Good Corporate Governance: The Tax Dimension

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Increasingly, the OECD and its member governments have recognized the synergy between macroeconomic and structural policies in achieving fundamental policy goals. Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders.

Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and society at large. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy.

Corporate governance is only part of the larger economic context in which firms operate that includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, tax, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates can also have an impact on its reputation and its long-term success.

The recent attention to corporate governance questions has raised some important issues concerning the interaction of corporate governance and taxation issues. Most of the corporate governance discussion has centered on the appropriate regulatory framework for establishing the principles of corporate governance. Thus consideration has been given to corporate law questions, regulatory and disclosure practice, principles of ethical conduct and the like. However, there has been relatively little attention paid until recently to the relation between corporate governance and tax rules. This means that tax and governance principles can sometimes be operating in an incoherent fashion.

These issues have recently been highlighted by a series of corporate scandals in the U.S. and Europe and by the aggressive promotion of tax shelters by some large accounting and law firms.

Tax and corporate governance issues can intersect in several different contexts. One set of issues is how to ensure that tax does not encourage behavior that is con-

[*] This article expresses the views of the author and does not necessarily represent the OECD or its members.

trary to the interest of the company and/or of its shareholders. Another set of issues is how to ensure transparency and quality of management decisions in the tax area. In particular, it is important to ensure that the board, shareholders and other stakeholders are aware of the stakes that are involved in the management of taxes. Both sets of issues are briefly discussed below.

1. Putting Tax on the Corporate Board's Agenda

Good corporate governance principles should extend to the corporation's attitude towards its tax liabilities. This is not a question of whether or not a corporation should seek to minimize its tax burden, but more an issue of the board's responsibility to assess the financial and reputation risks associated with any particular tax strategy.

Aggressive tax planning can create significant financial risks (adjustments and penalties). It can also create risks in terms of reputation (*e.g.* in cases of fraud as can be seen for the recent Enron case). It is a striking fact that while taxes often represent a very significant portion of a company's profits and potentially huge risks (tax adjustments may sometimes lead a company to bankruptcy), there is generally, in practice, limited involvement of the board and even more limited involvement of the shareholders in the management of a corporation tax strategy. A recent survey of business suggested that less than half of boards systematically carry out a formal strategic review of their tax strategies and yet many companies surveyed acknowledged that the risk of being challenged by the tax authorities on issues related to transfer pricing or tax havens or activities which are primarily directed to reduce tax was increasing.[1]

Some have argued that the board needs to formally endorse the tax strategy proposed by the tax directors; others that the CEO should sign the tax returns and yet others that tax returns should be publicly available. It is clear that governments are more and more convinced that encouraging responsible corporate tax behavior, combined with providing a better service to taxpayers, is the only effective long-term strategy to promote good compliance.

The duty of a company's auditors to review tax liabilities, tax assets and tax risks is also an issue which connects corporate governance and tax issues, including the extent to which auditors themselves should be permitted to give tax planning advice.

In some companies, tax managers and/or tax advisors are remunerated as a percentage of the decrease in the company's consolidated tax bill. One area that might be worth investigating is whether such remuneration policies can be compatible with good corporate governance and if so to what extent. For example, should they be specifically disclosed to the board and to the shareholders?

What is clear is that the recent spate of corporate scandals, the success of a number of tax administrations in challenging aggressive tax schemes and the general change in attitudes towards tax planning, will all combine to produce a greater awareness in the boardroom of the importance of tax issues.

[1] *See* Henderson's Global Investment Summary.

2. Ensuring that Tax Rules Do Not Encourage Behavior that is Contrary to the Interest of the Company and/or its Shareholders

In general, the effect of tax rules can be either to increase or lighten the after-tax cost of certain types of conduct, depending on the structure of the rules. The tax rules can thus have an implicit regulatory function which is similar in some respects to rules which are directly focused on corporate governance issues. This can happen in a number of different situations.

Some tax rules are aimed directly at corporate governance issues. For example, as a result of the OECD's work on the bribery of foreign officials all OECD countries tax systems deny a tax deduction for bribes and other illegal payments, thus increasing the cost of such payments. Similarly, in some cases deduction is denied for certain types of corporate expenditures such as so-called "greenmail" payments made in connection with corporate takeovers. In other cases, there is a limit on deductibility of executive compensation, again raising the after-tax costs of such payments.

Rather than making certain types of corporate conduct more expensive with the intention of restricting the conduct, some tax rules are aimed at encouraging certain corporate behavior. The most obvious example is the deduction for charitable contributions by corporations, which functions as a governmental subsidy for the private support of designated projects and activities. Favored tax treatment of certain kinds of employee benefits such as employer-provided health care, retirement benefits, child care, educational costs and the like are other examples.

In other cases, the impact of tax rules on corporate governance is more indirect. The tax rules for certain transactions, responding to tax principles and considerations, are often structured without taking their impact on corporate governance issues into account. Thus, for example, the tax treatment of employee stock options, determined simply by applying tax principles, can have an impact on the structure of executive compensation and, in turn, on executive behavior in ways which might be important from a corporate governance perspective. The granting of extensive stock option plans may, for example, encourage individual employees to behave in a manner which is contrary to the interest of the company and/or of its shareholders.

Another type of interaction is involved when certain forms of income are given preferential tax treatment. Some tax systems give preferred treatment to income in the form of capital gains on shares, as opposed to dividend distributions. In these circumstances, when problems of corporate performance arise, there might be an incentive for shareholders to avoid adequate monitoring of corporate management. The existence of a preferential tax rate might be one of the factors contributing to make it simpler and cheaper to just sell the shares at the preferential rate rather than trying to improve corporate conduct. The payoff for increased monitoring is an increased dividend stream which is more heavily taxed than the capital gain. Thus "flight and not fight" conduct might be encouraged indirectly by the tax rules at the expense of appropriate corporate governance practices by creating divergent interests between the shareholders (who might want to limit the immediate costs) and the company (in the longer term). There are several important academic studies which look at the empirical effects of preferential capital gains taxation on shareholder propensity to sell rather than monitor.

Tax considerations may in some instances encourage management to make fiscal decisions on behalf of the shareholders that are contrary to the longer term interests of the company. Thus, for example, issues arise in the context of business reorganizations where the tax treatment of termination costs may in some instances encourage shareholders to decide in favor of plant closures, irrespective of the longer term interests of the company and other stakeholders.

There is a similar issue with respect to the impact of the general system of corporate-shareholder level taxation on corporate governance. In a so-called classical corporate tax system, where income is taxed both at the corporate and shareholder levels, there is pressure to retain the income at the corporate level rather than distribute it as dividends and thus incur a second layer of tax. This results in several pressures which are relevant to corporate governance questions. The company is freer to make investment decisions with respect to the retained funds which are not subject to direct market discipline. If the funds were first distributed to the shareholders, who would then have the ability to decide whether to reinvest in this company or another company, a more efficient allocation of funds might be achieved. The extra tax burden on distributions discourages distributions, encourages retentions and may, in the long run, make a corporation less accountable to its shareholders.

Tax and financial accounting and income reporting rules also raise corporate governance issues. Companies in some instances might try to inflate corporate profits for financial accounting purposes. If the financial accounting rules are also used to determine profits for tax purposes, with a resulting increased tax cost, the tax rules can act as a deterrent to profit manipulation. On the other hand, in some cases, the essentially conservative nature of financial accounting rules, aimed at the protection of creditors, may not be appropriate for determining the government's current share of the company's operating results. Thus it is important that the interaction between tax and financial accounting rules be examined in the context of any review of corporate governance.

3. Conclusion

There are many other interconnections of tax and governance issues but this brief list should be sufficient to make clear that any serious consideration of corporate governance must take into account the tax dimension.