Henderson
Global Investors

Responsible Tax

October 2005

Henderson Global Investors, founded in 1934, is a leading investment manager, providing a wide range of investment products and services to institutions and individuals in Asia, Europe and North America. Henderson manages over £66.5 billion (as at 30 June 2005) in assets and employs more than 800 people around the world. We take an active interest in corporate governance and corporate responsibility and believe that excellence in these areas by the companies in which we invest contributes significantly to long-term shareholder value. Our Responsible Investment Policy, setting out our overall approach to corporate governance, remuneration and corporate responsibility, can be found at www.henderson.com.

We are very grateful to all the companies that took part in the discussions on which this paper is based. We should also like thank the following, who made helpful comments on a draft of the paper:

- Pat Ellingsworth, Head of Group Taxation and Corporate Structure, Shell
- John Fox, Head of Tax, BT
- Philip Gillett, Group Tax Controller, ICI
- John O'Driscoll, Head of Tax and Treasury, BG
- Keith Tucker, Executive Vice President: Taxation, Anglo American

The views expressed and the recommendations made in this paper are those of Henderson Global Investors alone.

Please send inquiries and comments on this paper to: Rob Lake,
Head of Corporate Engagement, Henderson Global Investors –
rob.lake@henderson.com

Contents

Page

Executive Summary 2

1. Background 5

2. Principles 6

3. Implementing the principles 10

4. Reporting 12

5. A good practice self-assessment on responsible tax 14

6. Conclusion 15

Notes 16

Executive Summary

Tax, risk and corporate governance - findings from a survey of the Chairmen of the FTSE350, published by Henderson in February 2005, focused on the approach to tax being taken by the boards of the UK's largest companies. This paper sets out conclusions derived from subsequent discussions with heads of tax at a number of FTSE100 companies. These discussions have explored in more detail how tax professionals make day-to-day judgements in an environment characterised by constant investor pressure for high financial returns, increasing complexity and change in tax regulations and new drivers of reputation risk linked to public expectations of corporate behaviour on tax.

Tax is a cost to business as it is to individuals, and paying tax unnecessarily may breach legal duties to shareholders. But the companies we have spoken to have a finely nuanced approach. They recognise that there is value to be derived from positive working relationships with tax authorities and a good reputation in the eyes of government more broadly, as well as with customers, employees and the public at large. Where these sources of value might be prejudiced by 'aggressive' tax planning, the prudent business course might be to forego the tax opportunity.

We document here a number of principles that guide tax decision-making at leading companies, propose ways of improving disclosure on tax to investors and others, and suggest a framework companies could use to assess their approach to tax.

Principles specific to tax

- ***Presumption of openness with tax authorities***
  Written guidelines for many tax departments state explicitly that the company should always make full disclosure to tax authorities. As one head of tax put it, 'a scheme that depends on something not being found out is a bad scheme'.

- ***Beware of complexity***
  Complex tax structures have become more risky in the current environment of rapid change in tax regulations. In some developing countries complex arrangements may be misunderstood by tax authorities and challenged, even where they are technically robust. This may prejudice relations with governments.

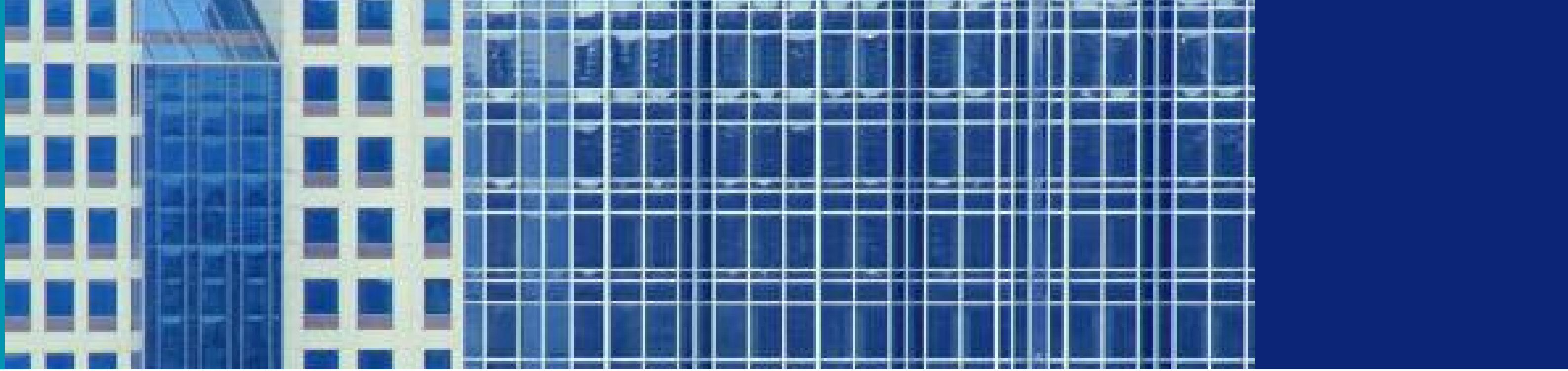
- ***Alignment with the underlying business***
  Many companies have formal guidelines requiring tax arrangements to be consistent with 'real world' business operations. These are judged to be more robust, more likely to be operated correctly, less likely to be closed down, and easier to explain to investors and others.

- ***Awareness of reputation and relationships***
  Tax departments attach value to having good relations with tax authorities and actively consider the implications of tax initiatives for their wider corporate reputation.

Principles enshrined in corporate commitments

- ***Abide by the letter and spirit of the law***
  The notion that compliance with the letter of the law is not sufficient to meet society's expectations of responsible corporate behaviour is already widely recognised by companies. Many companies make an explicit commitment to abide also by the spirit of the law. Companies recognise that some tax planning that is within the letter of the law but inconsistent with its spirit is likely to harm their relationship with tax authorities.

- ***Social responsibility***
  Many companies make formal statements of commitment to social responsibility, corporate citizenship, making a contribution to societies in which they operate, or similar concepts. The OECD Guidelines for Multinational Enterprises, which are widely recognised as a reference point for corporate responsibility (CR), also urge companies to follow the spirit of the law in relation to tax. This is also an important component of public expectations regarding CR and tax. Companies may be particularly vulnerable to public criticism if they are perceived as not making an appropriate contribution to poverty reduction in developing countries, or as being able to gain unfair advantage over tax authorities in these countries that have limited resources and technical capacity. Being able to report cash tax payments that are 'appropriate' in this context is a growing preoccupation for some companies.



Implementing the principles
Our research shows that companies are implementing their principles on responsible tax by:

- Including explicit requirements in their tax policies to comply with overall business principles and commitments on social responsibility;
- Ensuring explicit board discussion and approval of tax policies;
- Providing written guidance to staff on how to deal with dilemmas and challenges;
- Developing assurance mechanisms that require managers to certify formally that they have complied with tax and corporate-level policies;
- Linking staff incentives to relations with tax authorities;
- Involving their corporate responsibility specialists in discussions on tax – though at present this happens in very few cases. This is a missed opportunity to harness these specialists' expertise in understanding stakeholders' expectations and facilitating companies' responses to them.

Reporting
Companies currently disclose little to investors or others on tax. Yet companies' tax policies, and changes in tax regulations, can have a significant bearing on financial analysis and other stakeholders' perceptions of companies. The Operating and Financial Review (OFR) will require policies for managing the company's principal risks to be described. Although companies are increasingly including tax payments in CR reports, contextual information on the policies underlying tax is needed to enable readers to judge whether the amounts of tax paid were appropriate.

Henderson encourages all companies to:

- consider whether tax matters constitute one of the 'principal risks and uncertainties facing the company' or one of the 'main trends and factors which are likely to affect the company's future development, performance and position' that will need to be covered in the OFR. If they do, a description of the overall strategy and principles guiding tax management should be included in the OFR, as well as the implications of known or likely changes in tax regulation;
- cover tax in their CR reporting, explaining the principles and policies that guide their approach and giving practical examples of their application, as well as showing the actual sum of total tax paid in each country of operation.

A good practice self-assessment on responsible tax
Our discussions with companies suggest a series of questions that all companies could ask themselves as a 'good practice self-assessment' on responsible tax:

- Do our overall Business Principles and statements of values articulate clearly how we see the relationship between serving our shareholders' interests and demonstrating social responsibility, including through our tax payments?
- Are our specific tax policies linked explicitly to our overall Business Principles, and have they been formally approved by the board? Have both tax and corporate responsibility staff been involved in their development?
- Do we ask the following questions about our tax policies overall and about individual tax initiatives:
  - Would we be happy to disclose this in full to tax authorities?
  - Would we be comfortable if this were disclosed to our customers, employees and the public?
  - Is this, or might it appear to be, unduly complex and contrived? If it is highly complex, and/or might be perceived as having no purpose other than to reduce tax, are we comfortable that we can explain its rationale to tax authorities and others?
  - Even if this is technically legal, have we considered whether the law was intended to allow us to do this? If it did not, are we comfortable that we can explain its rationale to tax authorities and others? How likely is it that regulations will be changed and this will no longer be possible?

  * If this were reported publicly, could we be accused of not making an appropriate contribution to society in the country in question? If so, would we be able to present a credible defence?

  * Could this lay us open to accusations of exploiting the weakness of tax authorities in developing countries? If so, would we be able to present a credible defence?

- What assurance mechanisms have we got to ensure that our overall business principles and our more specific tax policies are followed in practice? Are these effective?

- What guidance do we provide to staff on how to deal with practical dilemmas that might arise in relation to tax matters? Is this sufficient to keep pace with changing regulations and expectations?

- Does our reporting, in the OFR and our corporate responsibility publications, provide sufficient contextual information to allow investors and others to understand how we manage tax and whether our tax payments are appropriate?

The principles set out in this paper represent a good practice framework based on our research into the approach leading companies are taking to ensure that their tax management both serves shareholders' interests and demonstrates wider social responsibility. The suggested self-assessment framework derived from the principles will not guarantee that a company will never be criticised by shareholders or others about tax; but it should reduce the likelihood of this occurring, and enable a company to defend itself robustly if challenges arise. Henderson encourages all companies to apply the principles and the self-assessment framework.

1. Background

In February 2005 Henderson Global Investors published *Tax, risk and corporate governance - findings from a survey of the Chairmen of the FTSE350.*[1] This provided a snapshot of how the boards of the largest companies in the UK are addressing the complex challenge of rapidly changing tax regulations, investor pressure for high financial returns, and public expectations that companies behave as responsible corporate citizens. The survey found that while generally speaking tax is receiving greater board attention than in the past, fewer than half the boards of companies responding had reviewed tax strategically in the last year or adopted a formal tax policy. Companies confirmed that the likelihood of being challenged by tax authorities on their transfer pricing, use of tax havens, or activities conducted primarily or exclusively to reduce tax was increasing. Despite the increasing prominence of tax in corporate responsibility debates, most companies did not appear to have considered systematically the relationship between their tax management and their approach to CR.

To explore in more detail the practical implications of these issues, Henderson has held discussions with heads of tax from a number of FTSE100 companies. This paper sets out some of the recurring themes from those discussions. It does not seek to provide a comprehensive technical analysis of how tax professionals do their job. Rather, it distils some broad principles that underlie the professional judgements made by those we have spoken to. These appear to us to represent good practice in performing the delicate balancing act of paying neither too much nor too little tax to serve shareholders' interests while also demonstrating broader social responsibility.

A strand running through much of what follows is the need to distinguish clearly between cost and value. It is often argued robustly that tax is simply a business cost that should be managed and kept as low as possible. It is sometimes said there is a legal obligation on companies to do this in shareholders' interests. Yet the companies we have spoken to have a more nuanced approach. Paying tax unnecessarily is self-evidently undesirable, and clearly tax is indeed a cost to a company (just as it is to an individual). But there is also value to be derived from positive working relationships with tax authorities and a good reputation in the eyes of government more broadly, customers, employees and the public at large. Where these sources of value might be prejudiced by 'aggressive' tax planning, the prudent business course might be to forego the tax opportunity.

One company estimated in our discussions that it could reduce its effective tax rate by 1-2% in the short term if it exploited all the opportunities it does not take up on the grounds that they would damage its relations with tax authorities or governments, or undermine customers' and the public's trust in it, which would damage the company in the longer term. This is effectively one element of the price of the business asset of relationships, reputation and trust (other contributions will of course be made by corporate communications, marketing, community initiatives, etc.). Provided the rationale for a tax strategy that takes account of these factors can be clearly articulated and its value demonstrated, it should be supported by shareholders.

2. Principles

Companies described to us two levels of principles that guide their tax management: those that are specific to tax; and overarching commitments made at a corporate level and enshrined in statements of Business Principles, codes of conduct and the like, which cover all a company's operations. In many cases the spirit and concepts underlying these two levels of principles are closely related.

Principles specific to tax

2.1 Presumption of openness with tax authorities

A fundamental guiding principle for all the companies we spoke to was that they should be prepared to make full disclosure to tax authorities of everything they did. As one head of tax put it, 'a scheme that depends on something not being found out is a bad scheme'. Others would consider such a scheme fraudulent. Closely related to this, written guidelines for many tax departments refer explicitly to the objective of maintaining good working relationships with tax authorities. It was stressed to us that this does not mean simply conceding to any challenge by tax officials (and as a consequence paying more tax than might otherwise be necessary). Rather it is a matter of conducting relationships that will inevitably involve some disagreement in a professional manner, without dissimulation – or the appearance of dissimulation.

Some companies' Business Principles provide a top-level reference point for this approach to relations with tax authorities. For example, GlaxoSmithKline's *Employee Guide to Business Conduct* stipulates that 'if you have contact with government officials with respect to your duties at GSK, you must provide information honestly and avoid falsification of any kind'.[2]

One head of tax argued to us that maintaining confrontational relationships with tax authorities required a large tax department, which involved high costs. Open and positive relationships, on the other hand, could be conducted by a much smaller and less expensive tax department. The benefits of the latter were far greater than those of the former.

2.2 Beware of complexity

It was often put to us that unduly complex tax arrangements might prove counterproductive. A number of companies said they were extremely cautious about entering into arrangements from which it would be technically difficult or costly (or both) to withdraw. There is a perception that in the current environment of rapidly changing regulations – driven at least in part by the obligation to disclose certain tax planning arrangements to Her Majesty's Revenue and Customs (HMRC) – the vulnerability of complex structures has increased.

A different dimension to the pros and cons of complexity was provided by a company with extensive operations in developing countries. Here, it was argued, tax arrangements that were perfectly legal and technically acceptable, but complex, might be misunderstood by tax authorities with limited capacity and technical expertise. Such misunderstanding might lead to challenges and increased tax payments. In a situation in which government authorisation for company operations is required, such a breakdown in relations with government is highly undesirable. Therefore, as it was put to us, 'you have to pay for your ticket' in the form of tax payments that are higher than they might technically need to be.

2.3 Alignment with the underlying business

A number of companies have as a formal written principle guiding their tax management that all tax structures and transactions should be aligned with the 'real world' activities of the organisation's underlying business. One head of tax told us how he had devised a structure that would have saved $50-60 million per year in tax by centralising a large part of the company's supply chain management. The plan was rejected by the people in operational control of the supply chain on the grounds that it was inconsistent with their business model, would have required some staff to relocate to different countries, and would have required completely new (and costly) accounting and record-keeping systems. Another company told us that tax approaches in line with the underlying business are more robust and 'less likely to be closed down'. Others feel that they are more likely to be properly implemented by operational staff. A company whose business strategy rests on the development and promotion of brands that are specific to individual countries or sold only in a small number of countries told us it attaches importance to paying tax in those countries, and its brands are owned predominantly in the countries of sale. This

contrasts with approaches whereby international or global brands are owned centrally in a low-tax jurisdiction and fees paid for the use of the brands are therefore taxed at low rates in that country.

One company recounted that it had declined an opportunity to undertake a scheme that would have increased its reported earnings, but without providing a cash benefit. This was judged unsustainable: the company would have gained a positive reaction from the market to improved earnings in the short term, but would then have had to explain why earnings had subsequently fallen back.

Another leading company's draft new Tax Standard stipulates that country heads of tax should 'only carry out transactions that have a documentary evidence of a commercial purpose'.

2.4 Awareness of reputation and relationships

We heard frequent references in our discussions to the importance of corporate reputation as a guiding principle for tax teams. Companies' overall Business Principles frequently use reputation as a yardstick for assessing the appropriateness of behaviour. Many companies also refer explicitly to reputation in guidelines governing the tax department. One company refers less formally to the 'newspaper test': what would be the implications for the company if a tax option that is under evaluation were exposed and reported on the front page of a) the Financial Times and b) The Sun? (Another company uses the Sunday Times as its benchmark - we have no view on which is the most appropriate paper.) One company in particular noted that the recent changes to tax regulations and the increasing prominence of tax issues in the media means they now have to give greater attention to reputation considerations than hitherto.

For some companies reputation in the eyes of governments is of particular importance. Where companies cannot operate without government authorisation (e.g. in natural resource extraction), or where government is a significant customer (e.g. for a pharmaceutical company), prejudicing relations with government by tax planning that is inappropriate, or is perceived as such, could have serious adverse business implications. In some developing countries in particular, a single company may account for a very substantial proportion of total government tax revenues. In this situation the adverse implications of prejudicing relations with governments and broader public perception of the company are even greater.

One company told us of a situation in which the government of an emerging market country had offered it exemption from tax on profits. The company decided it was preferable to have profits taxed in the country, since public perception would have been negative if it had been seen not to be paying tax there (even though it was making other payments under its production agreement with the government).

Corporate commitments

2.5 Abide by the letter and spirit of the law

One would expect companies to abide by the letter of the law. But the notion that this is not sufficient to meet society's expectations of responsible corporate behaviour is already widely recognised by companies. The box below provides examples.

'We will observe the laws and regulations of all countries in which we operate, not just in the letter but also the spirit.'
HBOS, *Corporate Responsibility Report 2004 - Our commitment to the way we do business.*[3]

'In conducting business with due skill, care and diligence, HSBC seeks always to comply with both the letter and the spirit of relevant laws, rules, regulations, codes and standards of good market practice'.
HSBC, *Statement of Business Principles and Values*[4]

'ICI's policy is to conduct its business responsibly, with integrity and with respect for the interests of all those affected by our operations. As a minimum this requires compliance with the law in every country in which we operate. Legal compliance, alone, however, is not enough. In many areas ICI expects ethical and behavioural standards which go well beyond the minimum legal requirements.'
ICI, *Code of Conduct*[5]

There is a clear link between the concept of complying with the spirit of the law as a matter of CR and the straightforward business significance of good working relations with HMRC. As one company said in reply to Henderson's 2004 survey,

> *'…the impact on the company's relationships with its stakeholders and the Inland Revenue is considered when evaluating tax planning arrangements. For example, tax planning arrangements may fall within the realm of legitimate tax reduction but may be contrary to the spirit of the legislation. This could harm relationships with the Inland Revenue.'*

The OECD Guidelines for Multinational Enterprises,[6] which are widely recognised as a reference point for CR, also use the concept of the spirit of the law in relation to tax. The Guidelines are supported by companies, governments and non-governmental organisations alike and were developed through a process of negotiation among these three constituencies. The section of the Guidelines that deals with tax reads:

> *'It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with the tax laws and regulations in all countries in which they operate and should exert every effort to act in accordance with both the letter and spirit of those laws and regulations. This would include such measures as providing to the relevant authorities the information necessary for the correct determination of taxes to be assessed in connection with their operations and conforming transfer pricing practices to the arm's length principle.'*

We are aware of the debates among lawyers and others in the tax community surrounding the concept of the 'spirit of the law' and whether it is appropriate, feasible or permissible for taxpayers to surmise the underlying intention of tax law. But it is clear from Henderson's discussions with tax specialists in FTSE100 companies that even where they do not explicitly use the term, they regularly exercise pragmatic, professional judgement that in effect deals with this concept – for example by considering, as a matter of risk assessment, how the courts would view a particular tax scheme.

2.6 Social responsibility

Many companies make formal statements of commitment to social responsibility, corporate citizenship, making a contribution to the society or societies within which they operate, or similar concepts. A few examples are given below.

> 'We aim to be seen as socially responsible and an investor of choice.'
> Anglo American, *Good Citizenship – Our Business Principles*[7]
>
> '[The Code of Conduct] enshrines [BP's] commitment to honesty and integrity, […] and [its] commitment to mutual advantage in every relationship of which [it is] part. […]
>
> Our aim is that countries and communities in which we operate should properly benefit from our presence – through the wealth and jobs created, the skills developed within the local population and the investment of our time and money in people.
> *Our commitment to integrity – BP Code of conduct*[8]
>
> 'As part of the Business Principles, we commit to contribute to sustainable development. This requires balancing short and long term interests, integrating economic, environmental and social considerations into business decision-making. […]
>
> (Responsibility to society):
> To conduct business as responsible corporate members of society, to comply with applicable laws and regulations […].
> *Shell General Business Principles*[9]

Tax professionals frequently told us that their approach to tax is designed formally to be consistent with these overall policies and commitments. In some cases there are specific links between the concepts or principles used at this corporate level and those that apply within the tax function. For example, Shell links its corporate commitment to sustainable development to a principle of sustainability within tax management. This relates to a preference for tax arrangements that are stable and long-lasting, and is thus closely linked to the principles concerning complexity and alignment with the underlying business that are discussed above.

One company reported to us that it now actively considers its cash tax payments – not just its tax rate – from a corporate social responsibility and reputational perspective. Discussions take place on whether the reportable cash tax payment appears 'appropriate' or 'sufficient' in these terms. While the company does not have a 'target' cash tax payment, this concept is starting to emerge. Clearly this is an extremely difficult area – especially for companies with public free cash flow objectives. What constitutes 'appropriate' or 'sufficient'? More generally, companies are having to decide what 'social responsibility' means in relation to tax. The box below highlights some key themes in this discussion.

Tax and social responsibility

Claims that companies are 'irresponsible' over tax often appear to be prompted by perceptions that aspects of tax planning have been concealed, or that companies have failed to abide by the spirit of the law even if they have technically complied with its letter, using a combination of tax or financial 'engineering' and legal argument to make possible stratagems the law did not intend to allow.[10] To borrow a phrase from the Advertising Standards Authority's Code of Advertising Practice, it may have been legal, but was it decent, honest and truthful?[11]

Such tactics may be perceived as allowing companies to gain unfair advantage compared to the individual taxpayer, or as depriving the state of revenue that is due to it and which could be spent on public services. Companies may thus be accused of not making an 'appropriate' contribution to the society or societies in which they operate. These concerns may be voiced particularly strongly if companies are perceived as depriving developing countries of tax revenue that could be used to help alleviate poverty.[12] Companies may also be viewed as being able to gain unfair advantage over tax authorities in developing countries that have limited resources and technical capacity.

Clearly these themes find many echoes in the principles guiding tax management outlined above.

3. Implementing the principles

Companies described to us various mechanisms by which their policies on tax are implemented in practice, and by which their tax policies are linked to overall corporate commitments.

Formal links between tax policies and corporate commitments

A number of companies' tax policies refer explicitly to their overall corporate values and responsibility statements. Anglo American's tax strategy, formally approved by the board, refers explicitly to ensuring that the company's overall Business Principles are followed. At Shell the Tax Standard also explicitly requires consistency with the Group's General Business Principles.

Guidance to staff

Once policies have been put in place, it is clearly good practice to provide guidance and support to staff on how they should be implemented. BP's Code of Conduct provides 'Question and Answer' examples of how staff should approach dilemmas in the areas it covers. One of these, in the section on *Accurate and complete data, records, reporting and accounting*, relates to transfer pricing between a BP joint venture and a BP subsidiary.

Q. BP just seconded me to be the controller of a new production JV company. I see competitors in the same marketplace transferring crude at less than market price to a subsidiary of one of the joint venturers for resale at market price to a third party. That can have the effect of reducing taxes for the joint venture and increasing profits for one joint venturer. Should I suggest the JV consider a similar deal with one of BP's subsidiaries?

A. A BP employee who works for a separate JV has both a fiduciary duty to that JV and a duty to follow the code. Failure to live up to these responsibilities can result in disciplinary action, and even civil or criminal liability. Always take care about pricing between BP and joint ventures or third party partners. Always consult legal, tax or accounting. Remember, we need to maintain the trust of everyone we work with if we are going to stay a truly great company. We compete hard for our success, but fairness requires us to treat our partners as we would wish to be treated.

BP Code of Conduct, page 61

However, Henderson did not encounter many examples of such guidance dealing directly with tax matters. More attention to this area by companies would enable employees to deal with greater confidence with this difficult area. As the BP Code says, 'The business, legal, ethical, and public relations issues in this area are complex and the consequences of a poor decision can be significant'.

Assurance mechanisms

Many companies have assurance mechanisms requiring heads of business areas to sign formal statements each year certifying that all relevant corporate policies have been followed. These assurance statements cover both policies specific to the individual business area – e.g. tax – and overall corporate policies. Anglo American, Shell and ICI all have systems of this kind with explicit links between tax and other company policies. At ICI all managers are required to certify that 'there has been no material breach of the ICI Code of Conduct in your business'. Every year business unit managers at GlaxoSmithKline must complete a Self Assessment Questionnaire (SAQ), managed by Global Internal Audit, covering management of risks, and seeking information about areas where compliance with policies may be an issue. The SAQ was revised in 2004 to include specific questions about the consideration of reputation risk.

More focused assurance procedures apply within tax departments. At ICI, for example, managers of business units are asked each year to confirm that they have complied with the policy that stipulates that 'all Group Companies must enjoy an open, honest and professionally managed relationship with those Revenue authorities to which they are subject.' Confirmation is also required that policies in more specific areas have been followed:

- 'Are you satisfied that all intra-group purchases and sales of goods or services, involving a legal entity or business unit for which you are responsible, have been conducted on an arm's length basis in accordance with the Group policy on Intra-Group Transactions?'
- 'Are you satisfied that all records that may be required to substantiate the implementation of the Group policy on Intra-Group transactions and this arm's length approach have been retained?'

- 'Are you satisfied that all dealings with the Revenue Authorities, in respect of the tax affairs of all legal entities or business units for which you are responsible, have been handled in a professional manner consistent with Group policy? These dealings include the agreement of any tax liabilities and relevant filings and payments.'
- 'Are you satisfied that the Group Taxation Controller has been advised of any significant potential tax liabilities for any legal entity or business unit for which you are responsible? These may have arisen through different interpretations of the law or its application by the company and Revenue Authority; or for any other reason.'

Incentive systems
Some companies are experimenting with new ways of linking staff incentives to the desired approach to tax. At one major corporate at least, the annual bonus of the Head of Tax is determined in part by an assessment by HMRC of the company. This new arrangement – only recently introduced – will involve HMRC giving its view on such areas as the company's helpfulness in identifying transactions and the amounts of tax involved, and explaining their commercial context; the completeness and clarity of its responses to requests for information; and the clarity of its technical explanations of the technical views it has adopted.

Involvement of corporate responsibility specialists
With a small number of notable exceptions, Henderson found little current involvement of CR professionals within companies in discussions about their organisation's tax management. These specialists have expertise in monitoring social trends and the expectations of the company's stakeholders, maintaining dialogue with those who can influence the company's reputation, and facilitating the incorporation of insights from these activities into their organisation's policies and practices. This represents a valuable but largely untapped resource that could be brought to bear to help companies ensure they can meet the challenges posed by the rising public and pressure group interest in tax.

4. Reporting

4.1 The Operating and Financial Review
Companies currently disclose little to investors on tax matters. Yet principles and approaches to tax of the kind we have discussed here, and changes in tax rules introduced as a result of the government's views on companies' practices, can have a significant bearing on tax rates, cash tax payments, and thus analysts' modelling. Company results announcements are now reflecting the impact of changes to tax rules made as a result of the requirement to disclose certain types of tax arrangement to HMRC. Compass Group's interim results announcement in May 2005 and National Grid Transco's preliminary results in the same month both pointed to higher tax rates and cash tax payments in the future as a result of new regulations.

The new Operating and Financial Review (OFR) offers an opportunity to enhance disclosure. A number of provisions in the OFR regulations[13] and the Accounting Standards Board's (ASB) Reporting Standard[14] will require companies to consider whether tax-related information should be include in the OFR. For example:

- All OFRs will have to include 'a description of the principal risks and uncertainties facing the company.' The ASB Standard stipulates that 'the directors' policy for managing principal risks shall be disclosed'. If tax is considered a major risk issue, the board's overall policy should be set out. As the Standard goes on to note, '[…] it is expected that some risks, such as reputational risk, will be common to all.' As noted above, reputation is an important consideration in many companies' tax management. A number of companies have indicated to us that tax is among their most significant risks.

- The OFR is also required to 'analyse the main trends and factors … likely to impact future prospects'. The impact of government action to restrict tax planning opportunities might need to be reported here if the implications for the tax rate are significant.

- The OFR regulations also call for 'information about significant relationships with stakeholders other than members which are likely, directly or indirectly, to influence the performance of the business and its value.' Relations with tax authorities could certainly be said to fall into this category.

Investors need to understand how companies handle the complex balancing act of managing the various dimensions of tax so that tax rates and cash payments are kept at levels that best serve shareholders' interests. The rapidly changing regulatory and compliance environment, and the emerging news on its real financial impacts on companies, make this more important than ever.

Henderson encourages all companies to consider whether tax matters constitute one of the 'principal risks and uncertainties facing the company' or one of the 'main trends and factors which are likely to affect the company's future development, performance and position'. If they do, a description of the overall strategy and principles guiding tax management should be included in the OFR, as well as the implications of known or likely changes in tax regulations.

4.2 Corporate responsibility reporting
Public debate about companies and tax illustrates very clearly the long-held expectation that companies should make a 'fair' or 'appropriate' contribution to society in economic terms. As we have seen, many companies explicitly recognise and accept this principle in their statements of business principles and values. To demonstrate performance in this area, companies are increasingly including their tax payments in CR reports. Some are also developing more sophisticated ways to illustrate their total economic contribution either globally or to an individual country. Companies with substantial operations in developing countries are in the vanguard here, recognising the expectation that they should demonstrate how they are helping those countries to meet their development objectives.[15]

However, this is still relatively uncommon. The Global Reporting Initiative (GRI) guidelines for sustainability reporting – widely accepted as the benchmark for this type of reporting and supported in the Responsible Investment Policy that Henderson applies to all its funds – call for companies to report the 'total sum of taxes of all types paid broken down by country'.[16] In practice even those companies certifying that they are 'in accordance' with the GRI Guidelines have not reported in this way. Most companies provide only a global figure for tax paid, while a

small number provide a breakdown by region. Anglo American and Statoil are the only companies of which Henderson is aware that break down tax payments by country. Most of the companies providing some level of breakdown of tax by country or region are in the extractive industries. In this sector there has been significant interest in payment transparency from non-governmental organisations and governments. All the leading companies are participating in the Extractive Industries Transparency Initiative (EITI) launched by the UK Department for International Development with the aim of '[ensuring] that the revenues from extractive industries contribute to sustainable development and poverty reduction'.[17]

But simple disclosure of the amount of tax paid – whether this is on a global basis, in an individual developed country or in a developing country – does not address the growing public interest in whether companies have acted 'responsibly' in their tax management. Merely reporting tax provisions, as Royal Bank of Scotland (RBS) does in its 2004 Corporate Responsibility Report,[18] is also misleading. While RBS' reported provision for taxes and duties in the UK and abroad is £2.2 billion, the cash flow statement in the 2004 accounts shows that actual cash tax payments in that year totalled £1.394 billion (£812 million in the UK and £582 million overseas).[19]

Figures for total tax paid, or even figures for an individual country, such as those reported under EITI, will not in themselves indicate whether manipulation of transfer pricing of the type addressed in the BP Code of Conduct Question and Answer cited in Section 3 has taken place, and therefore whether more tax should in fact have been paid. Additional information is required if the reader is to assess whether the figures reported represent a 'fair' or 'appropriate' level of payment. A description of the principles and policies that govern tax management – such as those discussed in Section 2 – and of how they are linked to companies' overall business principles and values would help to provide fuller context. To illustrate the practical implications of these principles and policies, reports could include worked examples of how specific tax issues are addressed, or an account of the types of tax planning the company is and is not prepared to undertake.

Diageo has taken a valuable step in this direction. Its *Corporate Citizenship Report 2005* contains the following section:

Tax policies

With responsibilities to many groups of stakeholders including investors and governments, we strive to organise our tax affairs efficiently within the law. As part of this effort, we consider options available to us for the location of Diageo's profits and hence tax liabilities. Such decisions are always based on a combination of commercial strategy, cost and levels of taxation. However, our approach includes a strong preference for locating tax liabilities in territories where Diageo also has significant commercial operations. The prices charged for products bought and sold between Diageo subsidiaries in different countries affect their profitability and consequently their tax liability. Our global transfer pricing policy is based on the arm's length principle and is in accordance with OECD guidelines. We believe that this allows Diageo subsidiaries to earn fair and reasonable profits for the functions they perform in line with pricing evidence from comparable third-party, uncontrolled transactions.[20]

Henderson encourages all companies cover tax in their CR reporting, explaining the principles and policies that guide their approach and giving practical examples of their application, as well as showing the actual sum of total tax paid in each country of operation.

5. A good practice self-assessment on responsible tax

Our discussions with companies suggest a series of questions that all companies could ask themselves as a 'good practice self-assessment' on responsible tax:

- Do our overall Business Principles and statements of values articulate clearly how we see the relationship between serving our shareholders' interests and demonstrating social responsibility, including through our tax payments?

- Are our specific tax policies linked explicitly to our overall Business Principles, and have they been formally approved by the board? Have both tax and corporate responsibility staff been involved in their development?

- Do we ask the following questions about our tax policies overall and about individual tax initiatives:

  * Would we be happy to disclose this in full to tax authorities?
  * Would we be comfortable if this were disclosed to our customers, employees and the public?
  * Is this, or might it appear to be, unduly complex and contrived? If it is highly complex, and/or might be perceived as having no purpose other than to reduce tax, are we comfortable that we can explain its rationale to tax authorities and others?
  * Even if this is technically legal, have we considered whether the law was intended to allow us to do this? If it did not, are we comfortable that we can explain its rationale to tax authorities and others? How likely is it that regulations will be changed and this will no longer be possible?
  * If this were reported publicly, could we be accused of not making an appropriate contribution to society in the country in question? If so, would we be able to present a credible defence?
  * Could this lay us open to accusations of exploiting the weakness of tax authorities in developing countries? If so, would we be able to present a credible defence?

- What assurance mechanisms have we got to ensure that our overall business principles and our more specific tax policies are followed in practice? Are these effective?

- What guidance do we provide to staff on how to deal with practical dilemmas that might arise in relation to tax matters? Is this sufficient to keep pace with changing regulations and expectations?

- Does our reporting, in the OFR and our corporate responsibility publications, provide sufficient contextual information to allow investors and others to understand how we manage tax and whether our tax payments are appropriate?

6. Conclusion

Henderson's discussions with companies since the publication of our earlier report show that some companies do have clearly articulated strategies, formally set and approved by the board, that link their tax management to their overall corporate framework of business principles, values and culture. In some cases more specific tax strategies or standards have also been explicitly approved by the board. Internal control and assurance mechanisms operate to help ensure these strategies and policies are followed in practice.

It was clear from our earlier survey that many companies do not assume that the best way to serve shareholders' interests is to pay the short term 'minimum' amount of tax in a technical sense, regardless of other considerations. Rather, factors such as relations with tax authorities and other parts of government, and public reputation and trust, have to be taken carefully into account in order to arrive at an 'appropriate' level of payment. Our subsequent discussions have allowed us to gain more detailed and extremely valuable insights into the way these delicate judgments are made.

It has long been taken for granted as part of 'traditional' business ethics that companies should make an appropriate contribution to the societies within which they operate, and that payment of tax is one of the most significant demonstrations of this contribution. But it is only relatively recently that tax has become part of the newer debate that uses the terminology of 'corporate social responsibility' or just 'corporate responsibility'. Although tax professionals utilise many of the principles and tools of CR (such as evaluation of reputation risk), company specialists with formal CR roles are seldom involved in tax matters. This is a missed opportunity to strengthen companies' ability to respond appropriately to the rising public interest in tax.

Public reporting on tax is currently embryonic. Rapidly changing tax regulations have significant implications for some companies' effective tax rates and cash tax payments. This directly affects investors, so good disclosure is vital. Understanding the principles and policies framing tax management also helps investors assess companies' ability to achieve their business and financial objectives. Many companies may well conclude that they should therefore cover tax in the OFR. CR reporting provides an opportunity to provide more detail and to respond to the expectations of a wider audience that is increasingly interested in companies' economic contribution to society and in tax as a key measure of this. Simply reporting figures for tax provided or paid does not allow a rounded understanding. It is essential to provide contextual information on principles and policies, and their practical implications, so that readers can gauge whether reported tax payments appear 'appropriate'.

The principles set out in this paper represent a good practice framework based on our research into the approach leading companies are taking to ensure that their tax management both serves shareholders' interests and demonstrates wider social responsibility. The suggested self-assessment framework derived from the principles will not guarantee that a company will never be criticised by shareholders or others about tax – indeed two of the companies referred to in this paper, GSK and HBOS, are currently involved in significant tax disputes.[21] However, using the framework should enable a company to think through the possible responses of various parties to its tax management, and to defend itself robustly if challenges arise. Henderson encourages all companies to apply the principles and the self-assessment framework.

Notes

[1] http://www.henderson.com/global_includes/pdf/sri/tax_paper.pdf
[2] http://www.gsk.com/about/corp-gov/Employee-Guide-2004.pdf, page 50
[3] www.hbosplc.com/community/Corporate_Responsibility_Report_2004.asp
[4] www.hsbc.com/hsbc/about_hsbc/corporate-social-responsibility/ethical-finance/business-principles-and-values
[5] http://www.ici.com/ICIPLC/ici-overview/pages/code_conduct.htm
[6] http://www.oecd.org/dataoecd/56/36/1922428.pdf
[7] http://www.angloamerican.co.uk/static/uploads/Bus_Principles.pdf
[8] http://www.bp.com/liveassets/bp_internet/globalbp/STAGING/global_assets/downloads/C/coc_en_full_document.pdf
[9] http://www.shell.com/static/royal-en/downloads/sgbp/sgbp_300805.pdf
[10] See for example *The tax avoidance story as a morality tale*. Financial Times, 22 November 2004
[11] http://www.asa.org.uk/asa/codes/
[12] See for example *The shirts off their backs: How tax policies fleece the poor* Christian Aid, September 2005
[13] http://www.opsi.gov.uk/si/si2005/20051011.htm
[14] http://www.frc.org.uk/images/uploaded/documents/Web%20optimized%20OFR%20REPORTING%20STANDARD.pdf
[15] Examples include Anglo American, Rio Tinto, SABMiller and Vodafone.
[16] Global Reporting Initiative, *Sustainability Reporting Guidelines 2002*. www.globalreporting.org.
[17] www.eitransparency.org
[18] http://www.rbs.com/corporate01.asp?id=CORPORATE_RESPONSIBILITY
[19] http://www.investors.rbs.com/investor_relations/financial_info/results.cfm
[20] http://www.diageo.com/en-row/ValuesAndPolicies/CorporateCitizenshipReports/2005, p. 24
[21] The US Internal Revenue Service has claimed several billion dollars in tax and interest from GSK in a dispute over transfer pricing relating to the predecessor company Glaxo Wellcome. Halifax – part of HBOS – is involved in a case relating to VAT on the construction of call centres that is currently before the European Court of Justice.

Henderson Global Investors is the name under which Henderson Global Investors Limited, Henderson Investment Funds Limited and Henderson Administration Limited (all authorised and regulated by the Financial Services Authority) provide investment products and services.
4 Broadgate, London EC2M 2DA. Tel 020 7818 4100.

HGI33903/0905