Tax and directors’ fiduciary duties

INTRODUCTION

On 9 September 2013, the Tax Justice Network published a letter which it had sent to the CEOs of the FTSE 100 companies attaching a legal opinion from Farrer & Co (the “Farrer Opinion”) to the effect that UK company directors have no fiduciary duty to their shareholders to avoid tax.

According to Tax Justice Network: “It is often asserted that UK company directors have a fiduciary duty to their shareholders to avoid tax.” The Farrer Opinion is intended to show that there is no legal basis for such a statement.

In my view, the position is more complicated than the Farrer Opinion suggests. I will explain why and how directors’ duties affect decisions about tax planning.

First, it is worth pausing to consider what is meant by the statement. Does it mean that directors must pursue every available opportunity to save every penny or cent of tax? No-one would advance such an absurd proposition. The opposite proposition, that UK company directors have no fiduciary duty to their shareholders to avoid tax, is no more defensible. The truth lies in between.

The duties of directors are not complicated or hard to understand. Nor are they generally hard to apply in practice. What they require above all is for the directors to reach a carefully considered position that is intended to promote the success of their company, weighing in good faith the benefits and disadvantages and risks associated with the proposed course of conduct.

BACKGROUND

The duties of directors, which are owed to the company, came to be known as fiduciary duties when they were developed by judges on the basis that the position of directors is equivalent to that of trustees. The Companies Act 2006 replaced these duties with a set of statutory duties. The principal duty is found in section 172(1) of that Act:

“A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole...”

The key elements of this are:

• the director must act in good faith

• the director must consider that the decision in question is likely to promote the success of the company

• the success of the company is to be determined by the benefit for members as a whole.
The section goes on to list a number of matters that directors should take into account (the so called “enlightened shareholders’ interest”). These include: “(a) the likely consequences of any decision in the long term... (c) the need to foster the company’s business relationships with suppliers, customers and others, (d) the impact of the company’s operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct...”

This duty will rarely, if ever, require directors to take one particular course from a range of available options each subject to competing considerations.

In addition to the duty to promote the success of the company, there are a number of other duties. As noted in the Farrer Opinion one of these is to exercise “reasonable care, skill and diligence” (section 174, Companies Act 2006).

The Farrer Opinion states: “The language regarding "for the benefit of the members as a whole” is not there to impose a duty on directors to act for the benefit of shareholders;...”. If what they mean is that the directors are not required to act in a way that benefits shareholders at the time at the expense of future shareholders, I would agree.

It is also worth bearing in mind that the directors’ duties are enforced in principle by the company but if the company does not take action shareholders may be able to bring a “derivative” action. If the company is insolvent the liquidator or administrator will decide whether claims should be brought. The fact that shareholders (or, in an insolvency, creditors) are in control of claims is an important context for understanding what these duties mean in practice.

PRACTICAL EXAMPLES

It may be easiest to understand how the duty to promote the success of the company operates in practice by looking at some examples:

Disposal of shares
A company has a liquidity crisis and needs to raise cash urgently. It has a subsidiary it can sell. The sale would qualify for the substantial shareholdings exemption save that the shares have been owned for less than a year. If the directors decide to sell before the year is up, would they be in breach of their duty to promote the success of the company? To answer that, we need to know why they took that decision. We will assume they were aware of the consequences (otherwise they may be in breach of their duty to exercise reasonable care). But if the need to raise cash is very urgent and the buyer has made it clear the deal is only available for immediate acceptance their decision may be defensible. If, however, there is no good reason not to wait, it would be hard to avoid the conclusion that the board was not acting in good faith pursuing the success of the company.

Financing an acquisition
A company is considering how to finance a new activity or the acquisition of an asset. Should it do so by issuing equity or by borrowing? If the board had no information on the tax implications of the options it would be likely to have failed to exercise reasonable care. Properly advised it will look at the after tax position when making its decision. What if in the example the company can borrow using a hybrid instrument for tax purposes so that the interest is deductible by the company but treated as dividends in the hands of the recipient and therefore not taxed? The tax benefit lowers the financing cost of the transaction for the company. Again, the well advised board will assess the net cost to the company in deciding whether to proceed with this option. If the only reason for not doing so was that the advantage to the company was based on a tax benefit, a shareholder might well question whether the directors had promoted the success of the company for the benefit of shareholders.
That does not mean, however, that the board could not justify such a decision. The Farrer Opinion points to the additional factors that the statutory duty requires directors to take into account (the “enlightened shareholder interest”) as providing a basis for defending a decision that does not minimise tax. I would agree. In particular the “desirability of the company maintaining a reputation for high standards of business conduct” is likely to be relevant.

CONCLUSION

Do directors have a fiduciary duty to avoid tax? The real answer is that sometimes their duty to promote the success of the company will drive decisions to take the lower tax course of action. That is not so headline grabbing as the simplistic denial put forward by the Tax Justice Network but it is, perhaps, more useful. It is true, however, and the Farrer Opinion makes a good case for this, that a board that has good business reasons for wanting to adopt a tax planning policy that does not seek in all circumstances to minimise the tax paid should not be at risk of liability for breach of their duties. Boards should consider carefully and in detail their attitude to tax and its avoidance (or minimisation, if that is a better word) and be ready to justify their decisions, not on the basis that they are forced by their duties to take them but because they believe they are in the best interests of the company.

One last point to bear in mind, however, is that in the world of listed companies, the directors expose themselves to re-election by shareholders every year. A board that decides to pay more tax than it needs to will have to convince shareholders that it is in their interests to do so, not in a court of law but at the AGM and when they fill in their proxy voting forms.

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