid tax are illustrated in the way that many digital technology companies operate their business. Such companies, with substantial intellectual property, use what is commonly known as transfer pricing mechanisms to shift profits between related entities in various jurisdictions. An Australian entity for example will pay full value to purchase software products from a related overseas entity, usually registered in a place like Ireland, which results in the transfer of a majority of that profit to Ireland. As the majority of the value of the entity's products rests in its intellectual property any income earned may be classified as a 'royalty' under Australian taxation laws. If an Australian entity makes a payment overseas for the use of a royalty the only tax they will incur, subject to any particular tax treaty, is a withholding tax. When a royalty goes through a country like Ireland it will not be taxed and so a related company in Ireland pays no tax under Irish law. It is common for these 'shell' companies to be managed and controlled by an overseas entity, a company registered in California for example. However, they also pay no tax in the United States as US law only focuses on where a company is legally registered and not where it is managed. This means that none of the profits that are moved from Australia are taxable. DTAs, as discussed above, had originally been implemented to share tax between jurisdictions and stop the double taxation of income. They were not designed to ensure that multinational corporations are adequately taxed in a digital economy. The above has been termed double non-taxation and has increased tax policy concerns around the world.[10]

These types of tax vehicles have become a common tool used by corporations. But do they comply with the principles of good corporate governance and good corporate citizenship?

Duties of corporations

Company boards (or directors) have a duty to act in the best interests of a company. This broad obligation is set out under section 181 of the *Corporations Act 2001* and is one of the underpinning tenants of a broader suit of obligations that posits boards should act honestly, with business nous and with the interest of stakeholders at heart. The phrase 'in the best interests of the company' has been interpreted to refer to the collective interest of all members.[11] The implementation of tax structures which facilitate tax avoidance and their nexus to board obligations has not been explored in any great detail in Australia. However, the responsibility placed on boards in respect to corporate restructuring and management would logically extend to ensuring companies handle their tax affairs not only lawfully but in such a way so as to minimise their tax liabilities and maximise revenue.

The idea of acting in the 'best interests of the company' has generally been established to mean the best interests of the shareholders.[12] This view is extended to suggest that directors act as agents for shareholders and that their fundamental obligations are intrinsically linked to that which benefits their members.[13] A company may have legal structures in place which facilitate tax avoidance and from a strict business perspective it makes sense that in the process of managing and conducting the business in the best interests of the company such structures help maintain profit. Under both the common law

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and the Corporations Act directors also have an obligation to discharge their duties for a proper purpose. This may be construed to suggest that in the process of considering all relevant information boards may need to consider the possible use of any revenue saving tax structures. If the directors do not give proper consideration to such matters it is not outside the realm of possibility that they have failed to do what a majority of members want, that is, to increase revenue for the benefit of the company and the members themselves. Accordingly they may be liable for a breach of their duty to act in the interests of the company and for proper purposes.

The above is of course predicated on that fact that boards need consider only the interests of members. Should however, directors consider the interests of stakeholders who are not shareholders and the implications for a company viewed as being a bad corporate citizen?[14]

'Stakeholder' can be narrowly defined as those who are concerned directly with a company's inputs and outputs and this will generally include employees, members, suppliers and customers. However a broader view of stakeholder has been postulated which defines stakeholder as a group or individual who is affected by the operation of the organisation in its attempt to achieve its objectives.[15] This definition suggests that 'stakeholder' can include the broader society and it has been noted that there is value to be extracted by a company from these types of stakeholders. This value comes in the form of the reputation that a company makes for itself by being a good corporate citizen. The correlation between tax avoidance and corporate reputation is clear. The more positive profile a company has (gained from paying the appropriate taxes for example), the more it can present itself as an integrated part of society which creates a strong brand and will often lead to greater profits.

However, the current outrage in respect of multinational companies using complex anti-avoidance schemes to reduce their taxable income has reached fever pitch. Such multinationals are being perceived as ruthless corporate operators, who do not contribute their fair share of tax to maintaining the community. Though the corporate law has not changed to reflect any direct legal obligation for boards to consider other stakeholders it has been recognised that the interests of the general community in which a company operates can be and to an extent should be taken into account by board members.[16] It was stated by Berger J in *Teck Corporation Ltd v Millar* that if the directors of a company were to consider the consequences to the community of any policy that the company intended to pursue it could not be said that they had not considered the interests of the shareholders and conversely the best interests of the company.[17] It is becoming ever more prudent for companies to focus on corporate social responsibility which forms part of good corporate governance. An awareness of social values can guide corporate decision making which will assist in building value and reducing risk. This is ultimately beneficial to any company.[18] It may be that effectively managing a company's tax risks as part of a good corporate governance strategy, which includes being transparent, accountable and engaging constructively with tax authorities will lead to better corporate performance and ultimately a better dividend yield for shareholders.

Additionally, the fact that tax avoidance structures are legal does not completely avoid illegality because there is always a risk that their implementation may be in breach of the general tax anti-avoidance legislation. This is particularly so in the current global environment where it has become the objective of many governments to close perceived loopholes in their taxation laws. The transgression of anti-avoidance legislation may attract substantial fines.

Moving forward

There is clearly a tension between how a company should seek to reduce tax and the commitment it should show to appropriate corporate governance and being a good corporate citizen.

Not only is there a growing public backlash against the perceived tax avoidance conducted by multinational companies but governments have begun to seriously weigh into the debate in an attempt to stop what is commonly termed Base Erosion and Profit Shifting (BEPS). Billions of dollars are escaping taxation in the country where the profits are derived and in some instances, escaping taxation in any jurisdiction whatsoever. This leads to an erosion of government revenue. The OECD recognised in a report that it published on 13 February 2013 that archaic rules and treaties which had been used to protect companies from double taxation were too often being used to facilitate the non-payment of tax.[19] Double taxation agreements no longer reflect the way that multinational companies are doing business but potentially operate to erode the tax base of many countries and threaten the stability of the international tax systems.[20]

There are now a range of initiatives being explored by the OECD and different governments around the world to counteract these developments. The OECD has suggested a series of measures to stop the inappropriate use of DTAs to create a position of double non-taxation. This would potentially be done by closely scrutinising and amending as necessary model treaties and making recommendations on whether or not they facilitate exploitation and even whether a treaty should be entered into at all.[21] The attention of many jurisdictions as well as the OECD has also been turned to laws relating to transfer pricing. Transfer pricing laws need to be improved in order to put more emphasis on value creation and this would combat the problems associated with using intangibles to shift profits.[22]

Though governments have been accused of having more bark than bite in the past, it would seem that there is now a strong consensus that something needs to be done to prevent the exploitation of the global tax systems. Australia has already begun to implement some of the suggestions proposed by the OECD. The Australian government has various special reference groups examining these issues and continues to upgrade the national tax system with specific regard to the areas of transfer pricing and related areas such as thin capitalisation rules.

Ultimately good corporate governance in relation to tax affairs may be as beneficial to a company as lawfully paying the least amount of tax.

Conclusion

Boards need to act in the best interests of the company and this includes accounting for shareholder interests. Companies will always seek to minimise their tax. Tax mitigation is however very different from tax avoidance and this is something which needs to be carefully considered by boards. Where the threshold is in relation to how a board should structure its company's tax affairs remains unclear but there are some strong arguments suggesting that reputation and the perception of being a good corporate citizen is critical to companies. Therefore boards need to begin to ensure that they have regard to these facets of their business and not just an intense focus on maximising shareholder wealth. Ultimately good corporate governance in relation to tax affairs may be as beneficial to a company as lawfully paying the least amount of tax. A change in the way boards think and operate may be even more prudent considering the pejorative view governments and international bodies are now taking towards aggressive tax avoiders. It is not unreasonable to expect substantial, though perhaps slow moving, changes in international tax laws and treaties, making it increasingly difficult and risky for multinationals to employ aggressive tax avoidance strategies. The balancing act between companies using tax structures which facilitate avoidance and being good corporate citizens as part of a corporate governance strategy is a difficult one and one that will not be made any easier by the tumultuous international taxation landscape.

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Notes

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