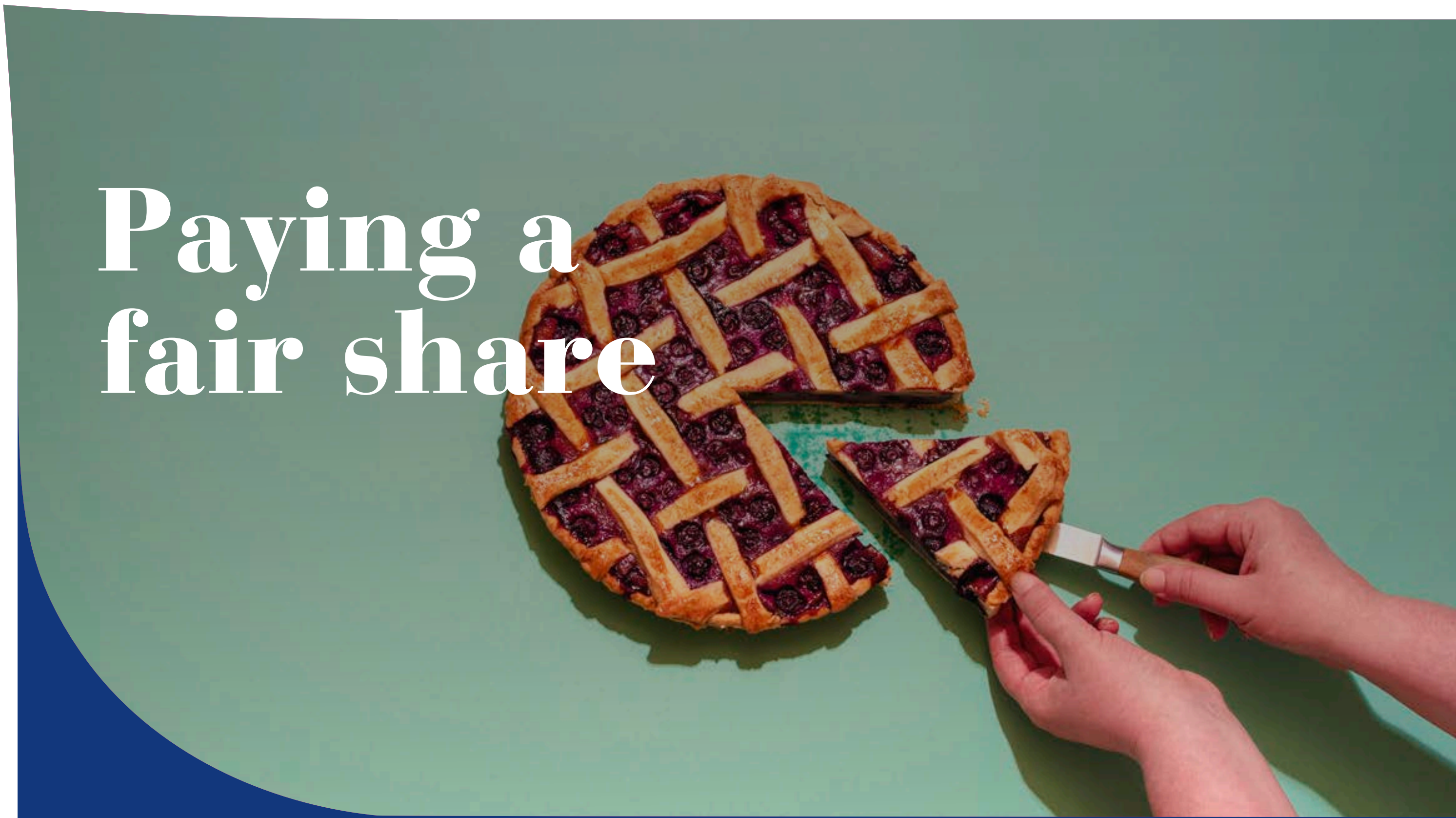
Paying a fair share



Companies that seek to aggressively minimise their tax payments will face increasing legal, financial and reputational risks as regulation tightens. Joanne Beatty explains why tax revenues are vital for cash-strapped public services, and how we engage with companies to ensure they pay a fair share.

Setting the scene

Tax payments underpin the functioning of vital societal services in developed countries and emerging economies. These include emergency services, health, education, infrastructure, welfare, justice, and environmental protection, including climate mitigation and ensuring a just transition. As a result, tax revenues represent the single largest source of funding for the UN Sustainable Development Goals.[1]

Investors need sufficient information to gauge a company's tax position and governance approach and anticipate any future risks to their holdings. Aggressive tax practices can lead to investigations by regulators, resulting in fines or retrospective clawback of underpaid tax. A company's reputation and social licence to operate can also be damaged if it is thought not to be paying its fair share.

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Public services are under immense strain in many countries in the wake of the pandemic, with soaring inflation adding to the pressure. Against this backdrop, it is vital that tax burdens are distributed proportionately, rather than falling on the most vulnerable segments of the population. However, some multinational companies employ aggressive tax practices to minimise their tax payments, meaning that governments must make up the revenue shortfall by increasing the burden on individuals, or borrowing more.

Aggressive tax planning and practices are those where companies reduce their tax liability through arrangements that may be legal but are not in keeping with the intent of the law, and are often not transparent. These practices may increase profits in the short term, but pose significant risks that undermine investment returns in the medium and long term.[2] There are many ways that companies may seek to exploit tax loopholes and avoid paying their fair share of tax owed. The key strategies and practices deployed include:[3,4]

- Host country incentives to companies to locate in a low tax jurisdiction (eg tax havens, shell companies and other incentives)

[1] hermes-eos-public-engagement-report-q3-2019.pdf (hermes-investment.com)
[2] Microsoft Word – Exempt Solicitation Amazon 2022-04-14 (cictar.org)
[3] UNPRI Engagement guidance on corporate tax responsibility
[4] hermes-eos-public-engagement-report-q3-2019.pdf (hermes-investment.com)

- Exploitation of tax loopholes, for example transferring assets such as intellectual property from a subsidiary in a high-tax jurisdiction to a low-tax jurisdiction
- Base erosion of the national tax base through profit shifting. This is when multinational companies shift profits generated in the country into other jurisdictions, such as offshore financial centres with lower or zero tax rates, to minimise their tax burden. This can include the use of marketing services and trading company structures to shift profits.

Aggressive tax practices have wider financial impacts. Data from the Organisation for Economic Co-operation and Development (OECD) shows that tax avoidance costs between $100-$200bn in lost revenue annually.[5] This is significant when you consider the contribution this revenue makes to a government's ability to fund vital services. On average, corporate income tax is estimated to contribute 9% of government tax revenues in OECD countries, and over 15% in emerging markets.[6]

At the company level, aggressive tax practices can result in reputational damage and the loss of a company's social licence to operate. Over time companies avoiding tax may become increasingly vulnerable to changes in tax regulations. Aggressive tax practices attract the attention of tax authorities leading to non-compliance investigations. These practices also distort macroeconomic conditions (the avoidance of a tax is effectively a form of unintended subsidy), raising portfolio and systemic risks that undermine long-term value creation. From a portfolio perspective, aggressive tax practices undermine fair competition at the sector level and reduce the money available for government spending on necessary services and infrastructure.

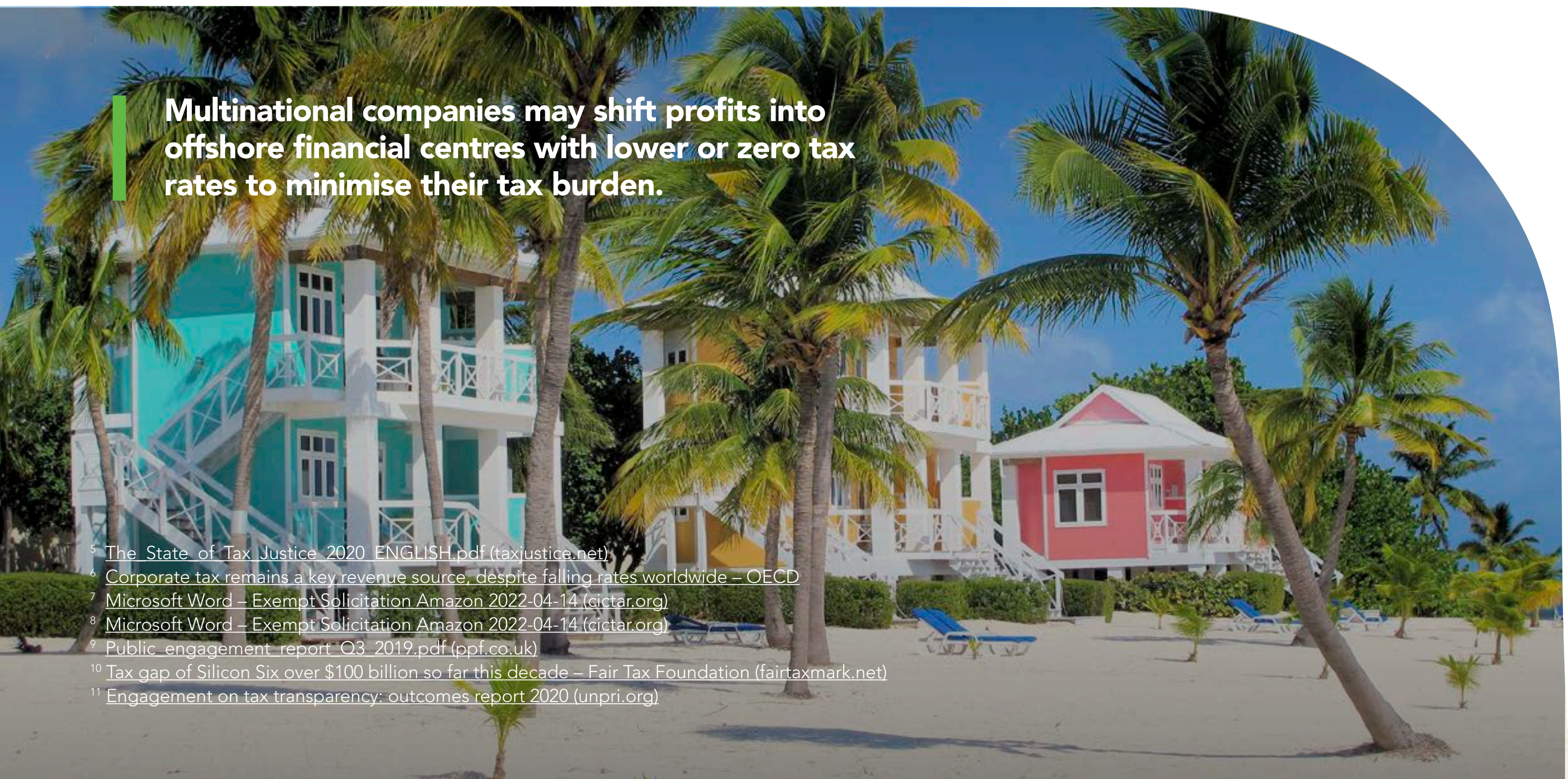
Globally, regulatory changes to tax transparency rules are requiring companies and governments to disclose more financial and tax information at a country-by-country level. These regulatory changes in the EU and US will lead to legal, reputational and financial risks for those companies that seek to aggressively minimise and avoid their tax payments.

Tax burdens: size matters

Generally, small-to-medium-sized businesses (SMEs) have little choice but to pay corporate taxes in their home jurisdiction. But many high-profile multinational companies use aggressive tax practices to avoid paying their fair share.

The digitalisation of the economy has made it easier for multinationals to hold intangible assets such as patents, trademarks and copyrights in overseas affiliates in countries with a lower tax rate than the home country. Revenues are transferred into group companies where there is no or minimal physical presence, yet little ability to tax offshore income.[7] As a result, brick and mortar businesses, often SMEs, must shoulder an increased tax burden. This is at a time when inflationary pressures globally are impacting the viability of many SMEs.

Non-disclosure presents challenges to investors in terms of evaluating the risks to the company with respect to taxation reforms. It can be hard to assess whether a company is engaged in responsible tax practices that ensure long-term value creation for the company and the communities in which it operates.[8] Three years ago, we highlighted Starbucks, Apple and Vodafone as among those criticised for their tax practices. In 2019, research by Fair Tax Mark found that Amazon, Apple, Facebook (Meta), Google, Netflix and Microsoft had the poorest tax conduct.[9,10] Amazon, Alphabet and Facebook were also among eight companies considered 'unresponsive' by lead investors in the UNPRI's collaborative engagement on corporate tax transparency, which ran between 2017 and 2019.[11]



Multinational companies may shift profits into offshore financial centres with lower or zero tax rates to minimise their tax burden.

[5] The State of Tax Justice 2020 ENGLISH.pdf (taxjustice.net)
[6] Corporate tax remains a key revenue source, despite falling rates worldwide – OECD
[7] Microsoft Word – Exempt Solicitation Amazon 2022-04-14 (cictar.org)
[8] Microsoft Word – Exempt Solicitation Amazon 2022-04-14 (cictar.org)
[9] Public engagement report Q3 2019.pdf (ppf.co.uk)
[10] Tax gap of Silicon Six over $100 billion so far this decade – Fair Tax Foundation (fairtaxmark.net)
[11] Engagement on tax transparency: outcomes report 2020 (unpri.org)

Tax loopholes are tightening globally

Since our 2019 tax article we have seen increased regulatory and legislative momentum globally to improve the mandatory disclosure of company financial and tax information. A key recommendation of the UN FACTI high level panel on Financial Accountability, Transparency and Integrity was to introduce requirements that "all private multinational entities publish accounting and financial information on a country-by-country basis".[12] The Covid-19 pandemic has increased the urgency, as tax policy is a key mechanism through which governments can rebuild the economy and mitigate the economic effects of the pandemic.

Since 2020, G20 leaders and governments have enacted a sweeping range of reforms focused on companies paying a fair share of tax and improving transparency in tax reporting:

- In 2021 the European Union (EU) adopted legislation to require a degree of public country-by-country reporting.[13] This legislation was supported by investors representing over US$5.6trn in assets under management.[14]
- The US House of Representatives in 2021 passed the Disclosure of Tax Havens and Offshoring Act, which proposed amendments to the Securities Act of 1934 to require country-by-country reporting. In 2020, we wrote to the US House Committee chairs and ranking members in support of the bill. The Act requires certain US companies to publicly disclose information related to the tax jurisdiction, income, and assets of their subsidiaries as well as country-by-country financial information annually.[15] This Act had wide support.[16]
- In 2021 the OECD-led reform of the international tax system was finalised ensuring that multinational enterprises will be subject to a minimum 15% tax rate from 2023. Unprecedented agreement was reached with more than 130 countries and jurisdictions representing more than 90% of global GDP.[17] This significant reform is focused on addressing the tax challenges arising from the digitalisation of the economy.[18]

The landmark deal to reform the international tax system is the first fundamental change in over 100 years and increases tax transparency. The agreement adopted a two-pillar solution, with both pillars being implemented concurrently by 2023.[19]

- **Pillar One** aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest multinationals.[20]
- **Pillar Two** introduces a global minimum corporate tax rate set at 15% that countries can use to protect their tax base.[21,22] It does not eliminate tax competition, but it does set multilaterally agreed limitations on it. There are mechanisms to protect the right of developing countries to tax certain base-eroding payments such as interest and royalties.[23]

If implemented successfully the two pillars are expected to have a significant impact on profit shifting by multinationals as well as the role of tax havens.[24] The 15% tax rate will give countries a share of taxes on profits earned in their territory. Initially, it is expected to apply to the top 100 or so companies and is targeted at the most aggressive users of tax-reducing domiciles including many tech companies.

In keeping with this momentum, on 16 August 2022, US President Joe Biden signed the Inflation Reduction Act (IRA) into law.[25] This 15% minimum tax on the corporate profits of the largest most profitable companies creates a corporate alternative minimum tax or floor on the percentage of taxes that a filer must pay to the government regardless of how many deductions and credits are claimed.[26]

The landmark deal to reform the international tax system is the first fundamental change in over 100 years and increases tax transparency.

[12] https://www.factipanel.org/news/facti-panel-report-has-been-published
[13] https://www.europarl.europa.eu/news/en/press-room/20211108IPR16839/corporate-tax-transparency-meps-okay-new-country-by-country-reporting-rules
[14] https://dwtyzx6upklss.cloudfront.net/Uploads/u/m/t/investorsignonletteronpubliccbcr_signatories_final_758353.pdf
[15] The U.S. House Passes Two Axne Bills | The Iowa Torch
[16] https://thefactcoalition.org/64-investors-with-nearly-2-9-trillion-in-assets-under-management-show-support-for-the-disclosure-of-tax-havens-and-offshoring-act/
[17] International community strikes a ground-breaking tax deal for the digital age – OECD
[18] International community strikes a ground-breaking tax deal for the digital age – OECD
[19] Brochure: Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021 (oecd.org)
[20] Which include a mandatory and binding dispute resolution process for Pillar One but with the caveat that developing countries will be able to benefit from an elective mechanism in certain cases, ensuring that the rules are not too onerous for low-capacity countries
[21] International community strikes a ground-breaking tax deal for the digital age – OECD
[22] Brochure: Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021 (oecd.org)
[23] Brochure: Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021 (oecd.org)
[24] New International Tax Reform: The end of tax havens? – The Oxford Strategy Review
[25] BY THE NUMBERS: The Inflation Reduction Act – The White House
[26] What Is the 15% Minimum Corporate Tax Senate Democrats Are Proposing? – Bloomberg

Investors seek increased transparency

Increased transparency is also being driven by investors and stakeholders seeking more disclosure on tax through voluntary reporting. Effective from 1 January 2021, companies are encouraged to report their tax strategy, governance and tax payments on a country-by-country basis under the Global Reporting Initiative (GRI), one of the world's most used voluntary sustainability reporting standards.[27]

The GRI 207 tax criteria recognises the role that tax contributions have on sustainable development. The standard was developed in response to growing investor concerns and stakeholder demands for tax transparency, and sets expectations for increased disclosure of tax payments on a country-by-country basis, alongside tax strategy and governance.

Reporting against the GRI 207 tax criteria will improve transparency and comparability of tax information. It also paves the way for a more informed public debate as well as better policy and investment decisions. The development of the tax standard followed consultation with multinationals, accounting firms, academics, politicians, investors, and other stakeholders. It is the first global reporting standard to combine management approach disclosures on tax strategy with public country-by-country reporting of business activities, revenues, profit and tax.[28]

Companies claiming to report in accordance with the GRI standards are required to make disclosures on all material topics. Investors consider a company's tax practices as financially material, that is, reflecting the organisation's significant economic, environmental and social impacts and capable of substantially influencing the assessments and decisions of stakeholders.[29] A number of companies are already reporting in line with the GRI 207 tax standard, including Anglo American, Apple, Philips, Randstad, Vodafone, Royal Dutch Shell, and Ørsted.[30]

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For certain sectors, additional tax disclosure that goes beyond country-by-country reporting may be required, such as reporting at the state or municipal level. This has been a practice for companies in the extractives industry due to intensive community impacts and corruption issues.

[27] https://assets.kpmg/content/dam/kpmg/xx/pdf/2020/11/the-time-has-come.pdf
[28] https://www.globalreporting.org/about-gri/news-center/backing-for-gri-s-tax-standard/
[29] GRI 207:TAX 2019, Global Reporting Initiative, 2019 (PDF 250 KB)
[30] https://www.angloamerican.com/~/media/Files/A/Anglo-American-Group/PLC/investors/annual-reporting/2021/anglo-american-country-by-country-report-2020.pdf, p.2; https://www.results.philips.com/publications/ar20/downloads/pdf/en/PhilipsCountryActivityAndTaxReport2020.pdf, p. 6; https://www.randstad.com/s3fs-media/rscom/public/2021-02/randstad-annual-report-2020.pdf, p. 238; https://www.vodafone.com/sites/default/files/2021-10/vodafone-tax-report-19-20.pdf, p. 11; https://reports.shell.com/sustainability-report/2020/servicepages/downloads/files/gri-index-shell-sr20.pdf, p. 11; https://via.ritzau.dk/ir-files/13560592/4751/6293/Annual%20report%202021.pdf, p. 123

Our expectations

Companies should operate not only for their shareholders, but also for a wider purpose that benefits society. Ultimately, this will support savers and pensioners, who rely on sustainable returns in an economy and a society that is capable of providing them and their families with a secure future.

Our engagement expectations are focused on four critical areas: tax policy, governance, stakeholder engagement and transparency.

Policy

We expect to see a clear set of principles on tax responsibility that include paying tax in line with the location of economic value generation and with the legislative intention of tax law. We look for policies that cover the company's tax-related approach to corporate structuring, transfer pricing, use of debt, due diligence, lower tax jurisdictions, tax havens and use of incentives. The company's tax policy and tax governance framework should be disclosed and should reference GRI tax standards. The disclosure should include the company's approach to tax risks, including how risks are identified, managed, and monitored; and how compliance with the tax governance framework is evaluated, including incidents of non-compliance.

Governance

We believe that a company's tax strategy and practices are the responsibility of the board. We expect the board to oversee risk management and compliance, including in relation to tax. In particular, the audit or other risk committee should have oversight of tax risks and the implementation of tax policy. We will look for evidence that the remuneration committee has considered tax behaviour in the structuring of executive remuneration policies to ensure that remuneration does not incentivise overly aggressive corporate tax practices and personal income tax/capital gains behaviours.

Stakeholder Engagement

We believe a company should be aware that its tax practices are of interest to various stakeholders and that by engaging with them, it has the potential to influence its reputation and position of trust. We believe that an organisation's approach to stakeholder engagement on tax can enable it to understand the evolving expectations related to tax, including potential future regulatory changes, enabling it to better manage its risks and impacts.

Transparency

We seek clear disclosure of the company's approach to tax and the consideration of tax in corporate activities. This should accompany a clear explanation of taxes paid on a country-by-country reporting basis. The company's description of its tax approach and results should be aligned with its purpose, its reporting disclosures and our engagement.

Our engagement approach

We have been engaging with companies on tax transparency and fairness in line with our engagement plan since 2016. These include companies in the technology, mining, consumer staples and pharmaceuticals sectors. We assess company tax practices and disclosure in our engagement research and look for tax transparency, including reporting under GRI's 207 tax criteria. We urged the Danish healthcare company, GN Store Nord, to improve its tax reporting, including providing country-by-country reporting. We expect to see improvements in its disclosure in 2023.

Rio Tinto is an example of a mining company publishing reports on annual taxes paid with lump sums at the country level as well as aggregated disclosure. Such information is key to ensuring that companies demonstrate their long-term social licence to operate, empowering communities to make informed decisions about resource extraction in their backyards. In our engagement with Marathon Oil, we encouraged the company to publish the taxes it pays in Equatorial Guinea in line with the standards of the Extractive Industries Transparency Initiative (EITI).

In 2022, ahead of the company's annual meeting, we engaged with Amazon on a shareholder proposal that publicly highlighted the company's tax avoidance strategies. An exempt solicitation filed with the Securities and Exchange Commission by co-filers Pensions & Investment Research Consultants (PIRC), OIP Trust and Greater Manchester Pension Fund, stated that Amazon does not disclose revenues, profits, or tax payments in non-US markets in its standard reporting and has faced increased attention from tax authorities.[31] With management opposing the proposal it was defeated, although according to our calculations it gained 17.5% of the dissident vote.[32] It is worth noting that the last tax transparency shareholder proposal at a major multinational (Google in 2014) received support of only 1%.[33,34]

[31] Microsoft Word – Exempt Solicitation Amazon 2022-04-14 (cictar.org)
[32] 0001104659-22-065872 (d18rn0p25nwr6d.cloudfront.net)
[33] Microsoft And Cisco Face Shareholder Pressure Over Public Disclosures (forbes.com)
[34] Form 8-K (sec.gov)

Microsoft and Cisco are expected to face shareholder proposals on tax transparency this year.

Microsoft and Cisco are expected to face similar shareholder proposals later this year. Nordea Bank and several Danish pension funds filed a shareholder proposal with Microsoft urging the company to disclose its public country-by-country tax information in line with the GRI tax transparency standard. Cisco faces an identical proposal filed by three shareholders. The proposal references the fact that the company's 2021 annual report is silent on whether it had conducted any intra-entity transfers of intellectual property to the US despite an increase in US profits.[35]

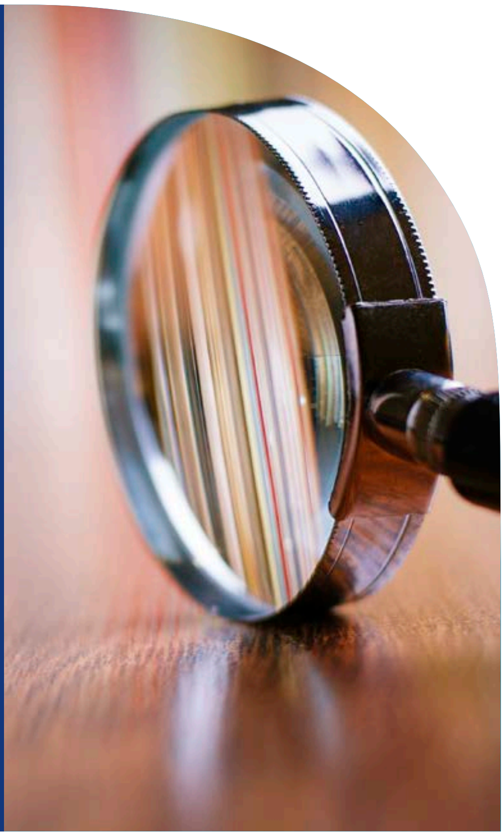
As we found in 2019, although tax transparency has improved in some sectors and geographies, in others it remains limited. Engagement on tax transparency and fairness can be challenging. Companies cite commercial sensitivity, the potential implications for competitiveness, or the prospect of misinterpretation by media or the public, for example in relation to legacy corporate structures in tax havens. In addition to our expectations, we reflect our concerns about a company's tax transparency in our vote recommendations – for example where a company has been unresponsive to investor concerns, or in support of certain shareholder proposals.

Outlook

We have developed a watchlist of high priority companies that will be the focus of our engagement efforts for the remainder of 2022 and into 2023. The list was developed based on our engagement with companies, research conducted by PIRC and the Centre for International Corporate Tax Accountability and Research (CICTAR), plus companies that have been named in the press for aggressive tax practices and/or tax avoidance.[36] We will engage based on our responsible tax principles to:

- Seek commitments from companies to pay fair tax on a country-by-country basis in line with the location of economic value generation and the spirit and intention of the law.
- Strengthen company global tax policies and principles particularly in relation to tax management, good governance and transparency.
- Ensure companies are balancing the interests of various stakeholders.
- Increase tax reporting and disclosure in accordance with GRI tax criteria 207.
- Consider vote recommendations in accordance with our Corporate Governance Principles where expectations fall short.

We will also continue to support the development of market best tax practices and advocate with public policymakers at an international level and individual country levels to achieve greater tax transparency.



[35] Microsoft And Cisco Face Shareholder Pressure Over Public Disclosures (forbes.com)
[36] Why 55 U.S. Companies Paid No Taxes Last Year (marketrealist.com); Big Companies Like FedEx and Nike Paid No Federal Taxes – The New York Times (nytimes.com); 15 Biggest Companies That Don't Pay Taxes (yahoo.com)

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