

DECISION SCIENCES INSTITUTE
Tax Ethics for Benefit Corporations

Dov Fischer
Brooklyn College
dfischer@brooklyn.cuny.edu

Michael Kraten
Providence College
michael.kraten@icloud.com

ABSTRACT

Traditional corporations have engaged in tax mitigation schemes that have deprived society of their fair share of taxes. In their defense, these companies have argued that they owe their shareholders the duty to minimize the tax bill under all possible legal methods, even if they do not pass the smell test. Benefit corporations, on the other hand, strive for a higher code of ethics. The purpose of this paper is to outline certain basic tax-avoidance schemes that benefit corporations should avoid. While they may be legal and defensible (by some) for a traditional corporation, benefit corporations should avoid these schemes.

KEYWORDS: Benefit Corporations, inversions, tax avoidance, intellectual property, transfer pricing, and tax ethics

INTRODUCTION

Traditional corporations have engaged in tax mitigation schemes that have deprived society of their fair share of taxes (Zucman 2016, 102). In defense, these corporations have argued that they owe their shareholders the duty to minimize the tax bill under all possible legal methods, even if they do not pass the smell test (Dowling 2013, 182). Benefit corporations, on the other, strive for a higher code of ethics (Saporito, 2015). This article outlines certain basic tax-avoidance schemes that benefit corporations should avoid. While they may be legal and defensible (by some) for a traditional corporation, benefit corporations should avoid such schemes.

Hiller (2013) describes five characteristics of benefit corporations: (1) the purpose of the corporation to provide a public benefit, (2) the independent third-party standard to annually review corporate public benefit, (3) the duties of directors to consider a broader spectrum of interests beyond shareholder profit, (4) transparency, and (5) Benefit Corporation enforceability by means of a benefit enforcement proceeding. Table 1 lists the five characteristics that Hiller attributes to benefit corporations.

Table 1. Hiller's (2013) five characteristics of a benefit corporations

Benefit corporation characteristic		Tax ethics implications	
(1) Public benefit	Purpose of the corporation to provide a public benefit.	Provide public benefits in the form of tax payments to host communities	"a material positive impact on society and the environment" (Model Act, §102)
(2) Third-party standard	Independent third-party standard to annually review corporate public benefit	Not applicable	
(3) Director duties	Duties of directors to consider a broader spectrum of interests beyond shareholder profit.	Broadens the traditional concept of directors' legal fiduciary duties beyond shareholders of the corporation. (Hiller 2013)	
(4) Transparency	Requiring an annual benefits report	Embrace organizational simplicity and avoid complexity	
(5) Enforcement	Enforceability by means of a benefit enforcement proceeding	Not applicable	

We focus on Hiller (2013) characteristics 1,3, and 4 in greater detail as these characteristics relate closely to our issue of tax avoidance: (1) the purpose of the corporation to provide a public benefit, defined as "a material positive impact on society and the environment (Model Act, §102); (3) the duties of directors to consider a broader spectrum of interests beyond shareholder profit, which according to Hiller broadens "the traditional concept of directors' legal fiduciary duties beyond shareholders of the corporation"; and (4) transparency, requiring an annual benefits report.

SCHEMES TO BE AVOIDED

In this section we describe six practices that should be avoided by benefit corporations. We then provide a general "smell test", the seventh practice. The first six practices each violate at least one of Hiller's characteristics that relate specifically to benefit corporations. The seventh characteristic does not violate any specific characteristic but violates the "smell test."

Table 2 outlines the practices to be avoid, which we describe in greater detail below.

Table 2. Tax Practices Benefit Corporations should avoid

<i>Practices to avoid</i>	<i>Reasons</i>
Transferring intellectual property developed in the home country to other countries to avoid home country taxes	Public benefit, transparency
Borrow money in the home country while cash languishes in overseas subsidiaries	Public benefit
Corporate inversions	Public benefit, director duties, transparency
Tax position which can be reasonably challenged by the tax authority	Transparency
Classify of cash as “permanently reinvested” overseas so as to not report a deferred tax liability	Transparency
Transactions undertaken entirely for tax purposes	Public benefit, transparency
Any transaction or practice that would draw criticism	Appearance of impropriety

Refrain from transferring intellectual property from the home country to avoid taxes

Companies such as Delta Airlines have taken up schemes to transfer their brand name to low-tax nations such as Ireland and the Netherlands (Bachman, 2014). They would then have the U.S. business pay a hefty royalty to the overseas company that owns the brand name, thereby reducing the U.S. tax bill. This activity does not pass the smell test. The brand name was developed in the U.S. by U.S. employees. This activity violates the requirement that the company have a materially positive impact on its community. Furthermore, the transfer of intellectual property is shrouded in secrecy and violates the spirit of transparency.

Refrain from borrow money in the home country while cash languishes overseas

Companies such as Apple have borrowed billions in the U.S., sometimes to pay shareholder dividends, even though billions of dollars remain in overseas bank accounts (Holtzblatt et al 2016). This activity would be absurd were it not that these companies wished to avoid paying U.S. taxes on their overseas profits. Mind you, the U.S. allows a credit for overseas taxes paid. It is just that these companies do not wish to pay their fair share of U.S. taxes on overseas profits. It is easy for these companies to convince the public that the U.S. has no moral claim to tax overseas profits but this is not the case. The ability of companies such as Apple and Google to make profits overseas derives from the benefit of the U.S. educational system and other factors that enabled these companies to grow and thrive in the U.S. before dominating overseas markets. Until such time that the U.S. changes its tax system to a territorial one for both individuals and corporations, companies should not undertake schemes to avoid U.S. taxation on foreign profits.

Avoid corporate inversion mergers

Besides the unsavory tax avoidance, the practice is a betrayal of the home country, which provided a home for the company to grow and thrive. Considering that it is the board of directors who makes critical decisions such as corporate inversions, directors of benefit

corporations should be especially apprised that they have fiduciary duties not just to shareholders but to the local communities. To the extent that inversions increase complexity they also impede transparency.

Avoid any tax position which the tax authority can reasonably challenge

Companies routinely take tax positions or claims that they know the IRS will challenge (Drake et al 2016). Furthermore, they estimate the probability that these claims will be sustained in favor of the taxpayer. For financial reporting purposes, if the probability is at least 50% that a claim can be sustained, the taxpayer can take the benefit. For a benefit corporation, there is no reason to take positions that their sustainability is in doubt. The practice of taking uncertain tax positions violates the spirit of the transparency characteristic. If a benefit corporation encounters an area of uncertainty in taxes, it should be forthright about the matter with the taxing authority.

Full disclosure of Deferred Tax Liability for overseas cash

Most large companies avoid reporting this liability by stating that they never intend to repatriate their overseas cash (Edwards et al 2015). This practice is disingenuous and inconsistent with accounting concepts. If overseas cash is included in consolidated assets then a deferred tax liability should be recorded to reflect the moral costs to repatriate that cash.

Only engage in transactions that have a sound business, rather than tax, purpose

Some transactions only make sense because of the associated tax benefits. Benefit corporations should avoid such transactions. This is the ethical guideline of Avi-Yonah (2008) for all corporations and benefit corporations should at least adhere to that standard.

CONCLUSION – THE “SMELL TEST”

The previous list of tax practices to be avoided by benefit corporations is just that, a list. As a matter of practice, lists are self-defeating. At the end of the day, benefit corporations should avoid any transaction or practice that would be criticized by the press and political leaders if it came to light. An example includes the carried interest provision under which hedge fund managers receive compensation that is taxed at much lower capital-gains rates rather than earned income rates that most people pay (Goldstein and Protess, 2017). As another example, in the recent U.S. presidential election, it came to light that Donald Trump most probably did not pay taxes for the past two decades due to carrying forward large losses from the mid-nineties (Confessore and Appelbaum, 2016). While the logic of carrying forward losses seems fair to sophisticated businesspeople and accountants, it appears like a “loophole” to non-sophisticated observers.

The legal profession has been a pioneer in recognizing that one must avoid even the appearance of improper behavior (Abramson, 2000). The U.S. Department of Justice (2017) lists fourteen General Principles of Ethical Conduct (Please see table 3). Interestingly, the first principle views public service as a public trust, which is very similar to the public benefit characteristic of a benefit corporation. The twelfth principle specifically refers to taxes, asking employees to “in good faith” pay their “just ... taxes.” The fourteenth principle provides an overarching guidance: employees should avoid even the appearance of violating ethical standards.

Table 3. U.S. Department of Justice's (2017) General Principles of Ethical Conduct for employees and applicable lessons for Benefit Corporations tax ethics (Principles 1,12, &14)

1. Public service is a public trust, requiring employees to place loyalty to the Constitution, the laws and ethical principles above private gain.

2. Employees shall not hold financial interests that conflict with the conscientious performance of duty.

3. Employees shall not engage in financial transactions using nonpublic Government information or allow the improper use of such information to further any private interest.

4. An employee shall not, except as permitted by [these standards of conduct], solicit or accept any gift or other item of monetary value from any person or entity seeking official action from, doing business with, or conducting activities regulated by the employee's agency, or whose interests may be substantially affected by the performance or nonperformance of the employee's duties.

5. Employees shall put forth honest effort in the performance of their duties.

6. Employees shall not knowingly make unauthorized commitments or promises of any kind purporting to bind the Government.

7. Employees shall not use public office for private gain.

8. Employees shall act impartially and not give preferential treatment to any private organization or individual.

9. Employees shall protect and conserve Federal property and shall not use it for other than authorized activities.

10. Employees shall not engage in outside employment or activities, including seeking or negotiating for employment, that conflict with their official Government duties and responsibilities.

11. Employees shall disclose waste, fraud, abuse, and corruption to the appropriate authorities.

12. Employees shall satisfy in good faith their obligations as citizens, including all just financial obligations, especially those—such as Federal, State, or local taxes—that are imposed by law.

13. Employees shall adhere to all laws and regulations that provide equal opportunity for all Americans regardless of race, color, religion, sex, national origin, age, or handicap.

14. Employees shall endeavor to avoid any actions creating the appearance that they are violating the law or the ethical standards set forth in this part. Whether particular circumstances create an appearance that the law or these standards have been violated shall be determined from the perspective of a reasonable person with knowledge of the relevant facts.

Benefit corporations must hold themselves to a high standard and have an obligation to be ethical not just in fact but also in appearance. While the previous tax circumstances to avoid derived from the five characteristics of benefit corporations listed by Hiller, this represents our proposed addition to the ethical practices of benefit corporations: namely to be ethical not just in fact but also in appearance.

In truth, our additional characteristic is just a component of the transparency characteristic. Companies do not generally engage in practices that are unsavory if they knew that those practices would come to light. There are numerous other instances that are encompassed within this appearance or smell test for a benefit corporation. These include the practice of lobbying lawmakers for advantageous tax positions. Another example of above-board tax practices to be expected from a benefit corporation relates to sales taxes. Benefit corporations

that sell over to consumers over the internet should collect taxes for every state that charges sales taxes.

We conclude with Warren Buffett's apt description of his ethics test for his lieutenants:

"I want them [the CEOs] to judge every action by how it would appear on the front page of their local newspaper, written by a smart but semi-unfriendly reporter, who really understood it, to be read by their families, their neighbors, their friends. And it has to pass that test" (www.thebusinessquotes.com/warren-buffett-quotes/).

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