

Corporate Social Responsibility and Strategic Tax Behavior – Comment on the paper by Reuven S. Avi-Yonah

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Professor Avi-Yonah addresses two questions:

“First, from the perspective of the corporation, should the corporation cooperate and pay the corporate tax, or should it engage in ‘strategic’ tax behavior designed to minimize or eliminate its corporate tax burden?”

Second, from the perspective of the state, should the state use the corporate tax just to raise revenue, or should it also try to use it as a regulatory tool to steer corporate behavior in directions that it deems beneficial to society?”

This comment is only directed towards the first question – which really is an important and highly topical question in global commercial environment.¹

This became an issue for states and their treasuries as soon as it became possible for companies to exploit as well regulatory and tax competition between nation states as different regulatory structures of tax legislations and it has become even more relevant as it has become evident that the “world is flat”² and it is possible to place either operations or at least organizations in whichever part of the world you like. However, it might be useful to test if we have any common understanding about the “strategic” tax behavior or if we are able to make a distinction between acceptable and unacceptable tax strategies. This is however outside the scope of this comment so I won’t even try.³

I am not quite sure, whether we should agree with professor Avi-Yonah when he states that “if engaging in CSR is a legitimate corporate function, then corporations can also be expected to pay taxes to bolster society as part of their assumption of CSR.” It is by no means self-evident that paying taxes is an elementary part of the CSR and even less self-evident that companies should voluntarily pay anything they are not obliged to pay. Therefore, I do find – despite this skepticism – it justified to

¹ Due to this there is no need to raise questions connected to the second question, *e.g.* concerning distributive taxation or a need to find some welfarist approach or other possible justifications for the use of taxes. A comprehensive overview of the welfarist approach is KAPLOW/SHAVELL, *Fairness versus Welfare* (2002).

² The concept is from FRIEDMAN, *The World Is Flat* (2005).

³ As an example it may be noted that some Finnish companies have subsidiaries in the Netherlands with their only task to own real estates or other commercial premises in Finland. These premises are leased to the parent company or to some other subsidiary within the group. The economic rationale behind this is that Dutch taxation has had much more favorable treatment for profits from real estate sales. This is not considered an aggressive tax planning but a routine arrangement to save company and its shareholders from taxes.

say “that the answer depends on our view of CSR” but I still have some doubts if this view really “depends on our view of the corporation”.

I hope I am not too cynical when I ask if corporate social responsibility really is justification for companies to be “happy taxpayers” (which is quite a rare phenomenon in commercial community). Besides that I must say that as much I appreciate professor Avi-Yonah’s analysis of the three competing (or sometimes completing) views of the corporation they do not get much attention on the management floor or in the boardroom where the relevant decisions are made. Sometimes it is even questionable if the CSR gets enough attention there but my understanding is that companies do not really see taxation as a CSR issue. Instead, taxes are recognized merely as a standard cost related to profits, the specialty of which is that it is sometimes avoidable or at least possible to reduce by tax planning.⁴

This being so, the question for management and for board members is, why should we give shareholders money to the state if we have a legal way to operate without doing so and if we can minimize the tax burden without taking too much risk. From the boardroom point of view this is far from being a simple “transfer value from the state to our shareholders”-scheme as the board faces a question of acceptable ways to make profit and risks related to them. There are several types of risks (litigation, reputation, financial and criminal sanctions, *etc.*) connected to aggressive tax planning and every board has to balance the pros and cons when adopting strategic tax decisions. A workable starting point for this discussion is: if you are not ready to disclose it and make it absolutely transparent you usually shouldn’t use it. If tax designing seems to require exemptions from standard financial reporting the company is quite certainly on the grey area and it should just step back and accept taxes as a standard cost.

1. Our Understanding of CSR

Even though corporate social responsibility as such has been a subject of discussion from early 1960s only,⁵ the phenomenon as its self is much older. As soon as large industrial companies begun to emerge, they took some concern for the living conditions of their staff. Although we may have doubts if this really was concern for the welfare of the staff or concern for the availability of the staff, it appeared in forms which are common for genuine social responsibility. Companies or their owners built houses, schools and hospitals, hired teachers and nurses and so on. Sometimes this was based on pure economic rationales as it was the only way to guarantee the availability of the workers, sometimes it was real paternalism of socially-aware or

⁴ Tax liabilities are in most cases among the three or four largest groups of operational costs of companies and all tax-related information is hence essential for shareholders, creditors and investors to understand the performance of the company. This being so, the disclosure and transparency of tax-arrangements are essential from the corporate governance point of view but this does not as itself justify any CSR-related obligation *e.g.* to avoid aggressive tax planning.

⁵ See FRIEDMAN, Freedom and Capitalism (1962). Paradoxically enough from our present viewpoint, Friedman only recognized one social responsibility for the corporations: to generate profits for the benefit of shareholders.

religious industrialists but whatever the reasons, they caused action easily recognizable as social responsibility.⁶

Social responsibility as its current form, responsible behavior instead of pure wealth maximization, only emerged from 1970s or 1980s. When analyzing the business community understanding by CSR Vincent Commenne⁷ has found six different levels:

- At the first level, being responsible means respecting the laws of the country where the company operates and providing jobs. The rules are formulated by the government and followed by the company.
- At the second level, which Commenne characterizes as being “marginally higher up the scale”, some amount of charity is added but otherwise there’s no real difference to level 1.
- At the third level, companies adopt a negative criteria which means that they are not doing real harm, *i.e.* do not pollute too much, do not exploit the natural resources too much, do not product harmful products or at least do not try to hide the harmful effects of those.
- At the fourth level, companies commit themselves to positive actions *e.g.* by integrating environmental management to their line operations or by recruiting underprivileged employees.
- At the fifth level, companies adopt global responsibility by using higher than demanded standards for working conditions, wages, pollution and so on. One typical example in Western Europe is to have a social audit or some similar mechanism for the production chain which starts from developing countries to guarantee *e.g.* the non-use of child labor or the minimum standards of working conditions.
- At the sixth level there are no “normal” commercial companies but only those created to practice societal responsibility in partnership or at least in common understanding with NGO’s or other societal actors.

The “official” European definition is somewhere near the fourth level as the European Commission defines CSR as “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis”.⁸ This is far from enough for the NGO’s, which tend to claim for much more far-reaching commitments as well as regulatory European approach on CSR. The minimum standard acceptable for these NGO’s is that companies must respect international human rights treaties, International Labour Organization’s conventions, international environmental agreements and national laws. The real concern is on conditions in the developing countries as these minimum standards are usually less demanding than the legislative obligations in

⁶ See in general COMMENNE, *Economic Actors’ Participation in Social and Environmental Responsibility* (2006).

⁷ COMMENNE, *id.*, at 64-66.

⁸ EUROPEAN COMMISSION, *Corporate Social Responsibility: Encouraging best behaviour*, June 15, 2006 (*see* http://ec.europa.eu/enterprise/library/ee_online/art11_en.htm).

the European Union or in other industrial societies. Saying this I am aware of national tensions in many industrialized countries as well as national or local criticism against job reductions, factory closings, *etc.* In these discussions we hear loud and demanding arguments saying that those are against company social responsibility but I consider these as national or local politics which should be kept separate from real and global corporate social responsibility.

All this means, that the commitments of the business community and the expectations of the NGO's are far from being common or even having common ground. The European Commission and many European governments are willing to follow the attitudes of the business community as their main concern is on the economic growth and on the competitiveness of European or national companies. But this is not the issue in this context and I only brought this up to show that taxation is not a "traditional" CSR issue and being a good taxpayer is not recognized as a CSR action in the current discussion of the CSR. This means that it is not only companies that do not recognize taxation as a CSR issue but that this has been the attitude of governments and NGO's as well.

2. From Social Responsibility to a Happy Taxpayer?

As CSR is tightly related to moral arguments, it is easy to say that the companies should follow their CSR-obligations but this does not by definition mean that companies are obliged to follow those obligations. If such an obligation exists, it is moral, not legal. Besides that, the main focus of the social responsibility in the global business environment is clearly on reaching some minimum common standards. Following those standards is most often supposed to mean that companies accept the responsibility in improving working conditions, stopping pollution, promoting better education and in general promoting sustainable development in developing countries.

It is pretty easy to say that these goals are generally accepted and get their justification from this acceptance. It might even be legitimate (although probably impossible to give any water-tight proof) to say that due to improved customer satisfaction or decreased risk of customer reactions responsible behavior will in the long run increase profits despite the fact that such behavior most certainly means immediate costs and therefore decreases short-term profits. This, in fact, means similarity or at least likeness with investment decisions as the expectation of future profits exists. For managements and boards this is essential as their primary task is to create value for shareholders. As I see it, the value creation is not and needs not to be synonymous with maximization of short-term profits but the target should be set to enlightened and long-term value maximization as defined by Jensen and as adopted into the new Companies Act of the U.K.⁹ If the management and the board work for enlightened value maximization they don't only have a permission but do have an obligation to

⁹ U.K. Company Law Reform Bill, Explanatory Notes (2005), ch 324, Guidance (2005), ch 10 and 62. The concept originates from JENSEN, Value Maximization, Stakeholder Theory, and the Corporate Objective Function, 14/3 Journal of Applied Corporate Finance 8, 9 (2001), who stresses the importance of stakeholders for the value maximization.

take stakeholders into account as this is elementary for the maximization of the shareholder value.

However, it is not acceptable to try to misuse this acceptance by expanding the use of the label “CSR” to other areas without some justification. If we try to build such justification we must firstly keep in mind that paying taxes has not been recognized as a primary CSR-obligation and I am not sure if it is even a secondary one. Secondly it should be noted that tax planning or strategic tax behavior are normally considered problematic by the state only (the one losing cash flows from taxes) and other stakeholders seldom react to it. Thirdly this means that it is extremely difficult to claim that a company is promoting the enlightened value maximization by voluntarily paying taxes as it is quite difficult to see the connection between short-term cost and expected long-term profit. Instead, taxes are treated as standard costs which companies should minimize whenever that is possible by legal means.

Therefore, and although it is self-evident that every government is keen to collect taxes whenever that is doable, my conclusion is that taxation should not be discussed as a CSR issue nor as engaged to the enlightened value maximization. For companies, taxes are primarily costs and most often nothing more than costs. For shareholders, more costs means less profit and less added value for their investments. For other stakeholders (except the state) taxation is neutral unless it has effects on their specific stakes. From the management and boardroom point of view there should be some added justification to claim that “it is never justified in pursuing tax strategies that have as their only goal minimizing the corporation’s tax payments to the government”. Otherwise, and if this is a moral argument only, the managements and the boards are allowed to use every legal way to reduce the costs. There is no “shall” but “should” only and it is quite often a weak argument.

It is very easy to agree with professor Avi-Yonah’s conclusion as he says that “it seems crucial to leave corporations free like private individuals to attempt to address problems not of their own making”. Still, and while agreeing with this it is essential to keep in mind that corporations are not private individuals but organizations managed by individuals. Those individuals (managers and board members) are trustees for shareholders primarily and have to listen to them and respect their opinion. Despite exemptions the general message from the global investor community is clear enough: make profit and create value. Otherwise you should expect to be sacked and substituted by somebody willing and capable of doing that. That is basically the rationale for decisions which aim at reducing the tax burden and it is without doubt a tough task to create a moral argument (be it named as social responsibility or something else) to outweigh that rationale in boardroom discussions. To make the international investor community convinced of that rationale would be a real challenge.