

The Missing Billions: Aggressive Tax Planning and Corporate Social Responsibility in Israel

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Introduction

Until recently, the promotion of issues concerning the general public's interest was considered to be mainly the responsibility of the state. However, in the era of globalization, it is increasingly accepted that attention should focus on large business corporations as well, due to their growing economic and political power. The position according to which corporations must act with social responsibility toward all their *stakeholders* (and not only to increase their shareholders' profits) has been therefore gaining ground. While the limits and scope of this new concept of responsibility is still ambiguous, it is generally agreed that it requires corporations to address at least some of the externalities of their business activities, by making adjustments to their production, distribution, employment, and other processes. The premise of this concept is that assuming responsibility on the effects of their conduct would minimize the damage caused by corporations to major issues of public interest, and would actively contribute to the creation of a society that is more equitable, just, and sustainable.

This paper focuses on the relationship between **aggressive tax planning practices** and **corporate social responsibility**. It argues that contrary to standard understanding of the concept of corporate social responsibility, practicing responsible tax policies must be part of what we consider as socially responsible conduct. The paper grounds this claim both theoretically (by alluding to the idea of the social contract) and practically (by highlighting the potential harm caused to the state treasury by aggressive tax planning undertaken by large Israeli corporations).

More specifically, the paper argues that full payment of taxes is a key part of the "social contract" between the state and its citizens. This is a corollary of the doctrine stating that tax funds are at the basis of the infrastructure and of the provision of appropriate services to the public, and an important component in the reduction of economic and social disparities. Therefore, even if aggressive tax planning does not violate the law, given that the issue of corporate social responsibility is viewed as applying to areas that go beyond compliance with the law, corporations are expected not to deviate from the boundaries of the "social license" granted to them, and to avoid such planning.

The paper starts, in the **first chapter**, with a review of the provisions of Israeli law with regard to tax planning, focusing on the distinction between aggressive, illegitimate tax planning, and legitimate tax planning practices. It then moves to discuss, in the **second chapter**, the theoretical relations between tax payment and corporate social responsibility. For this end, the second chapter portrays the current position of CSR theory that does not include tax planning practices as part of CSR demands. It then argues that a proper understanding of the social contract idea determines that honest and straightforward tax practices must be carried out by corporations who claim to be committed to CSR. The chapter concludes with a review of possible critiques to tying tax practices within CSR policy and our correlative responses, and with a short review of the practical *business* reasons for avoiding aggressive tax planning on the basis of sheer business profitability. The **third chapter** provides practical justifications for considering corporate tax policy as a component of socially responsible behavior. To this end, it examines the extent to which the declarations made by corporations concerning their commitment to social responsibility are consistent with their activities in the field of taxation. For this purpose, as detailed below, we have conducted a study that examined the effective tax rates paid by the largest public companies in Israel (which were listed in the Stock Exchange Tel-Aviv, TA-25 index) between the years 2006-2009, in comparison to the statutory tax rates applicable to them. The resulting 'tax gap' (as explained later in this paper) was compared to the amounts invested by the surveyed companies into philanthropic contributions during the same years. The main argument of the paper, is that this 'tax gap' illustrates the implausibility of employing aggressive tax-planning practice, and at the same time declaring a commitment to social responsibility.

1. The Right to Tax Planning: Legitimate and Aggressive Tax Planning

1.1 *The right to tax planning and the justification for limiting it*

The possibility of conducting one's business in a variety of channels, each resulting in different taxation, constitutes the domain of tax planning. Tax planning practices undertaken by the taxpayer are based on complex legal and business transactions that usually result in a reduction of tax liability and often in its cancellation. It is usually thought that taxpayers have the right to plan their business moves in such a way that would lead to an "optimal" tax liability for themselves, as long as they do so by legal means.¹ Many tax systems, including the Israeli one, recognize this right.² The most obvious example of tax planning is perhaps the choice between forms of legal incorporation – that is, the choice to conduct one's business as a company or partnership, a choice that may dramatically alter the tax liability on what may be the same type of business activity. Another example is the choice between performing a transaction in one step or in several steps (for example, by transacting a sale in installments or as a conditional sale, relying on accounting rules that may lead to losses recognized for tax purposes).

While the mere recognition of tax planning as a legal privilege is controversial,³ some even consider it a basic constitutional right, taken as a part of the constitutional protection to private property.⁴ According to this approach, the right to tax planning derives its justification, among others, from the principles of personal freedom and its derivatives of private ownership and the freedom of contract and association; as well as from the democratic character of the regime and the principles of the rule of law.⁵ The importance of tax planning for business management has been noted repeatedly in Israeli case law and in the legal literature. For example, Supreme court Judge (ret.) Dov Levin noted in an article that:

"It is natural that the citizen-taxpayer, in his economic considerations and in determining his business policy, pays increasing attention to the tax burden imposed on him, because ignoring the scope and depth of taxation and its implications for the

¹ D. Glicksberg, *The Limits of Tax Planning*, The Harry Sacker Institute for Legislative Research and Comparative Law, Faculty of Law (hereinafter: "Glicksberg")

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³ As noted, there is a disagreement in the literature over whether tax planning is indeed a right and whether it is a part of the right to private property., Prof. Y. Edrei, for example, thinks that as long as the tax is based on proper and correct principles, it does expropriate private property but it is used as a means to distribute wealth between the individual and society. See Y. M. Edrei, "About declarative constitution and constitutive constitution: The status of constitutional property rights in the hierarchy of human rights," *Mishpatim* 28:461, 522 (1997), See also Prof. A. Joran, "The scope of constitutional protection of property and judicial intervention in economic legislation," *Mishpatim* 28:461, 443 (1997). In light of the limited scope of the present paper, we do not discuss the topic in detail and assume for the purpose of the present paper that a right to tax planning exists.

⁴ Glicksberg, p. 29

⁵ Y. Gross, "Tax evasion and artificial transactions," *Missim* 15/4 p. a-7, p. j-6 (hereinafter: "Gross").

robustness of the economic enterprise, for the resilience of the business, is liable to bring about the collapse and liquidation of the business.”⁶

Nevertheless, similarly to other rights granted to individuals in society, the right to tax planning is not an absolute right but a relative one that must be balanced with other rights and interests, which may conflict with it. Thus, even if tax planning is recognized as a right, there are various considerations that justify its restriction:⁷

First is the *social justice consideration*. The main argument against tax planning is that tax avoidance by taxpayers increases the tax burden on other taxpayers. As a result, the tax rate paid across society is no longer determined only by social and economic considerations, but is also decisively influenced by the ability to finance the operation of tax planning (hiring of accountants, etc.). This can upset the relative distribution of the tax burden among various citizens, as initially determined on the basis of various social and economic considerations.⁸

A *Second* consideration is an *economic* one. Tax payment is the main source for financing the state budget, and through it the elected government can carry out its national priorities. The use of tax planning may harm society as a whole because it leads to a reduction of the total common resources held by the state. Moreover, reduction of the financial resources held by the state as a result of tax planning may lead to reliance on grants and loans from foreign sources, and therefore to the renunciation of some of the government’s economic and political independence.⁹

A *third* consideration is the *democratic* consideration. Tax collection is one of the pillars of democracy, being the result of a broad social consensus regarding the participation of individuals in the funding and allocation of the resources needed for the welfare of society as a whole. This agreement is based on the recognition of the authority of government to use the tax instrument to achieve social and economic goals. Because the tax rate that has been determined is the result of a social decision, tax planning may lead to the formation of a gap between the formal-legal tax regime and the tax regime arising from tax planning. The formation of such a gap marks an erosion in the social acceptance of the tax arrangements.¹⁰ For example, an activist group called *UK Uncut* has recently organized demonstrations and

⁶ D. Levin, “The boundary between the allowed and the prohibited in tax planning,” *Roe Cheshbon* 39 (1990) 109, p. 110.

⁷ The Israel Tax Authority, **Report of the Committee on Addressing Aggressive Tax Planning**, (2005) pp. 11-13 (hereinafter: the “Committee Report”). Available (in Hebrew) at: <http://ozar.mof.gov.il/taxes/taxesplan07-2005.pdf>. (accessed 21.6.12)

⁸ Glicksberg, pp. 31-35.

⁹ This phenomenon is most pronounced in developing countries, which are more vulnerable to the consequences of international tax planning. This is because in many cases the bodies governing the country do not have sufficient financial resources to investigate taxpayers who commit tax offenses (such as using fake tax invoices and false transfer prices) and to check the validity and scope of existing tax planning. See in this matter, R. Murphy, J. Christensen, S. Kapoor, **Closing the Floodgates, Tax Justice Network**, London (2007), p. 137.

¹⁰ Glicksberg, p. 66.

protests against giant corporations operating in the UK, such as Vodafone and Arcadia Group Limited. According to the group, these corporations avoided paying taxes worth hundreds of millions of pounds to the British Government by relying on various complex tax planning moves based mainly on the use of tax havens. The corporations did this despite the fact that they accumulated their profits through business activities carried out in England. Note that part of the motivation for the demonstrations by the group was triggered by significant cuts in public services and resources that the British government began implementing following a reduction in the tax base and the 2008 financial crisis.¹¹

A *fourth* consideration for restricting the scope of tax planning as a right, is a legal one, and it rests on the doctrine of *good faith (bona fide)*, as well as the principle of *non-abuse of legal rights*. Both these doctrines are considered central in Israeli private law,¹² and have acquired binding legal status under the Law of Contracts (General Part), 1973, which establishes the principle of good faith as a general principle, applicable to all areas of the law.¹³ According to these two doctrines, individuals are expected to treat each other with respect and dignity, and even have one other's interests at heart while conducting mutual business. The implication of these doctrines to tax policy mandates that the owners of the right to plan taxes are required to exercise their right in a non-harmful manner and not take advantage of the resources that society places at their disposal.¹⁴ According to Prof. David Glicksberg, a leading Israeli tax expert, the principle of good faith must be viewed as part of the general anti-planning norms in Israeli law, based on which it is possible to disallow certain tax planning moves even in the absence of a specific fiscal anti-planning norm.¹⁵

1.2 Distinction between legitimate and aggressive tax planning

The Israeli Supreme Court has declared, on several occasions, that while planning one's taxes may be legitimate, this is not always the case: ***"A person may take advantage of any provision of law that exempts or relieves him from taxes, as long as he does not try to distort by his actions the intention of the legislators or to act illegally in order to become eligible for the exemption or relief that was not intended for him"***.¹⁶

In light of the profound social aspects of the tax liability, the legal delimitation of the tax planning domain is of great importance. The restriction of this domain is accomplished both by

¹¹ The UK Uncut website at: <http://www.ukuncut.org.uk/about/cuts>. (accessed 21.6.12)

¹² The Good Faith doctrine was declared in Israeli case law a "majestic" doctrine. See ----.

¹³ Through applying section 61(b) of the Contracts Law), that states as follows: *"The provisions of this law will, as far as is appropriate and mutatis mutandis, apply also to legal acts other than contracts and to obligations that do not arise out of a contract."*

¹⁴ Glicksberg, pp. 39-40.

¹⁵ Glicksberg, p. 57; Gross, p. 17.

¹⁶ Civil Appeal 4639/91 Director of Land Betterment Tax vs. Chazon David and Elsa, Lifshitz David and Chana, Mor Uzi and Bat-Sheva, *Misim* 8/3 (June 1994), 95, p. 104 (paragraph 10 of Chief Supreme Court Justice (ret.) M. Shamgar). Emphasis added.

subjecting a portion of tax planning to criminal norms and by anti-planning norms that disallow the tax benefits at the fiscal-civic level.¹⁷

Tax planning aimed at tax evasion or tax avoidance, including, for the most part, using illegal means, falls within the criminal sphere of the tax law. By contrast, other tax planning methods which lead to tax avoidance, and are carried out by legal means, may raise questions concerning the legitimacy of tax planning. Although these questions of legitimacy should be addressed in the civil domain (under the aegis of anti-planning norms set by the state, discussed below), there may be extreme cases in which all components of the tax planning are legitimate in themselves, but given the circumstances of the case, the conclusion may be that the tax planning falls within the criminal sphere.¹⁸

Thus, the first distinction that must be made is between "legal (non-criminal) avoidance of tax" and "illegal (criminal) tax evasion", by examining the measures undertaken to achieve the goal of reducing the tax burden. Accordingly, the tax evader is a person who avoids tax payment, but does so using legal means only, and makes full and truthful disclosure of all the facts. By contrast, the tax evader achieves his goal mainly by concealing facts and misrepresenting them.¹⁹

Within the category of non-criminal tax planning, Israeli law further distinguishes between *aggressive tax planning*, which refers to illegitimate tax planning in a fiscal context, as it deviates from accepted norms and from the intention of the legislators; and *legitimate tax avoidance*, which includes tax planning to which the anti-planning norms do not apply.

The words of Chief Justice (ret.) Aharon Barak in the **Rubinstein** case, explain this distinction:²⁰

"An artificial transaction does not mean an illegal transaction. For the most part, this is a legal transaction, but for some reasons the law regards it as an illegitimate transaction in the fiscal context. The tension, therefore, is not between legal and illegal; the tension is between legitimate and illegitimate from the point of view of the tax laws; the tension is between a transaction that reduces taxes legitimately and a transaction that reduces taxes illegitimately. The dilemma involves delineating the boundary between legitimate and illegitimate tax planning. We wish to delineate this boundary line and balance the right of the taxpayer to plan the tax by taking legitimate

¹⁷ Glicksberg, pp. 30-31.

¹⁸ Committee Report, p. 23.

¹⁹ Criminal Case 55/96 *State of Israel vs. Promedico Ltd.*, P.M. 1997, p. 384 (hereinafter: the "Promedico case").

²⁰ Civil Appeal 3415/97 Ministry Assessor for Large Enterprises vs. Yoav Rubinstein et Co. Construction Development and Finance Company Ltd., *Misim* 17/4 (August 2003), e-59, e-64 (hereinafter: "The Rubinstein case").

advantage of the various tax laws with the public interest in collecting taxes and maintaining a just and equitable tax system."

Indeed, setting the boundary between legitimate and aggressive tax planning is a complex task and a source of many disagreements between taxpayers and the tax authorities. Thus, in 2004 the Israeli Tax Authority appointed a committee for handling aggressive tax planning. Below is the definition of the main characteristics of aggressive tax planning, as it appears in its report:

- *"The main purpose of the activity or activities that are the object of tax planning is to avoid paying taxes or to lower taxes significantly, and the commercial reason for that activity, if any, is marginal.*
- *The tax planning relies on technical adherence to the letter of the law, but deviates from the intention of the law and the purpose of the legislation.*
- *At times, the tax planning contradicts generally accepted economic patterns.*
- *In most cases, the tax planning is complex and relatively sophisticated.*
- *It is reasonable to assume that if the tax authorities were aware of the tax planning, they would not approve it."*²¹

The Committee also noted that aggressive tax planning is characterized by intensive use of legal and financial tools, including foreign tax havens and transfer prices, and often disingenuous use of tax treaties.²²

1.3 Anti-planning norms applicable to aggressive tax planning under Israeli law

As is the case in many other countries,²³ Israeli law chose to limit the right to tax planning in cases of aggressive planning, by "anti-planning" provisions, found both in legislation and case law. These norms are aimed at delineating the boundary between permitted and the prohibited areas of tax planning. Some provisions of the legislation are general. For example, Article 86 of the *Income Tax Ordinance [New version] 1961* (hereinafter: "*Income Tax Ordinance*") grants the tax assessor the authority to ignore a transaction if he believes that it is artificial or fictitious, and that it may reduce the amount of tax paid by the taxpayer, or if one of its main purposes is tax avoidance or inappropriate tax reduction.²⁴ Other anti-

²¹ Committee Report, p. 22.

²² Ibid., p. 3.

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²⁴ The interpretation of this provision was the centerpiece of the Promedico case, which led to the prosecution of a group of people associated with a natural product enterprise for presenting a fictitious transaction in order to avoid paying taxes. The court examined the reciprocal relations between the contractual system, the tax system, and the criminal system, stating that the decisive question in the matter was whether the transaction was real, artificial, or fictitious.

planning norms, included in specific legislative provisions, are, for example Section 75B of the *Income Tax Ordinance* which imposes tax on the controlling shareholder of a "controlled foreign company." The essence of this provision is to impose tax on the controlling shareholder in cases in which a foreign company is owned by a resident of Israel, if most of its income is passive or most of its profits are derived from passive income. This is accomplished by considering the controlling shareholder of the controlled foreign company, which has passive income that has not yet been distributed, as if that income had been distributed to the controlling entity as dividends. The practical implication of this provision is taxation of the controlling shareholder based on the accrual of the passive income in the company despite the fact that it has not yet been distributed in practice.

Section 5(5) of the Income Tax Ordinance imposes tax on a "foreign business corporation." Such a company is defined as the corporation of a foreign resident, under the control of five people at most, held directly or indirectly, at a rate of 75% or more by individuals who are residents of Israel.

The anti-planning norms that have evolved in Israeli case law include, among others, the following tests: The prevalence of "*essence over form*" test: when the agreement is not what it appears to be, i.e., there is a discrepancy between its external appearance and its true nature, the court shall classify it based on its economic substance;²⁵ "*The purpose of business*" test: if the transaction lacks commercial reason or a credible reason, the court may classify it as an artificial transaction ;²⁶ The "*different classification of the transaction*" test: if the court reaches the conclusion that the transaction that took place between the parties is different from the external designation given to it by the parties, it shall be taxed based on its factual and legal reality.²⁷

In addition to the above anti-planning norms, in Amendment 147 to the Income Tax Ordinance, which took effect on January 1, 2006, the legislature added section 145a2 to the Income Tax Ordinance that imposes an obligation to report the practicing of aggressive tax planning, as well as section 75c to the Income Tax Ordinance, which imposes an obligation of tax reporting requirements for trusts and trustees.²⁸ The explanatory note to the bill clarifies

²⁵ Glicksberg, pp. 122-123.

²⁶ The Rubinstein case, id. at p. e-65.

²⁷ See in this matter Civil Appeal 533/89 *Ministry Tax Assessor for Large Enterprises vs. Silberstein*, P.D. 47(3) 376, Further Civil Discussion 3962/93 *Minz and Silberstein vs. Ministry Tax Assessor for Large Enterprises*, P.D. 50(4) 817, where controlling shareholders were assessed conceptual income because of a loan they took from a company under their control; see also in this matter Civil Appeal Authority 8522/96 *Rochwerger Construction Company vs. Tel-Aviv Tax Assessor*, *Misim* 3/11, p. 70, where the tax assessor classified management fees as dividend by means of "different classification."

²⁸ A trust is a legal arrangement, concluded in Israel or abroad, in which a person or group of persons (the creator of the trust) separate themselves from ownership in property, which is given to the trustee. The trustee manages the property for the benefit of a third person (the beneficiary). As part of the efforts of the Israel Tax Authority to increase the taxpayers' obligation to reveal and report

the need for reporting requirements that would enable the assessor to deal with aggressive tax planning:

“Unlike tax planning in the past, current tax planning is global, highly sophisticated, and makes use of legal and financial tools as well as of “tax havens,” taking advantage of tax treaties. Some of the plans involve abuse of tax treaties or are based on an interpretation of the provisions of the law that distorts the intent of the legislators. Moreover, in some of the tax planning the taxpayer assumes that the probability that tax planning aimed at inappropriate tax avoidance or tax reduction would be discovered in the course of the audit of the assessment is low, that the taxpayer’s assessment will become outdated, and at most the taxpayer will be required to pay the tax that he would have had to pay in the first place.

*The provisions of this section are intended to assist in increasing enforcement and in the struggle against such tax planning by imposing **a duty to report** on transactions prescribed by the Authority.”²⁹*

The list of operations that the legislature defined as constituting tax planning and that need to be reported was published on 3 December 2006 as part of regulations enacted under the Income Tax Ordinance.³⁰ These operations include also the ones involving corporations that are foreign tax havens, as well as operations that make abusive use of tax treaties. Failure to report an operation included in the said list is a criminal offense, even if the planning itself is eventually found to be legitimate.

2. Tax Payment Practices and Corporate social responsibility

While there is no doubt that determining whether tax planning practices are genuine, or whether they are performed for the sole purpose of avoiding tax liability is a serious and complicated matter, it is also clear that aggressive tax planning practices plague our economies. Research shows that the resources put into tax planning practices among large firms are substantial, and that the potential harm caused to states' treasuries by these practices is immense.³¹ Interestingly, however, these harmful measures are being conducted by companies that – at the same time – declare that they are committed to acting in a socially responsible fashion. Our argument in this paper aims to expose the implausibility of

information, Amendment 147 to the Income Tax Ordinance added reporting requirements for the trustee, the beneficiary, and the creator of the trustee (all under certain conditions) as well as an obligation to submit affidavits and reports concerning the details of the trust: real identity of the beneficiaries, value of assets, date of transfer, and more.

²⁹ Bill for Amendment to the Income Tax Ordinance (No. 147), 2005, sections 47 and 48. Emphasis added

³⁰ Income Tax Ordinance (Tax Planning Requiring Reporting), 2007.

employing aggressive tax-planning practices and at the same time declaring a commitment to social responsibility.

The next lines will illustrate the strong connection between practicing honest and straightforward tax practices, and corporate social responsibility.

2.1 Corporate Social Responsibility: First and second generations

The "first generation" of corporate social responsibility is characterized by an interpretation of the term "social responsibility" as mere charity and philanthropy.³² Corporations operating in accordance with this approach assume that by allocating a certain annual amount to public donations they act with full social responsibility. In this context, Prof. Ronen Shamir analyzed the financial statements of companies resident in Israel, whose shares are traded on the Tel-Aviv Stock Exchange, and concluded that "*Israeli corporations perceive social responsibility as an act that supplements state welfare, as a practice of charity and community support, and as a support mechanism for the health and education systems, and to some extent as maintaining environmental quality.*"³³

According to the approach of the "second generation," the more advanced generation of social responsibility, genuine social responsibility is not a matter of philanthropy, but must be related to the core business of corporate activities.³⁴ This approach is based on the perception that corporations must take into account the social, environmental, and economic effects of their activity already at the stage of product development and service delivery. Examples of the implementation of this approach are the recycling of cell phones by cellular communication companies, the granting of preferential financing terms by banks to green investors, and so on. Transitioning from the "first generation" to the "second generation" of social responsibility requires that corporations adopt, among others, appropriate norms, enshrine them in ethical codes, and apply them in their routine business activities.

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³² For a depiction of corporate social responsibility in terms of generations, see Simon Zadek, *Third Generation Corporate Citizenship - Public Policy and Business in Society*, **The Foreign Policy Centre**, pp.9-11 (Hereinafter: "Zadek").

³³ R. Shamir, "Private market and public pressure: Shaping the concept of corporate social responsibility," in *Generations, Spaces, Identities: Contemporary Views of Society and Culture in Israel*, 237, pp. 260 (eds. Hanna Herzog, Tal Kohavi, and Shimshon Zelniker, 2007) (hereinafter, "Shamir");,

³⁴ Zadek, pp.9-11; Porter & Kraemer - *Business and Strategy*; R. Shamir, *Between Self-Regulation and the Alien Tort Claims Act: On the Contested Concept of Corporate Social Responsibility*, **Law & Society Review**, Volume 38, Number 4 (2004); C. Parker, *Meta-Regulation: Legal Accountability for Corporate Social Responsibility*, in D. McBarnet, A. Voiculescu & T. Campbell (eds.), **The New Corporate Accountability: Corporate Social Responsibility and the Law** (2007).

In light of the social and economic consequences of the use of aggressive tax planning³⁵, and given the changing balance of power between the market and the state, various organizations and private individuals worldwide, and especially in Europe, began to regard the tax issue as an integral part of the "second generation" of corporate social responsibility. This approach is based primarily on a perception of the issue of social responsibility of corporations as a matter that goes beyond compliance, assuming that the corporation is already subject to the law and complies with it.³⁶ According to this approach, even if aggressive tax planning is not conducted contrary to the law, given that the issue of corporate social responsibility goes beyond compliance with the law, corporations must avoid this type of planning, especially those that boast to be socially responsible.

The next part of this chapter will argue that engaging in aggressive tax planning activity is unjustified theoretically, on the basis of the "social contract" between the state and its citizens and of the necessity of tax collection for the proper functioning of society.³⁷

2.2 The tax system and the 'Social Contract'

Taxation is one of the foundations of democracy. It is an expression of the social contract regarding mandatory payments to the public treasury as a way of achieving social and economic goals. More vividly described, it can be said that the tax money is the blood that flows in the veins of the "social contract" between the citizens and their country, as the physical, social, and legal infrastructure of human society can be established only by means of tax collection. Without the taxpayers' money the state could not provide its citizens with essential services such as education, health care, garbage collection, security, a judiciary system, roads, water, sewage, and so on. These services and infrastructures form the social capital of the country, contribute to the reduction of the gaps between the various classes of society, and strengthen social solidarity. Furthermore, they allow the creation of an educated population, a skilled workforce, and a developed economy, all of which improve the country's standing in the global market.

Therefore, the libertarian perception of taxation as an arbitrary "taking" by the government from the citizens and a burden imposed on the shoulders of those who earn their living in the sweat of their brow, reflects a very narrow understanding of citizenship and communal life.³⁸

³⁵ Aggressive tax planning practices are very common, and increasing, in developed countries. For further information see http://www.taxjustice.net/cms/front_content.php?idcat=104; (accessed 21.6.12)

³⁶ D. McBarnet, *Corporate Social Responsibility Beyond Law, Through Law, For Law*, in **University of Edinburgh School of Law Working Paper Series** (March, 2009).

³⁷ M. Oniell, *The curious business of taxation*, **New Statesman** (UK, 12.11.2007) <http://www.newstatesman.com/politics/2007/11/tax-avoidance-corporations>; (accessed 21.6.12)

³⁸ Y. Edrei, *The Status of Property Rights*, pp. 488-490; Y. Edrei, "Taxation and the promotion of investment in financial, social, and human capital," *Mishpatim* 40 (2), 2010, 437 (hereinafter: "Social and human capital").

Indeed, provided that the tax system is generally just, when citizens try to evade taxation or to reduce the statutory tax rates, they are in fact harming their own communities, and derivatively themselves in the long run. This is because the money "saved" by paying less taxes, is often later spent on services that were formerly granted to them by state subsidy, and which as a result of the reduced tax base the state can no longer provide. Common examples of this are the need to pay for the education of children in kindergartens and schools, private health insurance, road tolls, and more.³⁹

Moreover, tax avoidance also increases the gap between those who can pay for the services and those who cannot pay for them. The gap is even wider when the decrease in state revenues from taxation is caused not only by a general policy of reducing tax rates but also by the use of aggressive tax planning by part of the population. Thus, those who have the ability to pay legal and accounting experts for aggressive tax planning increase their income relative to those who do not have the means to pay for these services. This outcome erodes the foundation of the social consensus and frustrates the legislative purpose underlying the determination of the tax burden. Therefore, even if aggressive tax planning falls within the letter of the law, it is in essence an unethical and unfair exploitation of the existing law, or as noted by Prof. Glicksberg, a modern illustration of the phrase "a villainy within the delineations of the Torah."⁴⁰

Yet another reason to consider aggressive tax planning contrary to the idea of social contract, is that reducing the tax base in the wake of aggressive tax planning promotes the concept of "small government," which reduces the scope of public services and considers the economic standards of the market the only principle that should guide society. While this surely is a plausible account of the state, it is nonetheless appropriate to conduct a public debate based on a democratic process about this concept, which has clear implications for the distribution of social wealth, before it becomes a *fait accompli*.⁴¹ In this context, we must bear in mind that in democratic and liberal regimes the law is not a complete expression of the moral values espoused by society, but serves as a framework within which society may discuss the legitimate activities it wishes to encourage or discourage. Just as in sports it is possible to condemn a certain type of behavior as "unsportsmanlike" and even punish those who engage in it despite the fact that they did not act unlawfully, so it is appropriate to condemn tax planning that is harmful to society as a whole even if it does not break the law.

2.3 Aggressive tax planning and corporate social responsibility

³⁹ It is understood that as a result of the adoption of neo-liberal ideology, the privatization of public services also leads to a situation in which the citizens are required to pay for services that in the past the state used to subsidize. However, our argument focuses on a situation in which citizens are required to pay as a result of cuts in the state budget and not because of the policy of privatization.

⁴⁰ Glicksberg, p. 38.

⁴¹ J. Christensen, R. Murphy, "The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the Bottom Line", *Development Journal* 47(3), p. 42 (2004)

The moral-social concept that seeks to deny the legitimacy of certain types of tax planning because of their harm to society is on an inevitable collision course with the individualistic approach, *laissez faire*-oriented, according to which as long as the taxpayer's activity is not illegal, it is legitimate. This position received its extreme expression in the words of the economist Milton Friedman, according to whom the only social responsibility of corporations is to increase profits for their shareholders.⁴² According to this conception, if it turns out that the corporation pays a higher tax than it would have paid had it undertaken some legal tax planning, this means that the corporation makes inappropriate use of the funds of its shareholders. This is because shareholders are entitled to decide what to do with their money and need not be subject to government decisions regarding the designation of these funds.⁴³

But when a corporation makes use of aggressive tax planning, the attendant moral and social implications gain even more poignant expression than when a private individual does the same. This is because society provides significant added privileges to corporations, such as limited liability and a separate legal entity, with the expectation that, in return, they do not deviate from the "social license to operate" that has been granted to them.⁴⁴ The license reflects the agreement of society in which the corporation operates to use its territory, its natural resources, and the public services it provides (such as an educated labor force, transportation, security, etc.), all of which are financed by taxes. In return, society expects that in the course of its activities aimed at increasing profits the corporation returns its share to society. Imagine, for example, what would happen if the police did not show up when the corporate stores were looted, if the fire brigade did not arrive when a fire broke out at the factory, if the garbage collectors did not clear the trash generated by the corporation, or if there were no roads on which the corporation could transport merchandise, and so on. In this sense, it is the state, with the infrastructure and the many services it provides, that enables the proper functioning of the corporation. Therefore, as part of the "social contract" between the state and its citizens the corporation is expected to pay the full tax on its earnings. From the perspective of society, the tax can be seen as a dividend that the corporation pays to society in exchange for using the resources it makes available. Thus, when the corporation evades its responsibility to pay taxes, even if it is not breaking the law, it acts unfairly, as a parasite that lives off society and prevents or delays its normal development.

For these reasons, the concept that the only purpose of corporations is to maximize shareholder profits is becoming obsolete, particularly in recent years when the public domain

⁴² M. Friedman, *The Social Responsibility of Business is to Increase its Profits*, **The New York Times Magazine** (September 13, 1970).

⁴³ KPMG, *Tax and Corporate Social Responsibility*, (2007, UK), p.18 (Hereinafter: "KPMG's Report").

⁴⁴ M. Porter & M. Kraemer, "Business and Strategy: the Link between Competitive Advantage and Corporate Social Responsibility", *Harvard Business Review* 1 (December 2006) (Hereinafter: "Porter & Kraemer - Business and Strategy").

has undergone processes of outsourcing and privatization, and when capital mobility literally knows no boundaries and is guided by considerations of profit and benefit.⁴⁵ With the rise of the power of multinational corporations, there is also growing awareness of their extensive influence on the distribution of global resources and of their political and cultural power worldwide.⁴⁶ Today, there are countries in which corporations have the power even to shape public policy, promote or restrain the creation of social reforms, and influence the allocation of resources in key areas such as employment, the environment, and social rights. This massive influence that corporations exercise increases social expectations of them as well as their responsibility toward the community within which they operate.⁴⁷

In light of this trend, there is increasing support in Western society for the notion that in addition to acting responsibly toward their shareholders, corporations must also take into account the needs and expectations of all relevant stakeholders, including employees, consumers, suppliers, authorities, and the environment. At issue are moral norms of behavior that go beyond the framework of classical market perceptions of profit and loss, and take into account the global, long-term effects associated with the business activities of corporations.⁴⁸ The field of corporate social responsibility assumes, therefore, that there is an extensive system of relationships between the corporation and the society in which it operates, and that this relationship imposes certain obligations on the corporation.⁴⁹

In our opinion, "first generation" philanthropy will not do. When a corporation contributes money to the community, there is a great likelihood that the money donated to promote a particular cause could be more vital and necessary for the realization of some other goal. The state has a broader and more systemic view than corporations do concerning the proper way to allocate resources in society. In light of this, and given the fact that the institutions that govern the priorities of the state have been democratically elected, it makes sense to pay taxes that will then be allocated according to national priorities, defined and determined by state institutions.

Given the significance of tax policy to social life, the overwhelming harm that aggressive tax planning may have on society's ability to function, and the anti-democratic nature of "giving

⁴⁵ See in this matter the statement of Prof. Michael Porter, a prominent figure in the world of American management in the past 20 years, published in 2011 in the *Harvard Business Review*, one of the most capitalistic magazines in the U.S.: <http://hbr.org/2011/01/the-big-idea-creating-shared-value/ar/1>; (accessed 21.6.12)

⁴⁶ To understand the scale of the influence, we note, for example, that over two thirds of global trade in goods and services is conducted by corporations and that the total annual income of the 200 largest corporations worldwide is greater than the income of each of 182 countries in which 82% of the world population resides.

⁴⁷ Shamir, pp. 238-240; Clinic for Corporate Social Responsibility of the Academic Center of Law and Business, *It Is Our Business: Report on Corporate Social Responsibility in Israel* (January 2010), pp. 1-4 (hereinafter: the "Clinic report 2010").

⁴⁸ T. Barkai, "Social responsibility of businesses: Neo-liberalism in Zionist translation," *Teoria Vebikoret* (33), 45, pp. 48-49.

⁴⁹ Clinic Report 2010, pp. 1-6.

back to the community" via sporadic contributions, it seems implausible not to include aggressive tax planning practices as an element of corporate social responsibility.

2.4 Critique and Response

The following arguments could be made against the claim that there is a connection between aggressive tax planning and corporate social responsibility.

(1) Payment of taxes is an obligation enshrined in the law, and therefore as long as the corporation does not break the law, objections about the tax rate it must pay should be directed at the state and not at the corporation.

Our response to this argument is that because of their growing political and economic power, giant corporations are able to influence the amount of tax they pay to the state in various ways. Indeed, quite a few countries that need foreign investment tend to negotiate with multinational corporations the tax benefits that the corporations will receive if they agree to invest in the country, and countries are even prepared to change existing legislation for this purpose.⁵⁰

Moreover, this argument applies only to the obligation to comply with the law and ignores the approach according to which the social responsibility of corporations applies beyond compliance with the law, and by virtue of which the corporation has ethical and social obligations as well.

(2) There is nothing wrong with corporations using foreign tax havens. This is because the state, if it chooses to do so, can impose a tax on profits derived from them, either directly or through affiliated companies.

Conversely, by using foreign tax havens the corporation takes part in a policy of questionable morality that includes, among others, secrecy with regard to the provision of financial information to international organizations.⁵¹ This policy forms not only a convenient platform for aggressive tax planning but also for tax evasion and money laundering. Moreover, countries that offer low corporate tax rates or zero taxes initiate a tax competition leading to a "race to the bottom" that undermines the economic stability of many countries. Therefore, corporations taking part in the creation of competition of this type conduct themselves in an irresponsible manner, both toward society and toward the country in which they operate.⁵²

⁵⁰ KPMG's Report, p. 26.

⁵¹ For more information on the global consequences of the phenomenon of financial secrecy, see the Financial Secrecy Index, created by Tax Justice Network, at <http://www.financialsecrecyindex.com>; (accessed 21.6.12)

⁵² KPMG's Report, p. 31.

(3) *Taxation should not be considered as part of corporate social responsibility because the corporate taxes paid out of the profits of the corporation are not part of any commercial activity but are manifest only after the transaction has been completed.*

In business practice, however, this is not true. Tax payment is part of the costs the corporation takes into account when it conducts its transactions. Moreover, the tax aspect is a significant consideration that affects the decisions taken by the corporation in its business activities, including the location where the business is established, the form of incorporation, and the timing of transactions.⁵³

2.5. Business reasons for avoiding aggressive tax planning

So far we have outlined the normative arguments that support our claim that as part of their social responsibility, corporations should avoid using aggressive tax planning. In addition to these arguments, however, there are also practical business reasons for avoiding aggressive tax planning on the basis of sheer business profitability. Just as more and more corporations are trying to integrate philanthropy into the core of their business based on a growing perception that "charity is good for business,"⁵⁴ they should also stop the use of aggressive tax planning because of the business risks involved, as detailed below.

A *first* business consideration for adopting a responsible tax policy is the growing importance that civil society attaches to the issue of taxation, which may harm the public image of corporations that adopt aggressive tax planning, and lead to negative media coverage. For example, the giant corporation, Google, was required to provide explanations to the public when newspapers worldwide published the fact that in 2007 its British branch avoided paying 110 million pounds in taxes through the use of foreign tax havens.⁵⁵ Barclays Bank, one of the largest banks in England, recently drew sharp

⁵³ KPMG's Report, p. 11. The large accounting firm KPMG released in recent years several reports dealing with these issues, arguing, among others, that when corporations adopt a policy of social responsibility, they should also consider the tax implications of their activities. Interestingly, in 2005 KPMG itself was sued by the U.S. government for developing, marketing and implementing potentially abusive and illegal tax shelters that U.S. taxpayers might otherwise have been unable to employ, costing the U.S. Treasury billions of dollars in lost tax revenues. KPMG admitted in court it committed fraud in designing the tax shelters and in trying to conceal the shelters from the Internal Revenue Service. As part of this prosecution, KPMG agreed to pay \$456 million as part of a Differed Prosecution Agreement, in order to avoid criminal prosecution by the U.S. government over abusive tax shelter. For more information see:

<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aplebPwsO81k&refer=us>; (accessed 21.6.12)

In light of this information, their recommendation not to practice aggressive tax practices is therefore rather ironic.

⁵⁴ Shamir, p. 252.

⁵⁵ R. Watts, *Google avoids £100m UK tax*, **The Sunday Times** (19.4.2009, UK)

<http://www.timesonline.co.uk/tol/news/uk/article6122329.ece>; (accessed 21.6.12)

public criticism when it was reported that in 2009 it paid a corporate tax a rate of only 2.4% (on a profit of 4.6 billion pounds that year),⁵⁶ and that hundreds of its branches are taxed in foreign tax havens, such as the Cayman Islands, Jersey, and the Isle of Man.⁵⁷

A *second* consideration is that complex tax planning can produce litigation costs related to the interpretation of the tax statutes. Reviewing the annual reports of corporations traded as part of the TA-25 index on the Tel-Aviv Stock Exchange reveals that in recent years many corporations were involved in legal proceedings because of disputes regarding the payment of taxes. According to Israeli law, corporations are not obligated to publish the fees they pay to their attorneys, and therefore it is difficult to estimate the amounts they paid to their legal advisors. But in view of the type of procedures listed and of their duration, it is likely that these costs are considerable.

Third, the more companies are taking advantage of loopholes in the law in order to create complex aggressive tax planning schemes, the greater the likelihood that the authorities will consider it appropriate to enact additional anti-planning norms. It is reasonable to assume that legislation of this type will create new complexities for the tax reports, which will encumber the business activities of corporation, in addition to creating new financial costs.

Fourth, the use of aggressive tax planning may damage the trust the authorities have in the corporation, and have a negative effect on the good relations between the corporation and the authorities. As a result, the corporation may lose contracts and be subject to various restrictions on its participation in tenders conducted by the government.⁵⁸

A *fifth* business consideration for adopting a responsible tax policy is the uncertainty with regard to the response of the authorities to tax planning by the corporation, and the possibility that the tax liability of the corporation will end up being higher than what has been paid in practice, may result in uncertainty for investors regarding the value of the shares of the corporation.⁵⁹ For example, in 2005 the British company *Vodafone* dropped a place to fifth in the FTSE100 following an announcement by the company that contrary to previous forecasts (which were based on tax planning conducted by the company), it will likely have to pay £5 billion in taxes for the years 2005-2008.⁶⁰ Such a drop in the

⁵⁶ BBC News Business, *Barclays UK Corporation tax bill of 2009 was £113*, (18.2.2011, UK), **BBC website** <http://www.bbc.co.uk/news/business-12511912>; (accessed 21.6.12)

⁵⁷ Editorial, *Corporate Tax Avoidance - Impoverishing the public* (19.2.2011. UK), **The Guardian** <http://www.guardian.co.uk/commentisfree/2011/feb/19/taxavoidance-barclay>; (accessed 21.6.12)

⁵⁸ KPMG's Report, pp. 32-34.

⁵⁹ SustainAbility, **Taxing issues - Responsible Business and tax**, p.3 (hereinafter: "SustainAbility").

⁶⁰ A. Hawkes, *Vodafone Shares Sink Under Tax Bill*, **Accountancy Age** (24 November 2005). See also: R. Murphy, *Vodafone's tax case leaves a sour taste*, **Tax Research UK** (23.10.2010, UK), <http://www.taxresearch.org.uk/Blog/2010/10/23/vodafones-tax-case-leaves-a-sour-taste/>; (accessed 21.6.12)

price of the shares can also lead to a situation where company shares continue to be traded at a lower value than their true value, if only because of the fear that in the future there will be some further uncertainty about the tax payments of the company.

In light of these considerations, the large accounting firm KPMG has published in recent years several reports showing that stakeholders have recently begun pressuring corporations to avoid aggressive tax planning when they adopt a policy of social responsibility. Ultimately, KPMG argues, if we take into account all the business risks stated above, it is highly doubtful whether it is profitable for corporations to undertake aggressive tax planning.⁶¹

3. From Theory to Practice: The "Tax Gap" Problem

This chapter presents the factual findings of a study we have conducted, which compares the actual tax payments of leading corporations in Israel, both to the statutory tax rates for these companies, and to their philanthropic donations. Our aim in this study was *first*, to expose the non-socially-responsible tax planning practices by leading Israeli companies; and *second*, to illustrate that the potential tax loss caused to the state as a result of aggressive tax planning far exceeds the benefit to the public from corporate philanthropy. The overwhelming result, detailed below, supports our conclusion, that the tax policy adopted by a corporation should be seen as an integral part of its social responsibility.

3.1. The Study's Findings: Aim, Work Method, and Underlying Assumptions

The study focused on the list of corporations traded as part of the TA-25 index of the Tel-Aviv Stock Exchange.⁶² Our aim was to test whether a general tendency can be observed according to which the annual tax rate paid by corporations is different from the statutory corporate tax rate. The gap between the **effective tax rate** (tax rate consisting of tax expenditures actually paid by the corporation as well as the book entry for the deferred taxes of the corporation) and the statutory corporate tax rate is called hereinafter the "**tax gap**." To discover the tax gap, we used the financial statements that corporations are required to publish. The reports were found on the website of the Tel-Aviv Stock Exchange. As of today, Israeli law does not require that corporations publish in their annual papers the tax rates paid by their affiliates in each country where they are taxed ("country-by-country reporting").

⁶¹ Please refer in this context to footnote 53 above.

⁶² The index is updated twice a year, on June 15th and on December 15th. The study we conducted was based on the corporations included in the index following the June 15, 2010 update. The list of 25 corporations examined: *Discount Bank, Bezeq, Bank Hapoalim, Osem, Cellcom, Partner, Mizrahi Tefahot, Harel, Perrigo, Strauss Group, Discount Investment Corporation, Elbit, Nice, Paz Oil, Chemicals, ORL, Teva, Delek Group, Israel Corporation, Gazit Globe, Leumi, MA Industries, Ormat Industries, Delek Drilling, and Avner Oil and Gas Explorations.*

Only a fraction of the corporations we surveyed did so. Therefore, we had no way of knowing whether and to what extent corporations that we surveyed use aggressive tax planning and sophisticated accounting practices in order to reduce their tax liability. Given this non-transparent state of affairs, we resorted to using a rough estimate: We examined the overall effective tax rate that corporations paid on their profits. It should be emphasized that the tax gap may also (or only) be the result of reasons unrelated to aggressive tax planning, such as tax benefits that the corporation receives from the state (for example, by virtue of the Israeli Law for Encouragement of Industry or the Israeli Law for Encouragement of Capital Investment)⁶³, timing differences, differences between tax rates in different years, and so on. Nevertheless, due to the lack of transparency, as noted, our objective was only to verify the existence of the tax gap (without determining specifically its origin for each company) and to indicate the resulting potential financial damage caused to the state. Our initial assumption was that none of the corporations that we surveyed undertakes tax planning that would establish any type of criminal grounds against it.

To produce results as reliable as possible and to minimize annual distortions (due to a gain or loss caused to the corporation in a given year), we checked the effective tax rate paid by the above corporations over four tax years, between 2006 and 2009.

The data were collected only from the consolidated financial statements of the corporations, as published on the website of the Tel-Aviv Stock Exchange as part of the mandatory duties imposed on public corporations. In this context, note that for some dually-traded corporations (i.e., traded both on the Tel-Aviv Stock Exchange and elsewhere in the world), we found only abbreviated financial statements for some years.⁶⁴ In these cases we were not able to find the data on contributions and no clarifications to the financial statements were available.

The calculation of the effective tax rate consists of the expenditure on taxes actually paid by the corporation and book entries for the deferred taxes. To calculate the effective tax rate, we examined the amount of "tax expenditures" declared by the corporation each year, and divided it by the amount of profit earned by the corporation in the same year. Regrettably, given the scope of the present study, and due to the aforementioned lack of transparency, we could not isolate from the amount of tax expenditure the amount of deferred tax attributable to each year. As a result, it must be taken into account that the effective tax rate

⁶³ Encouragement of Capital Investments Law, 1959 (refers mainly to R&D grants for Approved Enterprises) ; Encouragement of Industry (Taxes) Law, 1969 (refers mainly to Industrial Enterprises)

⁶⁴ We refer to papers published in the short format classified by accounting rules as K6, which does not include some of the clarifications and details that appear in the full papers.

shown does not reflect accurately the current tax rate actually paid by the corporation in the relevant years.⁶⁵

To obtain an average effective tax rate paid by the corporations in this period, a *weighted average* was obtained between the tax rates paid by each corporation in each of the four years (in such a way that the years in which a higher or lower tax rate was paid we assigned a different weight from that assigned for other years). This is because standard averaging is liable to result in a certain deviation relative to the overall amount of tax the corporation paid out of its total profits.

Some of the corporations showed a loss for the year 2008. Examination of their financial reports indicates that for various reasons, including the right of corporations to transfer losses to subsequent years for tax purposes, the amount of "tax expenditures" shown by these corporations had a negative numeric value, which probably represents a tax benefit. As the purpose of our examination in the present paper is only to examine the tax rate paid by corporations on their profits, receiving a tax benefit in a year in which the corporation posted a loss is not relevant for our calculation. Therefore, we decided to exclude this year from the data analysis for the relevant corporations. In other words, the calculation of the average tax rate for corporations that posted a loss for the year 2008 was based on the tax years 2006, 2007, and 2009 only.

The tax gap was calculated in the following manner: we compared the average effective tax rate paid by the corporation during this period with the average statutory tax rate that applied to corporations during these years.⁶⁶ We also took into account the fact that corporations defined for tax purposes as "financial institutions" (such as banks and insurance companies) pay, in addition to the corporate tax that applies, a profit tax, and therefore the average statutory tax rate that applies to them was higher in those years.⁶⁷ To discover the relationship between the rate paid by the corporation and the tax rate that applied to it, we divided the effective tax rate by the statutory tax rate applicable to the corporation, in accordance with the said classification of the corporation.

⁶⁵ We sent the data we collected to the corporations by e-mail and asked for their response (a copy of the letter is on file with authors). With a significant number of corporations we encountered serious difficulty in locating the person responsible for the social responsibility affairs of the corporation and to whom we needed to send the letter. In cases in which there was no information about social responsibility on the website of the corporation, we called up the corporation and asked to talk to the person in charge of the matter. As a result, we spoke with various officials and were transferred numerous times between the departments of Human Resources, Welfare, Customer Relations, Culture, and Public Relations. *Regrettably, from among the 25 corporations to which we sent requests for comment, only 10 corporations responded.* As a result, for the remaining 15 corporations we were unable to verify that the data truthfully reflect their books. The comments we have received were integrated into the study's findings.

⁶⁶ The statutory corporate tax rate during the relevant years was as follows: 2006: 31%, 2007: 29%, 2008: 27%, and 2009: 26%.

⁶⁷ The statutory corporate tax rate that applied to financial institutions during the relevant years was as follows: 2006: 40.65%, 2007: 38.53%, 2008: 36.8%, and 2009: 36.21%.

The potential tax loss is the amount of money taken away from the Treasury each year as a result of the existence of the tax gap (which is, as noted, the difference between the effective tax rate and the statutory tax rate). For the purpose of our investigation, the potential tax loss consists of the difference between tax expenditures the corporation was supposed to pay in 2006-2009 in accordance with the statutory tax rate, and tax expenditures that the corporation declared. To calculate the amount of potential tax loss caused to the State by all the corporations traded as part of the TA-25 index during the relevant years, we summed the potential tax loss we obtained for each of these corporations.

In addition to examining the tax gap, our study also looked into two other variables: *contributions rate, relative to profit*; and *transparency with regard to tax havens*.

As mentioned earlier, philanthropy typically characterizes "first generation" of CSR – it is voluntary, sporadic and often seen as a PR exercise. It was therefore interesting to examine the corporations' practices in Israel in the aspect of contributions, in order to compare it with their tax payment policy, which we consider as "second generation" of CSR. With regard to contributions, Israeli law mandates that corporations traded on the securities exchange specify in the report of their board of directors the corporate policy with regard to donations, if such a policy has been established.⁶⁸ They are also required to state the scope of their financial contributions to the community in the reported year.⁶⁹ It should be emphasized that a large part of the corporations contributed to the community also by means of "money equivalents," including many volunteer hours of their employees and sponsorships. However, because it is difficult to quantify contributions in "money equivalents" based on uniform criteria for comparison, we chose to consider only contributions paid as money.⁷⁰

As for transparency regarding the corporate tax rate paid by all subsidiaries of a corporation, it is worth noting again, that Israeli corporations are *not* required by law to publish where in the world each of their subsidiaries is taxed or the tax rate that applies to each of them. However, several Israeli corporations chose to do so on their own initiative and publish this data in their annual paper. In examining the extent to which aggressive tax planning is used, the importance of transparency in this matter applies only to corporations whose subsidiaries are not considered to be Israeli residents but are taxed in different countries/autonomies worldwide, some of which may also serve as foreign tax havens.

⁶⁸ Amendment (2001) to the Securities Regulations (Periodic and Immediate Papers) 1970.

⁶⁹ Securities Regulations (Periodic and Immediate Papers), 1970, section 10(b)(6).

⁷⁰ For some of the corporations that posted a loss for 2008 but chose nevertheless to transfer money for contributions, calculating the percentage that contributions represented of the amount of the loss for the year led to a negative numeric value that did not make sense. Therefore, for these corporations, we calculated the average amount of contributions based on the tax years 2006, 2007, and 2009 only. Similarly, for corporations that published the amounts of contributions only for some of the relevant years, we calculated the average based on the incomplete information at our disposal.

It is worth mentioning that our study was inspired by a study conducted in England by accountant Richard Murphy for the British Trade Union Congress (TUC). The study focused on the tax rates paid during the six years between 2000 and 2006 by the fifty largest corporations from among those traded on the London stock exchange (FTSE 100 index). Murphy was able to point to a general tendency, according to which the amount of deferred taxes that corporations papered in their annual papers each year increased significantly each year, reaching hundreds of millions of pounds.⁷¹ The conclusion of the study conducted by Murphy is that the actual tax rate paid by the corporations that he surveyed was on average lower by 5% than the effective tax rate papered by them and which also includes deferred taxes.⁷²

3.2. Data analysis

3.2.1. Regarding the average tax rate paid by corporations in the 2006-2009 tax years, we obtained the following results :

- (a) The potential amount of tax loss caused to the state by the corporations we surveyed amounts on average, for each year between 2006 and 2009, to a total of about **NIS 3.06 billion**.
- (b) 6 of the corporations surveyed paid on average more than the statutory tax rate. The proportional part they paid in relation to the statutory tax rate ranged from 100.03% to 111.61%.
- (c) 17 of 25 of the corporations paid on average less than the statutory tax rate. Of these, one corporation paid an average of less than zero percent tax.⁷³

⁷¹ Richard Murphy for Trades Union Congress, **The Missing Billions: the UK Tax Gap** (London, 2008), p.50 (Hereinafter: "The Missing Billions") <http://www.tuc.org.uk/touchstone/Missingbillions/1missingbillions.pdf>; (accessed 21.6.12). Murphy conducted a study in England for the British Trade Union Congress (TUC) about the tax rates paid during the six years between 2000 and 2006 by the fifty largest corporations from among those traded on the London stock exchange (FTSE 100 index). As part of his research Murphy points to an extreme example of one of the corporations surveyed: Between 2000 and 2006, the average amount of deferred taxes of each of the companies included in this specific corporation increased by hundreds of millions of pounds. The aggregate amount was so high that in 2006 the total amount of deferred tax of the corporation amounted to 47.7 billion pounds, an amount greater than the total corporate tax paid by all UK corporations together in the same year.

⁷² The Missing Billions, pp.23-29. If we apply Murphy's estimate to our research, it means that the potential tax loss caused to the state is higher by an additional NIS 2.15 billion per year on average (although we must consider the fact that Murphy's conclusions concerned corporation traded in England, whereas in the present paper we are dealing with corporations traded in Israel).

⁷³ The two limited partnerships on the list, Avner Oil and Gas Exploration and Delek Drilling, are not considered taxpayers according to the Income Tax Ordinance. The income and expenses, as well as the profits and losses of these partnerships are attributed entirely to the general partner (by share in the

3.2.2. Regarding the disclosure of the residence of the subsidiaries and the tax rates applicable to them, we received the following results from the 25 corporations surveyed:

- (a) 4 corporations have no foreign subsidiaries. Subsidiaries belonging to them are residents of Israel only.
- (b) 6 companies disclosed no information about the place of residence of their subsidiaries.
- (c) 4 companies disclosed in detail the place of residence and the tax rate applicable to each of their subsidiaries.
- (d) 11 companies have shown only the *main* companies taxed outside Israel, or provided information only on some of the years surveyed, or mentioned in a clarification to the included financial statements the list of companies that were part of the holding company, from which it is possible to glean the residence of most of its subsidiaries.
- (e) We discovered that some of the subsidiaries of 7 of the corporations are taxed in foreign tax havens such as the Cayman Islands, Bermuda, Switzerland, Jersey, and Guernsey.

3.2.3. Regarding payments for contributions we obtained the following results:

- (a) Total contributions paid by 15 of the 25 corporations (for which we have complete data on contributions) in the course of the four relevant years was NIS 164,294,623 on average for each of the years examined. Assuming that this figure represents the average amount of corporate contributions for the remaining ten corporations (despite the fact that the two limited partnerships stated that they did not contribute at all in these years), the total annual average contribution of all 25 corporations would amount to NIS 273,824,371.
- (b) The percentage of corporate profits (after tax) that contributions represent (including corporations for which we have partial information about donations) ranged from 0.06% to 4.08%. But it is reasonable to assume that a significant proportion of contributions have been recognized under Article 46 of the Income Tax Ordinance as *deductible donations* that grant the company credit at the level of the

partnership) and the unit holders who are "entitled holders" based on the ratio of their partnership holdings. Therefore, we were unable to calculate the effective tax rate applicable to these partnerships. Moreover, both partnerships indicated explicitly that they had not yet adopted any contributions policy and therefore did not contribute at all during the relevant years.

corporate tax. *In these cases the contributions by the corporation represent a percentage of earnings after tax that is even lower than the one calculated by us.*⁷⁴

- (c) For 8 of the corporations we were not able to locate in the financial statements the amounts donated during the relevant years, or we found data only for some of the years.⁷⁵
- (d) The ration between the state's loss (due to non-payment by corporations) and contributions made by these corporations is 11:1. Thus, the potential tax loss caused to the state as a result of aggressive tax planning and of the use of tax benefits far exceeds the benefit to the public from corporate donations.

The study's findings are troubling: the tax expenditures of the leading Israeli corporations are significantly lower than the statutory corporate tax rate in the years 2006-2009. This is so, in spite of the fact that corporate tax rates in Israel were reduced significantly in recent years (as explained below) and are currently ranked at the bottom of the list of developed countries (except Ireland).⁷⁶ As a result of the tax gap created in these years, the Treasury sustained each year a potential tax loss of at least approximately NIS 3.06 billion on average.

4. Rethinking tax policy and corporate social responsibility: The overall picture

In many countries, including Israel, corporate tax rates have been dropping significantly in recent years. In Israel, the corporate tax rate was reduced from 61% in 1985 to 25% in 2010, and plans to further decrease it to only 18% in 2016 were shelved only following public protest. Reasons for the decline in tax rates are, among others, the desire to attract investors into the country, the mobility of capital, and the assumption that low taxes encourage honest tax payment. In addition to the decline in tax rates, the granting of large tax benefits to encourage industrial development and capital investment (including benefits under the Law for Encouragement of Capital Investment, the Law for Encouragement of Industry, and the granting of participation exemptions) are further reasons for the decline in the country's tax base.⁷⁷ Reduction of tax rates and the inclusion of tax benefits in the encouragement laws are probably responsible for a significant portion of the potential tax loss, and among others, are likely to provide incentives for corporations to undertake various manipulations in order to meet the criteria for these tax benefit programs.

⁷⁴ It should be taken into account that some of the subsidiaries of the corporations were also traded separately on the TA-25 index (e.g., Israel Corporation, ICL, and ORL). In these cases it is plausible that the percentage of contributions made by these subsidiaries is low relative to other corporations; and by contrast, the percentage of contributions of their parent companies is high relative to other corporations.

⁷⁵ As noted above, the two partnerships stated explicitly that they have not yet adopted a contribution policy.

⁷⁶ Knesset – Research and Information Center, Description and Analysis of the Consequences of the Tax Policy of the Government (12 December 2010), p. 12.

<http://www.knesset.gov.il/mmm/data/pdf/m02714.pdf>; (accessed 21.6.12).

⁷⁷ Economic Capital and Personal Capital, pp. 47-48.

However, despite the steady decline in corporate tax rates and of increasing tax benefits, corporations *de facto* continue to seek creative ways to reduce their tax payments, and the extent of their use of aggressive tax planning continues to rise. The tax loss caused as a result leads to a dramatic deviation in the distribution of tax rates in society, which must be regarded as an issue related to social justice and to the responsibility of both the "creative corporations" and the government, for the standard of living of the general public.⁷⁸

Importantly, we are very much aware of the significant profits to the state from corporate investments. These gains include, among others, the development of infrastructure and technology, job creation, decrease in unemployment benefits and other transfer payments, the collection of additional taxes on the salaries of employees, attracting investments by other companies as a result of existing investments, and the like. Nevertheless, in our opinion, given the rate of potential loss of tax, and in light of the normative considerations presented above, new conclusions should be mandated. *First*, and most importantly for the purposes of this paper, we believe it is imperative that we think about aggressive tax planning practices as part of the demands of corporate social responsibility. *Second*, we strongly advise that the state reconsider the implications of the reduction in the overall tax base as a result of the granting of tax benefits and of the reduced tax rates.

Corporate social responsibility is a dynamic field, and the demands it imposes on corporations is constantly shifting. We believe that considering tax policy as part of this field's demands could be achieved mainly through public pressure. Indeed, one of the most significant factors in the increase of public awareness of "fair trade" has been the social pressure exerted on corporations by activists and NGOs worldwide. This pressure was manifest, among others, by demonstrations and propaganda campaigns, consumer boycotts, the sale of stocks and pressure on institutional investors to sell holdings, public shaming, and lawsuits. It seems that in a similar way it is possible to raise awareness of the importance of preventing the use of aggressive tax planning among corporations. The culture of tax avoidance by companies must be condemned, and it is necessary to clarify how payment of full taxes is a significant act of social responsibility and even of patriotism.⁷⁹ Moreover, public pressure must be exerted on corporations to increase transparency with regard to the amount of tax paid by their subsidiaries in the countries where they are taxed for their profits. We believe that the greater the pressure the public will put on this issue, the greater the need of the corporations will be to adopt a responsible tax policy as part of their social responsibility.⁸⁰

⁷⁸ Mind the tax gap, p. 12.

⁷⁹ SustainAbility, p. 29.

⁸⁰ An example of an organization that has recently begun public propaganda campaigns against the use of foreign tax havens is UK Uncut, the activities of which we described above. In addition, in June 2010 a coalition of large non-government and international organizations, including Oxfam, Action Aid, and Christian Aid, began a joint initiative to apply public pressure on the G-20 Conference with the aims of eradicating financial confidentiality and the massive worldwide use of foreign tax havens.

The second issue that the paper wishes to reconsider is the necessity to take into account the *overall "tax gap" picture*, while granting tax benefits and reducing tax rates – including aggressive tax planning practices. We especially advise to reconsider the argument in favor of reduction of tax rates as a mechanism to attract investment. Indeed, empirical findings support the conclusion that the reduction of corporate taxes encourages foreign investment only in the short and intermediate terms, whereas in the long term prolonged and consistent tax rate reduction can have disastrous consequences.⁸¹ For example, tax reductions in Ireland, which initiated a most aggressive international tax competition, indeed produced in the beginning great economic growth. However, over the time the social gaps widened, violence intensified and became a real phenomenon, and growth rates began to fall even before the eruption of the global economic crisis. Prof. Edrei concludes that neglect of the social capital at the expense of encouraging financial capital did not increase the welfare of the residents of Ireland.⁸² A similarly conclusion was reached by Christensen and Kapoor,⁸³ who showed that the main considerations underlying the decision of investors about the location where a manufacturing or industrial enterprise is to be established within the country are the presence of physical and social infrastructure, an educated workforce, and political and economic stability. By contrast, the weight they assign to incentives such as tax benefits and lower tax rates among their general considerations is not high.⁸⁴ It should be reminded that strong infrastructures are primarily the result of high tax payments. Professor Reuven Avi-Yonah adds that it is reasonable to assume that states would prefer to stop lowering the tax rates and granting tax benefits if an international agreement existed stipulating that states should avoid taking part in tax competition.⁸⁵

In this context it is worth mentioning that a *tax policy report* submitted to the Israeli parliament's Finance Committee in December 2010, noted that continued reductions in direct taxes could lead to increasing social gaps, which are already considered to be high among the developed countries. It was also noted that such reduction may shrink the "security cushion" of the Israeli economy, especially needed for financial coping in times of

Among its other actions, the coalition calls on the public to send letters of protest to the G-20 summit and to participate in propaganda campaigns organized by the coalition.

For additional details about the activities of the joint coalition, see its Internet site at <http://www.endtaxhavensecrecy.org/en/about-us/>. (accessed 21.6.12)

⁸¹ Social and human capital, pp. 47-48

⁸² Ibid. See also, SustainAbility, p. 16.

⁸³ J. Christensen and S. Kapoor, *Tax Avoidance, Tax Competition and Globalisation: Making Tax Justice a Focus for Global Activism*, paper given at Tax and Development Conference (2004), Helsinki, Finland.

⁸⁴ The OECD, **Economic Survey of Israel 2009: Assessing the macroeconomic policy framework** (2010, Paris).

⁸⁵ R. Avi-Yonah "Globalization, Tax Competition and the Fiscal Crisis of the Welfare State", *Harvard Law Review* (2000) vol. 113:1573. Prof. Edrei adds in this matter that the international tax competition is indeed "a race to the bottom that places in jeopardy the accomplishments of the welfare state and is liable to lead to its end," in Social and Human Capital, pp. 47-48.

emergency such as prolonged war or another global crisis.⁸⁶ Similarly, the Bank of Israel noted in its annual report for 2010, that the continuation of the planned tax cuts could jeopardize the two most important macro-economic objectives of Israel: reducing the budget deficit and reducing the national debt.⁸⁷ The Bank of Israel noted further that:

“Of all the tax rate reductions, the reduction of the corporate statutory tax rate was the sharpest and the most prominent one [...] At the beginning of the decade the statutory tax rate in Israel was higher than the average for OECD countries. As a result of the sharp reduction, tax rates in 2010 were similar, and it is expected that in 2016 tax rates in Israel will be lower than the average in OECD countries. It is important to note that in OECD countries the reduction in tax rates was carried out in parallel with an expansion of the tax base, with more rigid restrictions on authorized tax deductions, and therefore during this period... the gap between the statutory tax rate and the effective tax rate was reduced, and the latter was also calculated into the tax base. By contrast, in Israel [...] no significant change was made to the tax base during this period.”⁸⁸

Prof. Edrei recently expressed his opinion about this reduction:

“I also wish to point out the serious concern for the economic and social strength of the country as a result of joining the “contest of taxes” that many countries are engaged in, mostly developing countries. This competition courts the financial capital and neglects the human and social capital in Israel. Thus our policy makers ignore the many dangers, economic and especially social, associated with this competition, and demonstrate a lack of confidence in the economic might and strength of the country and in the ability of the social capital and human capital to attract the financial capital.”⁸⁹

Indeed, the overall tax policy of the state, which includes corporate tax rates, tax benefits to corporations, and a forgiving attitude towards aggressive tax planning practices, leads to a significant potential tax loss caused to the state. This tax loss is reflected in a decline in services and in various resources that the state finances for its citizens. It leads to a dramatic deviation in the distribution of tax rates in society, and it must be regarded not as a purely economic-professional matter but as an important aspect of social justice policy and of the responsibility of the government for its citizens' standard of living.⁹⁰ Moreover, it is important to note that the resulting reduction in the tax base leads to further strengthening of the corporations at the expense of a reduction of the public sector, and is one of the main reasons for the formation of the problem referred to as the "short blanket" syndrome in the allocation of the budget, and for the ongoing “drying out” of public

⁸⁶ Tax Policy Report, p. 13.

⁸⁷ The Central **Bank of Israel Report for 2010** (April 2011), pp. 193-214 (Hereinafter: “The Central Bank”); See also M. Arlozorov, *This is how Israel holds two contradictory records in the area of taxes*, **The Marker** (6.4.2011).

⁸⁸ The Central Bank, pp. 206-207.

⁸⁹ Social and Human Capital, p. 87.

⁹⁰ Mind the Tax Gap, p. 12.

services. In addition to a shift in the state's attitude towards corporate tax payments, all this mandates that we adopt a more robust conception of corporate social responsibility, to include corporate tax policy within its domain.

Conclusions

The purpose of this paper was to examine both the theoretical and the practical implications of aggressive tax planning for corporate social responsibility. We began by discussing the right to plan one's taxes under Israeli law, as well as the restrictions upon this right. We then moved to demonstrating the **theoretical grounds** of limiting aggressive tax planning practices, mainly on the basis of the social contract idea. More specifically, our argument explained that aggressive tax planning frustrates the ability of society to function, is detrimental to social equality and to the realization of social or economic policy by means of the tax system, and imposes an additional economic burden on those who do not or cannot undertake such planning. For these reasons, we argue that aggressive tax planning should be considered unethical and illegitimate, even if it is strictly in compliance with the letter of the law. Furthermore, we argued that as such, it should be regarded part of what corporate social responsibility should mean. After reviewing possible critiques to our approach, and responding to them, we have tried to establish the **practical considerations** for considering tax policy as a matter of corporate social responsibility. Our argument here relied on our own small scale-study, inspired by other studies conducted in the UK, according to which tax planning practices potentially cost the state treasury much more than it gains from corporate philanthropic gestures, which characterize "first generation" CSR.

The theoretical argument of the paper demonstrates why adoption of a responsible tax policy should be regarded as an integral part of corporate social responsibility. It rests on the perception that the corporation cannot maintain its proper functioning without the state that places its services and resources at its disposal. Considering that the corporation derives its wealth from the natural resources that belong to society as a whole, and from the human capital that the state trains, it is only fair to demand that the corporation does its part in supporting these structures. As part of the "social contract" between the state and its citizens, and due to the necessity of tax payments for the proper functioning of society, the corporation is expected to "repay its debt" to society by paying full tax on its profits. We emphasized that even if aggressive tax planning is not considered to be contrary to law, the corporation is expected not to exceed the terms of its "social license" to operate, and to avoid such planning, because the issue of corporate social responsibility goes beyond compliance with the law. Moreover, in light of the extended privileges enjoyed by corporations in society and of the increasing influence corporations exercise on the distribution of local as well as global resources, the expectation that corporations do not evade taxes is even more justified.

The practical portion of the paper examined the effective tax rate paid by corporations traded on the TA-25 index during the years 2006-2009. Our aim was to learn about the tax policies of these corporations and consequently about their social responsibility policy as well. The findings show that the tax gap between the effective tax rate and the statutory tax rate paid by surveyed corporations in the years 2006-2009, causes a potential tax loss to the state of 3.06 billion NIS on average each year. It is important to note again, that while the scope of practical study in this paper is not wide enough to mandate far reaching conclusions, it is nonetheless sufficient to primarily point out the general trend, according to which the actual tax rates paid by most of the leading corporations in Israel are significantly lower than the statutory corporate tax rate. The study further shows that this potential loss far exceeds the sum of donations made by these corporations to the Israeli society.