Taxing Questions

Assessing risk from changes to international tax rules

October 2014

INVESTOR BRIEFING

Background

Over the past 4 years, against a backdrop of public spending cuts across Europe, the amount of corporate tax paid by large companies has been subject to unprecedented scrutiny by civil society, politicians and the media. Political leaders are under pressure to ensure the tax burden is shared by multinational companies and that a level playing field is created for domestic small and medium-sized businesses.

Now the tax landscape is starting to change. The authorities in emerging markets are challenging multinational companies' tax practices. The Obama Administration recently announced plans to prevent corporate inversions, which have led to tax revenue losses for the US. And on 16th September, the OECD (Organisation for Economic Co-operation and Development) provided a progress report to G20 countries on proposed reforms intended to reduce multinationals' tax avoidance. Meanwhile, high-profile campaigns and media exposés about individual companies seem likely to continue, bringing with them the risk of consumer backlash and unexpected changes to the 'rules of the game'.

In the face of such ongoing change, companies whose profits are inflated by unsustainable tax practices may present investors with valuation risk. Investors may be concerned that valuations based on post-tax profits or cash flows (such as P/E multiples) may be susceptible to corrections, should the tax payments increase to a normalised level. But a lack of corporate disclosure prevents investors from adequately evaluating the risks facing companies.

This briefing highlights the key issues for investors to consider, including possible regulatory changes arising as a result of the OECD progress report. We suggest questions for investors to raise with companies, to enable investors to more accurately assess the risks facing portfolio companies. It's important that investors understand the reforms that governments may introduce - and work to identify those companies most vulnerable to shifting political and public expectations.

The Shifting Landscape

The question is no longer whether we will see reform of the laws governing multinational tax practices but, rather, how extensive that reform will be. In the UK, calls for changes to ensure companies cannot 'dodge' tax moved swiftly from protests on Oxford Street to the Public Accounts Committee at Westminster and then to No.10 Downing Street, via a Reuters exposé. The story was that the ubiquitous and seemingly successful Starbucks was actually, in accounting terms, unprofitable

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in its UK operations and so had paid no corporation tax in the UK in recent years.[i] A consumer backlash followed, which may have contributed to Starbucks' announcement in April of a fall in sales for the first time in 16 years.[ii] Eager to stem the tide, the company first offered a voluntary payment of £20million over two years[iii] and subsequently announced the relocation of its European HQ to England.[iv]

The 2013 G8 countries' summit in Northern Ireland saw corporate tax avoidance feature as a formal agenda item that resulted in agreement on certain principles. The OECD then published an 'Action Plan' and has recently issued a progress report about how to curb multinationals' shifting of their profits into secrecy jurisdictions (also often referred to as tax havens).[v] The UK government has already committed to implementing OECD recommendations on accounting reforms to make it easier for tax authorities to spot questionable tax practices.[vi]

Meanwhile, President Obama escalated sharply his rhetoric on US companies using foreign takeovers as an opportunity to relocate and avoid US taxes. In the face of White House accusations of a lack of morality and patriotism, Walgreen faced a drop in its share price[vii] after unexpectedly deciding not to relocate its HQ following its acquisition of Alliance Boots, thereby 'giving up' the opportunity to reduce its tax bill by up to a third[viii]. The US government recently announced actions to 'rein in corporate tax inversions',[ix] which had an immediate impact on the value of pharma companies.[x]

> "*Corporate taxes are a giant black box for investors...if investors learn that a company bears more risk than was known before, that could have an impact on their estimates of future cash flows and the return that investors would demand (i.e., increased tax risk should increase cost of capital), which could affect valuations.*"
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> - David Zion, Credit Suisse[xi]

The Tax Policies and Practices Under Fire

According to a 2013 report by ActionAid,[xii] only three of the then FTSE 100 companies published what ActionAid regarded as an adequate tax policy. The absence of a published policy does not necessarily mean that no policy exists. However, the lack of disclosure means investors need to inquire explicitly about a company's approach to issues including the use of transfer pricing (the prices at which related companies trade with each other, which can be used to shift profits between countries), intra-group financing (loans between related companies, which again can be used to shift profits between countries), use of or secrecy jurisdictions and the level of internal oversight and discussion of tax policy. Understanding a company's approach to these issues is vital to assessing the company's risk awareness and management.

Much of the political and civil society concern about corporate tax practices focuses on the disconnect between the jurisdictions where firms carry out their economic activity and the jurisdictions in which they pay tax. For instance, a firm might have the vast majority of its assets and staff in one country but state that the profits from their activity actually arose in another country with much lower tax rates.

From an international development perspective, such 'profit shifting' deprives developing countries of "*sufficient funds to finance sustainable development*."[xiii] However, profit-shifting has now also become a political issue in developed economies including the UK, following the Public Accounts Committee's bruising questioning of Amazon and Google executives. The idea that the UK and other developed countries are 'losing out' on tax revenues that they consider rightfully theirs has made the prospect of regulatory changes to the rules more likely.

Accordingly, investors need to understand how vulnerable companies might be to any changes which could increase their tax payments. Currently, there is an information deficit from major companies, with very little of the relevant data being disclosed. More and clearer information would allow investors to better assess the risks arising.

Secrecy Jurisdictions

A 2014 report from Christian Aid[xiv] referred to the FTSE100's "*enthusiastic use of opaque jurisdictions*"[xv] and highlighted that some 36% of all FTSE 100 subsidiaries are located in jurisdictions where the relevant authority does not require company accounts to be publicly accessible for a fee of less than either $10 or €10. Even when using the most comprehensive fee-charging database of company information, 73% of FTSE100 subsidiaries located in these 'non-transparent jurisdictions' do not report turnover; 80% do not report assets; and 67% do not report employee numbers[xvi] - precisely the information which would help distinguish between a subsidiary carrying out commercial activity and a one being used as a tax minimisation vehicle.

A number of companies have begun to act on the risks associated with the use of secrecy jurisdictions.

Closing subsidiaries in Secrecy Jurisdictions

Unilever

At its 2014 AGM, CEO Mr. Paul Polman confirmed that the company was closing the few remaining non-operating subsidiaries in secrecy jurisdictions.

HSBC

At its 2014 AGM, Chairman Sir Douglas Flint confirmed a 30% reduction in the number of non-operating subsidiaries in secrecy jurisdictions over the past two years.

Recommendations for Investors

Investors should encourage companies to increase their transparency and accountability, including by publishing a tax policy. This policy should:

- Set out the company's approach to tax beyond mere compliance with the law
- Include a code of conduct
- Define the level of aggressiveness of a company's tax planning, including details of tax planning subject to mandatory disclosure rules
- Rule out certain tax practices
- Communicate where the company is headquartered for tax purposes
- Outline criteria for negotiations with tax authorities
- Set out the internal governance structures for the development, implementation and review of the tax policy
- Specify where accountability lies within the company for the effective delivery of the tax policy
- Detail how the company's tax practices are integrated with the company's corporate responsibility objectives

Investors should support calls for country-by-country public reporting of comparable data and should encourage investee companies to not lobby against such measures (see box below on country-by-country reporting).
Investors should encourage investee companies to refrain from establishing subsidiaries in jurisdictions where they do not perform substantial business activity and to close dormant subsidiaries.

Assessing the Impact of Regulatory Changes

Investors need companies to be transparent in order to assess the tax risks they present - but transparency cannot ensure adequate mitigation and management of that risk.

Below we look at a number of common tax practices which are risky because they are under review and could be subject to regulatory change. We also make suggestions about how such risks could be mitigated and managed.

Tax Incentives

Countries seeking to attract foreign direct investment will often negotiate reduced tax rates with multinational companies. However there are serious concerns about the usefulness of many tax incentives. Countries are increasingly examining their benefits and wasteful tax incentives have been identified as one of the major tax issues for developing countries.[xvii] The OECD Tax and Development Taskforce has produced guidelines for tax incentives,[xviii] and is assisting several countries in reviewing their incentives regimes.

In July, a tribunal in Uganda ruled that Tullow Oil must pay $407 million[xix] to reimburse the country for tax incentives which the tribunal ruled illegal on the basis that the minister who signed the deal with Tullow was not allowed to grant such incentives. Tullow Oil has announced an intention to appeal the decision. This case shows the potential risks that tax incentives may pose to investors. It also highlights the potential benefit of following the recommendation of the OECD/IMF/UN and World Bank, that companies should ensure that 'if tax exemptions are to be granted, the tax authorities of the developing countries are fully involved in the negotiation and design of these exemptions.'[xx]

Recommendations for Investors

Investors should seek to understand an investee company's reliance on incentives and the immediate and long-term financial impact of the withdrawal of negotiated incentives, particularly in developing economies, by asking them to disclose:

- the duration and financial value of the incentives obtained in each jurisdiction;
- the company's view on the likelihood of relevant regulatory reform;
- the financial impact of any such reform; and
- the company's contingency planning for the ending of the incentive (in the case of both the expiration of the intended duration and a more sudden withdrawal because of reforms).

Transfer Pricing

Transfer pricing - the pricing of sales between related companies within the same multinational group of companies - is consistently identified as a source of tax abuse (although there is nothing wrong with transfer pricing itself).

The deliberate mispricing of sales of goods and services, in order to facilitate profit-shifting from high to low tax jurisdictions, is the most obvious form of abuse. However there are also concerns with the legal opportunities that transfer pricing facilitates. For instance, locating assets such as intellectual property in a low-tax jurisdiction allows a multinational to charge its subsidiaries fees to use that asset, thus reducing the taxable income in the subsidiary jurisdiction while generating taxable profit in a low-tax jurisdiction. Although legal, such transfer pricing has been heavily criticised for enabling companies such as Starbucks, Amazon and Google[xxi] to reduce their UK corporate tax bills. Any moves to reform transfer pricing rules to align companies' profit distribution more closely with their real economic activity would also potentially impact significantly on multinational companies with intellectual property located in low tax jurisdictions such as Switzerland.

Recommendations for Investors

Investors should engage with companies to understand how aggressively a company pursues transfer pricing and the financial impact on its cash flow and taxes due in the event that current practices must cease or be altered.

Investors should ask companies with intellectual property located in low-tax jurisdictions to model the financial implications of having to locate such assets in the countries in which they were developed.

Country by Country Reporting

Rio Tinto and Tullow Oil[xxii] rank among the few FTSE 100 companies which have moved towards public disclosures of the taxes they have paid in each country where they operate. Such public disclosures are seen by civil society as an essential step in tackling corruption and illicit financial flows in developing countries. These problems are ones that governments increasingly recognise, which has resulted in the requirement in the EU Accounting and Transparency Directives for all EU-based extractive companies to report their payments to governments in the countries where there have extractive operations.

But for investors, wider disclosure is essential to identifying material risks. The majority of multinationals resist requests for such disclosures, citing reasons including cost, commercial sensitivity and that such disclosure is not legally required. Readers of annual reports are therefore often given just a single figure for corporation tax paid globally, or at most a ‘UK’ and an ‘overseas’ figure.

However, upcoming regulatory changes mean that such resistance may ultimately be overwhelmed. In the EU, in addition to extractive industries reporting their payments to governments under the fourth Capital Requirements Directive (CRD IV), EU banks are now required to report their turnover and employees on a country-by- country basis, with the potential for profits, taxes and subsidies received to also be declared. Barclays has already made all this information public. The OECD has also recommended that companies must disclose country-by-country data to tax authorities - and the UK has already committed to implementing this.[xxiii] At present it is unlikely that firms will have to make *public* disclosures of the data. However once even restricted country-by-country reporting is required, arguments about the cost of collecting the data will be rendered void and civil society will continue to press for public disclosure.

Investors should support calls for public disclosure of comparable data. The granularity of the position of a company (for instance its payments, profits, turnover, employees) in each jurisdiction can help identify its exposure to complex profit shifting arrangements, its reliance on secrecy jurisdictions or on negotiated incentives with host governments all of which is relevant to risk assessment.

Companies may be concerned that public disclosure may expose them further to media or civil society criticism. This would suggest a need to address the substance of the company’s tax practices, which may otherwise be unexpectedly revealed in the media rather than seen as an acceptable reason for a lack of transparency. Responsible companies which feel their tax practices are justifiable should be able to communicate their activities in a way that positions their tax payments within their overall socio-economic contribution.

The Implications of the OECD BEPS Project Report

In September 2013, G20 countries' leaders identified the need to address the problem of 'Base Erosion and Profit Shifting' (BEPS) – a form of tax avoidance by multinational companies. They also endorsed an Action Plan, developed within the OECD with all G20 countries, to ensure that international and domestic tax rules do not allow or encourage multinationals to reduce their overall taxes by artificially shifting their profits to low tax jurisdictions.

On 16th September 2014, the OECD released its first set of reports and recommendations on the seven key tax issues that it had been tasked with working on. These outcomes have been agreed by representatives of all OECD and G20 countries and have significant implications for any company that currently takes an overly aggressive tax position in its global business. For instance, there is now:

- Agreement for international treaties to include a clear statement that treaties are not intended to create double non-taxation, to be combined with new minimum standards (e.g. limitation of benefits/principle purpose test) to prevent treaty shopping and other strategies aimed at stopping companies from inappropriately obtaining the benefit of certain provisions of tax treaties
- Agreement to introduce a template for companies to use in country-by-country reporting to tax authorities. Companies will have to reveal their revenues, profits, taxes paid and certain measures of economic activity.

The G20 has endorsed these proposals and reiterated its support for finalising the BEPS project by the end of 2015. Some countries have already committed to rapidly implementing certain aspects, and we can expect more commitments to implementation at the G20 summit in November and throughout 2015. It is clear that the BEPS project will mean real and substantial change in how multinational companies are able to operate. Any company that is currently adopting an overly aggressive tax strategy will likely be exposed to greater risk in the near future.

Intra-Group Financing

This mechanism involves multinational companies making loans from subsidiaries in low tax jurisdictions to those in higher tax jurisdictions. The loan may be at above market rates. The interest payable on the loan is tax deductible for the borrowing subsidiary. So effectively, the multinational shifts profits from a high tax jurisdiction to a low tax one by means of interest payments on an intra-group loan. This mechanism was also reportedly a feature of Starbucks' tax arrangements.[xxiv] The OECD will be looking at this issue in 2015 and so change should be expected. This has also been identified as a high priority issue for developing countries.[xxv]

Recommendation for Investors

Investors should ask companies to:

- detail the tax savings brought about by intra-group financing arrangements;
- explain the company's view on the likelihood of relevant regulatory reform;
- evaluate the financial impact of any such reform and the robustness of the company's contingency planning for such an event.

Treaty Shopping

This is the practice of structuring an investment in order to route payments through a jurisdiction with a beneficial tax treaty. Sustainalytics in a 2013 paper,[xxvi] provide the following example: "*when a MNC obtains a loan for its operations in an emerging market, it can route the loan through a country that has a tax treaty with the emerging market country to avoid local withholding taxes on interest payments.*"

The OECD has recommended the introduction of a minimum standard to prevent such activity.[xxvii] There is also a move towards greater attention being paid to tax treaties with developing countries; some developing countries (e.g. Mongolia and Rwanda) have started cancelling and/or renegotiating treaties they feel are not working to support development, while some developed countries (e.g. Netherlands) have agreed to review their tax treaties with developing countries, to ensure they are development-friendly.

Recommendation for Investors

Investors should ask companies to disclose:

- whether treaty shopping has been used in structuring the company's tax arrangements;
- the company's view on the likelihood of relevant regulatory reform; and
- the financial impact of any such reform and the robustness of the company's contingency planning for such an event.

Conclusion

Corporate tax practices will remain under a media, political, public, and civil society spotlight for some time. That spotlight exposes companies pursuing certain tax planning strategies to risks, including consumer backlash and abrupt regulatory changes in both developed and developing economies. Owing to a lack of transparency, investors sit mainly in the dark when it comes to knowing which companies face what risks. It's vital that investors see corporate tax practices as a material risk and push for greater disclosure from investee companies on their management of ever-increasing risks.

Contact

Louise Rouse
Director of Campaigns and Engagement
ShareAction
louise.rouse@shareaction.org

Chris Hegarty
Senior Adviser, Policy & Advocacy Scotland
Christian Aid
chegarty@christian-aid.org

About ShareAction

ShareAction (Fairshare Educational Foundation) is a registered charity that promotes responsible investment practices by pension providers and fund managers. ShareAction believes that responsible investment helps to safeguard investments as well as securing environmental and social benefits.

About Christian Aid

Christian Aid is a Christian organisation that insists the world can and must be swiftly changed to one where everyone can live a full life, free from poverty.

Why Christian Aid Works on Tax

Christian Aid works on tax justice because developing countries have a major problem with companies and individuals not paying their taxes and this seriously harms people living in poverty. Typically, developing countries collect around half the amount of tax collected by rich countries, as a proportion of their GDP. This in turn reduces the amount of money available to fund important public services including schools, hospitals, roads and justice systems. The people who pay the price are the poorest, who cannot afford private alternatives and depend on whatever services the state provides. In the longer run, tax is also important as a better alternative to aid for some developing countries, because it is a more reliable, predictable and sustainable source of income than aid from other countries.

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