

THE PENTOLOGY

VOLUME 1

CORPORATE TAX ETHICS

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Chapter 1

The Ethical Tax Framework

1.1 Introduction

What is perceived as ethical by one generation or indeed a different society in the same generation may not be perceived as ethical to the next.

Who would argue today that the capturing and enslaving of free people in their homeland to labour a lifetime in a foreign country under appalling conditions is somehow acceptable? Similarly, the suggestion of returning to a system that denies the democratic vote for women or requires women to give up their careers on marriage would be equally abhorrent today to every schoolgirl. Yet, these views were entirely conventional in the days of our grandparent's grandparents.

In business, the minimum wage, safe working conditions, annual leave, sick leave, redundancy payments and the provision of savings for retirement

were all heavily resisted at the time of proposal. Today, they are considered to be the basic rights of all employees in advanced societies.

In today's increasingly transparent Internet world, businesses and their officers are under increasing scrutiny and therefore increased pressure to ensure that ethical behaviours generally are promoted within their corporate cultures. In the case of companies operating in more than one jurisdiction, the Multinational Enterprises, the pressure is even greater due to the reality of different laws and societal values applying in each jurisdiction in which the Multinational Enterprise operates.

For example, most jurisdictions advanced in the corporation law are moving towards establishing strong positions against "corruption" by banning all forms of financial incentives or "bribes" to secure business contracts. Other cultures may simply view such payments as being in the nature of goodwill and are entirely acceptable. An ethical approach would be to adopt a global prohibition on anti-corruption while a more aggressive approach would be to secure contracts through independent agents familiar with "local customs".

Another example relates to variation in environment protection standards where most advanced jurisdictions will apply strict rules in relation to industrial emissions while less advanced jurisdictions do not. For those old enough to remember, the industrial catastrophes of Bhopal in India in 1984

(over 500,000 people exposed to methyl isocyanate (MIC) gas and other toxic chemicals.) and Chernobyl in the former USSR in 1986 (nuclear power station meltdown followed by uncontrolled radiation release over much of Europe), the need for tighter emission controls is entirely self-evident.

Nevertheless, international businesses continue to readily seek low cost industrial “solutions” under typically less regulated circumstances in third world countries weighing reputation risk against potential financial gain.

A more contemporary example of poor corporate ethical behaviour was Volkswagen’s choice to design, build and sell eleven million diesel motor vehicles that “cheated” United States and other environmental protection standards in respect of motor vehicle emissions. As the United States correctly opened a criminal investigation into Volkswagen on the discovery of the deception, Chief Executive Martin Winterkorn offered his “deepest apologies” and stated that he would be “ruthless” in getting to the bottom of the scandal, further stating that the “irregularities contradict everything that our company stands for”. If it did, the manipulation would never have occurred. Most people would probably believe that Herr Winterkorn should have instead at that time offered his resignation and soon after he did under public pressure.

All these outcomes, whether positive or negative, *are the subject of choices or decisions* made by Directors

on Boards and their operational management. Ultimately, there is a clear choice for such officers to act ethically or to act otherwise. Equally, the Lawmakers in every Government of the world have the capacity to also make a choice whether to allow such unethical behaviours or not. In this regard, the control to act ethically or not in the corporate context firmly rests with the independent decision-making of these executives and the Lawmakers.

It is the basic premise of the Pentology that ethical outcomes and behaviours are the product of a conscious decision making process.

1.2 What is Tax Ethics?

In his 1969 book “Adventures in Tax Avoidance”, Peter Clyne included the following comments in his introduction

“Tax avoidance has become too sophisticated for such a book to be written with any sense of responsibility. It is a game played by experts, locked in perennial battle with the revenue authorities. No one ever wins or loses. There are no certain answers, no clear cut instant solutions”, and further:

“so this book will help you to view the battle ground, understand the weapons used, and enable you to glance at some of the hills that yet remain to be conquered. You may both find this profitable and fascinating”.

Clyne made the world of tax avoidance seem so alluring, so tempting, that one could just imagine

oneself driving a luxury sports car along the coastline of a tropical tax haven to a sprawling villa purely funded by one's brilliant tax practices and advisers leaving a befuddled Revenue Authority in one's wake.

For a while this may well have been the case, but the world of tax has changed considerably since then.

Firstly, the taxation law itself has evolved vastly in favour of the Revenue Authorities since 1969 backed by Lawmakers, with the introduction of general anti-avoidance provisions, specific tax loop hole blocking legislation, risk assessment of taxpayers and greater duties on Statutory Taxation Officers signing off on the tax processes of companies.

Secondly, the Revenue Authorities have become increasingly more knowledgeable of the internal taxation practices of companies and tax advisory firms by way of the introduction of senior staff *from both*.

Thirdly, the introduction of Internet based search engines and data analytics has profoundly increased the Revenue Authority's capacity to identify inappropriate tax behaviours by companies and individuals.

Fourthly, international pressure has mounted on countries conventionally known as "the tax havens" that essentially peddle tax incentives *without any other economic motive such* as the development of new businesses to generate employment for citizens.

Clyne's practices are now largely considered outdated in terms of current norms, but there are still firms that continue to encourage aggressive tax practices as "smart" or "well worth the risk".

It is the view of the Pentology that these practices *are neither smart nor worth the risk* and will on average result in an economic loss to an organisation pursuing such practices, rather than the expected windfall tax gain.

There was a momentary temptation to name this volume of the Pentology "Adventures in Ethical Tax Behaviour". In the end, it was a clear decision to approach the tax function more like a civil engineer by providing the building blocks from which to build a certain taxation position for those organisations or companies wanting to operate ethically from a tax viewpoint.

For the purpose of this book, tax ethics is simply the choice to work on an ethical or no risk tax basis.

Like Clyne, it is hoped that the reader will find this both "*profitable and fascinating*".

1.3 Why a Principles Based Approach

The taxation law in almost all jurisdictions has now become so complex that a full technical examination as it applies to any particular commercial situation will likely be so lengthy as to confuse the initial

purpose of the work. For example, the entire income tax law in 1936 in Australia was less than 100 pages. Today, a Public Ruling in Australia is likely to be of this length or more.

Further, *a principle* will be likely more easily understood than the taxation law that applies to it. A case in point is the “arm’s length” principle under the transfer pricing law. The principle essentially requires that international related parties conduct their international related party transactions arrangements as if they were trading independent of each other. However, the taxation law and rulings in Australia currently runs to over 2,000 pages. When a company officer is dealing with operations in multiple jurisdictions, the analysis becomes even more complex.

Technical taxation detail should be addressed by either internal or external taxation specialists and, as a result, commercial actions determined. However, what is important for *company officers* is that they are in a position to understand a principle and then ask the appropriate taxation question that pertains to it.

For example, the Stamp Duty or transfer duty implications on a major acquisition may be complex due to the array of assets, intellectual property and financial obligations to be transferred and should be addressed by a specialist experienced in that area. However, the relevant question for the Company Officer is simply “What are the transfer duty implication for this acquisition”? It is simply a case of

the right question being worth more than a thousand *wrong* questions.

One *extremely* important objective of the Pentology is to open up the debate on how the *global society* should address *aggressive tax practices* and encourage the introduction in to law of *ethical tax practices* through *ethical tax regimes*. This is not just an issue for the Lawmakers or their constituents, the accounting or legal professions or the universities that train them, or indeed the “Western” or democratic nations. *Everybody* in some way is negatively affected by the outcomes of aggressive tax practices, except those who *choose* to seek financial gain from such practices *to the cost of mankind!!*

From a social conscience viewpoint, what elected Lawmaker would have the moral turpitude to argue *in public* that a nation’s foreign aid program to provide housing and education for war orphaned children in Africa should be scrapped to allow the *maintenance* of aggressive tax behaviour by billionaires and global corporates. Yet, this is precisely what is happening in practice. Answering a clear need for education in respect of ethical tax practices is also an important objective of the Pentology.

Although perhaps with a touch of wishful thinking, I would like to allow the proverbial “10 year old” to understand the concepts contained in this first volume of the Pentology and form his or her own view in the hope that such 10 year olds will be

inspired in some way to grow up and one day change society for the better. In the meantime, I encourage the parents and teachers of those 10 year olds to do the same as my parents and teachers did for me and to encourage ethical thinking.

Nevertheless, some concepts will be explained in unapologetically simple terms to broaden the potential readership and awaken social conscience at the risk of offending the intelligence of those who are more technically minded. The reader will also observe that the Pentology will not contain a single footnote for exactly the same reason.

1.4 Taxation Risk

For the purposes of the Pentology, taxation risk is defined simply as any negative consequence arising from non-compliance with the taxation law including financial costs and reputation risk.

It is important to recognise that there are more than just financial costs as downside risks to non-complying or aggressive taxation behaviours.

The focus on reputation with respect to the conduct of taxation matters by organisations has become increasingly important in modern times for at least three reasons.

Firstly, many Revenue Authorities around the world now focus on risk ratings for *at least* corporate taxpayers and high net worth individuals and will

increase audit activity and other risk-rated surveillance for such perceived non-complying taxpayers.

Secondly, the public's growing general awareness and lack of acceptance of aggressive tax practices through the Internet and other popular forms of mass communication has forced a retreat (or at least a rethink) on such aggressive tax practices by major corporates and high net worth individuals.

Thirdly, the growth of risk management practices has also meant that reputation risk is commonly identified by major corporates as a key risk with rigorous procedures and controls designed to protect the organisation from any potential matters that could damage its reputation including adverse tax outcomes and aggressive tax behaviours.

It is clearly arguable that the promotion of "ethical" tax behaviour by an organisation or major corporate carries with it not only commercial cache, but also the ability for company officers (and perhaps high net worth individuals who may own them) to sleep soundly at night knowing that there are no tax risks about to haunt them on their awakening. In the limited lifespan we are all subject to, these benefits should not be ignored.

1.5 Who is a Company Officer or External Stakeholder

A primary objective of the Pentology (but not the only objective) is to assist Directors of companies and external stakeholders in understanding the processes supporting an *ethical* approach to taxation and the consequences (costs and penalties) resulting from an *aggressive* style of tax management.

Any officer of the company involved in the taxation process must understand the broad principles of the company's tax policy or Board Tax Mandate and how it applies to their job responsibilities.

This would apply to the Managing Director, the Chief Financial Officer, the Head of Internal Audit, the Chief Risk Officer, the Group Financial Controller and the Head of Tax and their direct staff due to their responsibilities. However, there are many other roles within a company requiring consideration of the tax process in accordance with the company's tax policy.

This is not restricted to just senior roles such as a Head of Acquisitions role or Head of Distribution, but may also extend down to the most junior secretary charged with properly coding her bosses expense claim on business travel.

In this respect, it is important that all roles *within the company* involved in the taxation process be duly recognised and factored in to the company's ultimate approach to taxation.

There are other interested parties or external stakeholders to the organisation who will have either

a *financial* interest and/or a *possible* moral or legal interest on the choices made by the organisation in respect of taxation matters. These include current shareholders of the company, potential shareholders or investors in the company, financial institutions that are currently lending or considering the lending of monies to the company and a range of regulators. It is important to recognise that such external stakeholders will or should be concerned about any form of poor corporate tax behaviour as an indication of wider indiscretions within the company, a point that should not be lost on the Directors of the company.

1.6 Basic Elements of an Ethical Tax Approach

There are essentially four key elements to an ethical tax approach being:

1. Operating within the taxation law with appropriate support from external tax specialists whether they be conventional or ethical;
2. Working with the Revenue Authorities and Regulators on matters where clarification or certainty is required;
3. Lobbying for changes to the taxation law with Regulators or Policy Makers where considered desirable or where clarification from Revenue Authorities could not be obtained;
4. Not accepting any risk to reputation by way of tax matters.

As will be advocated throughout the Pentology, conducting a company's tax affairs in an ethical or conservative manner does not mean a negative financial outcome. An ethical approach, if appropriately followed, will result in:

1. The elimination of tax penalties, penalty interest and interest on late payment;
2. Reduced fees from external advisers
3. Reduced costs on tax audits and other engagements with the relevant Revenue Authorities;
4. The elimination of court costs;
5. Financial gains through lobbying;
6. Financial gains through reduced internal resources being spent on tax matters;
7. Financial gains through optimising "intended" tax benefits as opposed to "unintended" tax benefits.
8. No short term or long term downside "surprises" for Boards

The next question is how to integrate these basic principles into the normal operating procedures of an organisation or company. This is explained throughout the Pentology.

1.7 Aggressive Tax Behaviour

Aggressive tax behaviour is simply an approach to taxation that is not ethical and introduces tax risk.

At its extreme, aggressive tax behaviour includes tax fraud, however, there are many circumstances less

than tax fraud such as reckless indifference or negligent behaviour that will introduce tax risk for a company.

It is arguable that failing to set an appropriate tax policy and not advising one's external advisers about a company's risk tolerance when seeking advice is bordering on negligent behaviour but it certainly should be regarded as loose tax practice. While there is a duty to advise on tax risks for advisors, the matter in terms of its importance is underlined from the company's viewpoint by clearly articulating its tax policy – particularly if it is an ethical tax policy!

For example, if a senior staff member presents as legitimate advice an “advocacy piece” on a taxation matter before the Board, this could introduce tax risk as the opinion may not be correct. In such circumstances, it is important that the Board make reasonable enquiries as to the true basis for the advice and, if necessary, independent advice sought. Merely accepting external advice without any internal review introduces tax risk for the same reason.

Clearly, neither seeking external advice, nor internally raising the issue, would be reckless.

Further, poor tax risk management and governance practices can result in a taxpayer being viewed or categorised as taking an *aggressive* tax approach by the Revenue therefore increasing its tax risk rating. The taxpayer must take care in this regard.

1.8 The Mathematics of Tax Certainty

While probably beyond the day to day focus of a tax specialist or a company officer dealing with complex tax matters, an interesting question arises as to the relationship between ethical tax behaviours and the resultant financial outcome. As mentioned earlier in this introductory Chapter, it is the premise of the Pentology that ethical tax behaviours will produce a financially profitable outcome over time and over a level playing field.

This operates on the assumption that all taxpayers will commence at a baseline tax liability position and take advantage of tax benefits intended by the tax law such as investment allowances or research and development tax concessions.

The ethical taxpayer will then work with the regulator on uncertain positions or promote changes to the taxation law which only means a potential upside tax position.

The aggressive taxpayer will pursue his legal avenues, but will risk only downside positions in the event of a loss that includes penalties, penalty interest and loss of reputation.

As with the tax avoiders of old, the aggressive taxpayer will initially have the illusion of success that may represent an opportunity for short-term internal political gain. However, this should properly be considered as a potential tax liability and

appropriately recognised and reported as such under the accounting standards in the company's accounts.

Penalties, penalty interest, interest and loss of reputation do not occur where a taxpayer has chosen the ethical or no risk or ethical path and hence represent a permanent difference between the two choices.

This carries important implications for Lawmakers, which will be discussed later in this book.

