The Search For A Tax Ethic

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The need for a tax ethic

In recent years, the tax policies of corporations have come under the spotlight. There are many critics of tax avoidance, which is the use of loopholes to pay less tax without breaking the letter of the law. If corporations do too much to reduce tax liabilities, they are challenged by politicians and by the press.

Corporations can try to defend themselves on each occasion. They sometimes have good defences. But a corporation can also find it helpful to have an overall approach to tax planning, a tax ethic which sets out how it decides what to do. An ethic can guide decisions, to make sure they will be justifiable if they are challenged. A corporation can also publish its tax ethic, to show that it acts in a consistent manner and for good reasons, rather than simply hunting for the best tax-saving opportunities on each occasion.

A tax ethic of this kind governs the taxpayers, the corporations themselves. They are the ones who decide what to do, and what not to do. But professional advisers need to consider their ethics too. Is it acceptable for them to offer the most aggressive tax avoidance schemes to their clients? Or should they refuse to offer certain types of advice?

We shall mainly discuss tax ethics for corporations. But having done so, we shall set out a way to derive ethics for tax advisers from ethics for corporations.

What a tax ethic must do

A tax ethic must set out a general approach to the ethical aspects of decisions with major tax implications. What ethical guidance will a corporation apply when it decides how to structure new sources of finance, where to hold its intellectual property, or how to expand into new countries? An ethic might, for example, recommend that a corporation should attach special weight to the need for developing countries to secure their tax revenues. Or it might recommend paying a reasonable amount in tax in return for using the educated workforce, and the infrastructure, of each country where the corporation operates. Or it might say that a corporation should take care not to pay so much tax that it would have to close some operations, and throw people out of work.

We should look for a tax ethic that sets out general principles, rather than one that works mechanically to give an answer to the question "what should we do?" on each separate occasion. Business life is too complicated for mechanical computations to give sensible answers every time. There needs to be space to exercise judgement. At the same time, the principles in an ethic need to be strong ones, and they need to be applied firmly. If they are weak, the ethic will give very little guidance. And if they are not applied firmly, the ethic will make little difference to what a corporation does.

There is another reason why the principles need to be strong and applied firmly. Part of the job of a tax ethic is to allow a corporation to answer those who criticise its conduct. Shareholders may criticise a corporation for not taking reasonable steps to reduce tax liabilities. Politicians, pressure groups and the press may criticise it for going too far in reducing its tax liabilities. If a corporation can show that it only takes decisions after serious ethical reflection based on clear principles, it is likely to have good answers to its critics. But if the principles are not at all demanding, or if there is no serious consideration of whether transactions might be unethical, critics will not be impressed.

Possible contents

If we list some possible contents of a tax ethic, it can help to give us a clear idea of our goal. The following list is only a small sample. Some of the items mentioned may be omitted, and other items, not listed here, may be included. The aim is only to lend some definiteness to the discussion.

(a) A corporation should arrange its tax affairs so that if information about those affairs appeared in the press, the corporation would be able to justify its actions by disclosing full details of all of its tax affairs, and then explaining the reasons for its actions.

(b) A multinational corporation should not use a tax scheme that succeeds only because tax authorities in different jurisdictions have limited rights to information, meaning that no one authority can see the full picture.

(c) A corporation should not use a tax scheme that would obviously have been blocked by lawmakers, if they had considered it when they were passing the relevant laws.

(d) A corporation should not exploit a developing country's economic weakness when negotiating what tax it should pay.

(e) Tax burdens should not be reduced to a level that could be regarded as taking advantage of a country's infrastructure, workforce or natural resources by not paying adequately for the resources used.

(f) A corporation should take care not to disadvantage its shareholders by failing to negotiate robustly with tax authorities on matters of fact that affect tax liabilities.

Sources of a tax ethic

A tax ethic should not simply be one that a corporation finds convenient. It will only help to justify a corporation's decisions, if its contents are themselves justifiable. We need to find some general approach to ethics that is widely recognised as sensible, and that can guide corporations in formulating their tax ethics. Fortunately, that is not difficult. On the other hand, no general approach is perfect.

Utilitarianism

One approach that is very widely accepted is utilitarianism. This is the view that we should act so as to promote the greatest happiness of the greatest number of people.

By itself, this approach is not however enough to guide a corporation. On the one hand, a corporation might recognise that the happiness of the general population required plenty of tax to be paid to fund schools and hospitals, and that the increase in happiness from paying it would be greater than the decrease in the happiness of the corporation's shareholders. Then the corporation should not try to save tax. On the other hand, a corporation might reason that the best way to increase the happiness of the population would be to have a flourishing private sector, with plenty of economic growth, and that the best way to achieve that would be to keep as much money as possible in the private sector. Then the corporation should try to save as much tax as possible.

Utilitarianism can also recommend conduct that looks as though it is completely unacceptable. Suppose that a corporation is desperately short of cash, and can only survive by making a false claim for a tax refund. If that would mean thousands of people keeping their jobs, instead of becoming unemployed in the middle of an economic depression, there would be a utilitarian argument for making the false claim. But most of us would still think that it would be wrong to do so.

Utilitarianism may therefore both leave a corporation without adequate guidance, and lead it astray. We should consider combining utilitarianism with another approach.

Virtue ethics

The idea of putting virtue at the centre of ethics goes back to ancient Greece, and particularly to the work of Aristotle. A virtue ethic does not give us a list of things to do in specific situations. Instead, it says we should have certain virtues, such as courage and honesty, so that when we find ourselves in ethically demanding situations, we act in ways that are appropriate, and that can be justified.

This looks ideal for our purposes. The emphasis on having virtues, and on thinking appropriately in each situation when it arises, gets us away from a mechanical procedure that would simply prescribe an answer. And we should also be protected against doing things which might seem good in utilitarian terms, but which strike us as wrong, like making a false claim for a tax refund so as to stay in business. We would instead see such actions as contrary to virtue.

Virtues are, however, usually thought of as virtues of individuals. It is individuals who are courageous, or honest. How can we extend this idea to corporations, which do not lead human lives?

We need to borrow from the tradition of civic virtue, a tradition that goes back to ancient Greece and Rome. It emphasises the fact that we need to behave in certain ways, if a society is to hold together.

Much of the emphasis in this tradition has been on forms of government, and on ensuring that people do not become subject to arbitrary power. For that reason, the tradition is also known as the tradition of republican virtue. But there is also a strand of thought that emphasises the virtues that are needed to make a society flourish. People must be willing to make their contribution to the good of their society.

We can use this strand of thought, but it was not developed for the modern business environment, so we do need to modify it to suit our purposes. What follows does not derive entirely from the historical tradition that lies behind the notion of civic virtue. But we can still use ideas from the tradition to help us to justify contents of a tax ethic. We can use a concern with making a society flourish in two ways.

The first way is this: The virtue of honesty is one that needs to pervade the whole of society. If it is practised by individuals, but not by corporations, it will not have its beneficial effect of allowing us to interact without a constant fear that we may be cheated. We must all have dealings with corporations, and we need to be able to trust them, just as we need to be able to trust individuals. The level of honesty required goes beyond merely giving correct answers to questions that may be asked. It also implies not concealing information that is clearly relevant. This is not just information that is relevant to a specific transaction. It includes information that is relevant to assessing the character of a person, or of a corporation, so that we can tell whether we should have dealings with them. So corporations should not rely on concealment. This would justify items (a) and (b) on our list. (In relation to item (a), there might not be any requirement to disclose information before any questions were asked, but the corporation should make sure that it would be in a position to disclose complete information.)

The second way is this: A corporation should act so as to sustain an environment in which business can flourish. There are ways in which businesses have always done this, since long before tax became significant. It is, for example, essential that businesses stick to their contracts. One business will only agree to supply goods or services to another, if buyers nearly always pay the agreed price. It is clearly in everybody's interests if all businesses display the virtue of keeping promises, and they mostly do so.

We can extend the idea of sustaining the right environment to taxation. Corporations can only make profits in a society in which there is a stable currency, a system of commercial law, protection against theft, an educated workforce and infrastructure such as roads. So if an environment that allows business to flourish is to be sustained, corporations should make sure that enough taxes are collected to provide these things. This could be used to justify item (e) on our list. It would also justify item (f), because corporations will attract share capital more easily if investors expect that corporations will stand up to tax authorities. Every corporation that does not do so encourages officials to be unreasonable with other corporations.

This does still not give us all that we need. There are two main challenges, although the tradition of virtue ethics does suggest responses to both of them.

The first challenge is that we only have an argument for ensuring that enough tax is collected to provide some fairly basic services. This might be less than half of the amounts typically collected in modern welfare states. A response would be to say that it is part of virtue to accept the decisions that a society takes through democratic political processes, and not to subvert a political decision in favour of a particular size of public sector by avoiding tax. This could justify items (c) and (d) on our list.

The second challenge is that if what matters is to ensure that enough tax is collected, what would be wrong with a few corporations using avoidance to pay hardly any tax, so long as the other corporations paid their shares? A response would be to say that it is manifestly contrary to virtue to avoid one's own share of a burden.

The tradition of virtue ethics can therefore provide some guidance when formulating a tax ethic. It does not give us everything we would need. Utilitarianism also has a role to play, because consequences of actions do matter. But the two traditions can be blended quite comfortably, as one reason why ways of behaving are virtuous is that they tend to have good consequences.

Duty, a social contract and fairness

There is a strong tradition that claims that an ethic should be based on the demands of duty. We have certain duties, such as duties of honesty or of helping people in need, and we should perform those duties, simply because they are our duties, rather than because of their roles in allowing society to flourish. We shall not try to use this tradition as the foundation for a tax ethic. If we think in terms of duties that it is right to perform, simply because they are duties, we need the duties to be very well-defined. And if duties are very well-defined, they are not likely to help us to decide what level of tax avoidance is acceptable. There is a well-defined duty to obey the law. But tax avoiders do obey the law, in their own calculated way. The question is, how far should they respect the spirit of the law? It is not easy to give a precise answer to that question, so it is not easy to formulate a duty to respect the spirit of the law that is specific enough to be issued to anyone as a command.

There is a connection between duty and the idea of a social contract, a hypothetical agreement between all of us on how society should be run. This tradition is very important in political philosophy. The idea is that if people can be seen as having made an agreement, they have a duty to abide by the agreement. For example, we have implicitly consented to allow elected governments and legislatures to make our tax laws. Then we should abide by those laws, and we should not seek to frustrate those laws by using clever tax avoidance schemes. We could extend the argument to corporations by arguing that if they choose to do business in a country, they implicitly agree to its social contract. If they do not like the contract, they should not do business in the country.

While this might be a valuable line of thought, we shall not pursue it here. One difficulty is the same as that which arose with duties. It is not clear how much tax planning would amount to frustrating the laws, so a rule precise enough to be a term in a contract could not be drafted. Another difficulty springs directly from the analogy with contracts. If a corporation makes a business contract, it must abide by the precise words of the contract. It is not obliged to do more than the contract says, for example by observing the spirit of the contract. So if the social contract argument were to be used against the tax avoider, we would need an argument to explain why tax laws, considered as contracts between taxpayers and the state, were different from business contracts in this respect.

Finally, there is the notion of fairness. This can be taken in two senses. First, there is a notion of fairness that is linked to the idea of a social contract. If we have entered into a social arrangement, it is only fair that we should comply with its demands on us. When it comes to tax avoidance, this takes us back to the difficulties that we have just discussed. What are those demands? Do they really go beyond what the letter of the law says, and if so, how far beyond it? Second, there is fairness in the sense of paying one's fair share. This would seem to make a case against tax avoidance. After all, how can it be fair for a rich corporation to get out of a tax burden? Other, poorer, taxpayers will have to pay more. But things are not quite that simple. If a corporation reduces its tax burden, the shareholders who benefit are likely to include pension funds and other investment funds that hold the savings of people on modest incomes. And in any case, the idea of fairness is too vague to allow us to reach any agreement on what a fair distribution of the tax burden would be.

Justifying a tax ethic

We have recommended a blend of two general approaches, utilitarianism and virtue ethics, and we have discarded some others. Does this leave us vulnerable to challenges from people who prefer those other approaches?

It does not.

If we can find respectable sources of guidance to use when formulating a tax ethic, and if we find that the ethic yields decisions that are widely regarded as sensible, that will be enough for practical purposes.

This practical attitude seems to leave one question unanswered. Why should a corporation have a tax ethic at all? We have found ways to justify the contents of tax ethics, but that does not answer this fundamental challenge. There is, however, one thing we can say. If there were no business ethics, the environment would not be one in which business could flourish. And it would be quite difficult to argue that business ethics should not extend to taxation.

How should directors decide on standards?

In any large corporation, it is the directors who will have to set the tax ethic. They could make it demanding, or relaxed. How are they to decide?

They cannot take a vote among the shareholders. There will be too many of them, their views will be too diverse, and some major shareholders, such as mutual funds, will act on behalf of thousands of individuals. The directors also cannot rely entirely upon their personal values. As directors, their job is to serve the corporation, not to make the corporation behave exactly as they would behave in their private lives.

One obvious starting point is the views of the business community. There are plenty of business people who disapprove of aggressive tax avoidance, so a decision to listen to the views of business people is not a clever tactic to justify a relaxed ethic. Business people also have the advantage that they understand the pressures on businesses. They know that paying suppliers and salaries, and making a profit, have to come before paying tax.

Beyond the business community, it is sensible to consider the views of politicians, and of the well-informed public. This is partly because a tax ethic needs to be one that can help to justify the corporation's conduct to the wider world, and partly because people outside the business world can offer fresh perspectives. It is, however, perfectly reasonable for directors to disregard views that reflect ignorance of how tax systems work, or that are expressed merely in order to jump on a political bandwagon.

Having considered a wide range of views, directors must make their own decisions. They would fail in their responsibilities if they simply took some sort of average of the views they considered, rather than choosing a tax ethic themselves.

A tax ethic for the professional adviser

We have so far discussed ethics for taxpaying corporations. Can we extend the notion of a tax ethic to professional advisers, in a way that would take us beyond the standard professional ethic of reporting anything illegal to the authorities?

It is possible to do so, but there is an important constraint. The adviser's role is to present options to the taxpaying corporation. The corporation itself must take the decisions. It is not the adviser's job to **tell** the corporation which options it should choose. It is also not the adviser's job to hide certain options from the corporation, because the adviser believes that those options would be ethically questionable.

Having said that, any adviser is free to say at the outset that they will not offer certain types of advice. An adviser can also cease to act for a client if they become unhappy with the choices that the client makes. We need a tax ethic that can give guidance on what limits to set on the conduct of clients.

One way to do this would be to say that an adviser should not act for a client unless the client's own actions were in accordance with a tax ethic that could be defended as reasonable. In this way, we can avoid the difficulty that would come from writing an ethic for advisers as if the tax affairs of their clients were their own affairs. Writing an ethic in that way would confuse the roles of advisers and decision makers. We avoid the difficulty by taking the tax ethics of corporations for granted, and then asking whether those ethics could be defended. An adviser could decide not to work for a client, if the client's actions did not comply with a defensible tax ethic. (Clients would not need to have written out their tax ethics. Advisers could still consider whether the actions of clients were in line with hypothetical ethics that would be defensible.)

This would mean that an adviser would not be tied to a single ethic that they expected their clients to observe. A fairly wide range of tax ethics might be defensible. But the adviser's position would be no worse than the position of any outside commentator on the tax ethics of corporations. We all need to recognise that there are several different answers to the question, "what should a tax ethic say?"