

# Five Years of Pushing for Change: Assessing Corporate Tax Strategies

Though it lacks the magnitude of climate change, the excitement of technological innovation, and the visibility of gender equality, a company's approach to its tax obligations is nevertheless a critical element to consider when evaluating a company's sustainability profile.

Sustainability in business can be defined as the policies and practices which companies implement not only to adapt, grow and thrive in the future but also to avoid diminishing the resources available for present and future generations.<sup>1</sup> Taxes are the means with which communities and countries build the physical, social, and educational infrastructure needed to support present and future growth and development.

Corporations are currently incentivized to minimize their tax burden in order to maximize profits. Yet in the long run, tax-shirking behavior proves to be short-sighted, as it exposes a company to policy and litigation risk, generates reputational risk amongst stakeholders, and promotes distrust. Companies pursuing overly aggressive tax avoidance strategies exacerbate existing inequalities based on company size as well as industry.

We recognized early on that a company's tax strategies could put it at risk in terms of reputation, regulation and ultimately financial performance. Since 2014, we have captured material tax-related data in our CSA. Here, we summarize some of the findings gained over the last five years.



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<sup>1</sup> World Commission on Environment and Development, 1987, General Assembly of the United Nations, <http://www.un.org/en/ga/president/65/issues/sustdev.shtml>

## Taxes are a critical link between companies and their surrounding societies.

### Aggressive Tax Optimization is a Sustainability Issue

Five years ago, RobecoSAM became one of the first companies to consider the sustainability of companies' tax strategies by asking firms questions on the subject in our Corporate Sustainability Assessment (CSA). Taxes are a critical link between companies and their surrounding societies: corporations benefit from the physical infrastructure, education systems and public services paid for by taxes.

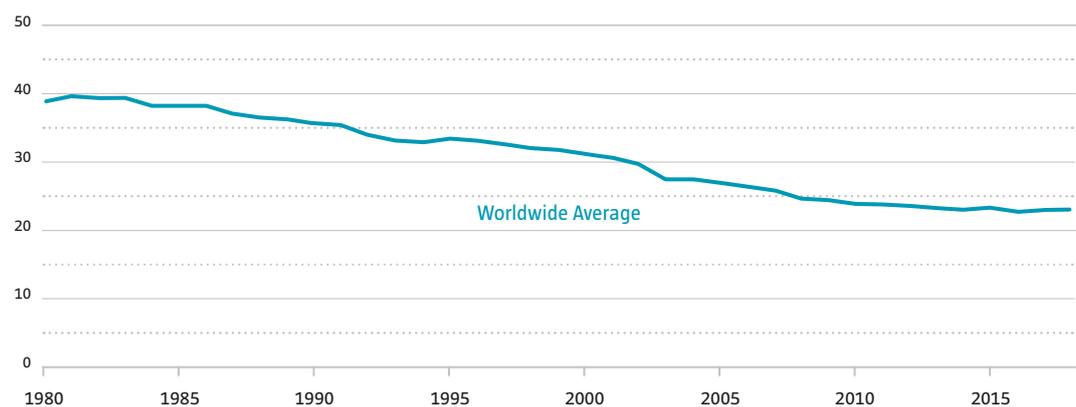
Yet from a narrower, more self-interested perspective, corporations are incentivized to minimize their tax burden in order to maximize their profits. Moreover, increasing competition between tax territories has created opportunities for companies to arbitrage their tax liabilities. This had led to a "race to the bottom" between countries, with global corporate tax rates declining since 1980.<sup>2</sup>

## Increasing competition between tax territories has created opportunities for companies to arbitrage their tax liabilities.

These issues have major ramifications. The UN Conference on Trade and Development estimates that developing countries lose around USD 100 billion in annual tax revenues due to multinationals shifting their profits to tax havens.<sup>3</sup> Rich countries also lose out: a 2014 US Senate report<sup>4</sup> showed the US misses out on around USD 150 billion in tax revenues each year to offshore tax schemes. For this reason, governments worldwide are increasingly taking measures against so-called base erosion and profit shifting (BEPS), which enables companies to avoid tax by exploiting gaps and mismatches in tax rules to shift profits to low- or no-tax jurisdictions.

While optimizing tax payments can enhance a company's profitability in the short term, we do not expect that the implicit subsidy companies receive from paying a low tax rate will persist. Further, we believe current rates are artificially low and we anticipate they will revert to the global mean in the medium to long term; governments are increasingly putting policies in place to capture tax within their borders, and international cooperation in equalizing tax has been increasing.

Figure 1: Top Marginal Corporate Tax Rates in Decline Since 1980



The average statutory tax rate has declined in every region since 1980. The majority of countries have corporate tax rates below 25%. Increasing competition between tax territories has created opportunities for companies to arbitrage their tax liabilities.

Source: Tax Foundation (taxfoundation.org), Corporate Tax Rates Around the World, 2018

<sup>2</sup> Tax Foundation, Corporate Income Tax Rates around the World, 2017 <https://taxfoundation.org/corporate-income-tax-rates-around-the-world-2017/>

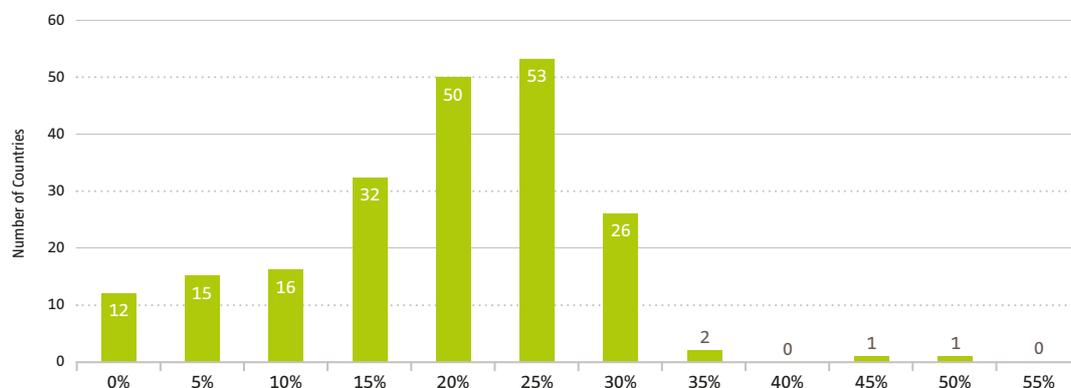
<sup>3</sup> Estimates range from USD 70-120 billion per annum. Data and estimates derived from S. Nicholas, "How To Crack Down on Tax Havens", Foreign Affairs, March/April 2018.

<sup>4</sup> "Offshore Tax Evasion," United States Senate Majority and Minority Staff Report, Committee on Homeland Security and Governmental Affairs (2014).

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Figure 2: Distribution of Worldwide Corporate Tax Rates



The distribution of corporate tax rates around the world; 75 countries (36%) have corporate tax rates of 15% or lower. Amidst greater international policy coordination, we expect this distribution to narrow, and countries with corporate tax rates at the lower end of the tax spectrum (0-10%) to move towards the median corporate tax rate between 20 and 25%.

Source: Tax Foundation (taxfoundation.org), Distribution of Worldwide Corporate Tax Rates, 2018

Current tax configurations are not sustainable, and therefore policy action is inevitable.

**We believe, in the long term, current tax configurations are not sustainable, and therefore policy action is inevitable. Potential policy action includes but is not limited to the following:**

- 1. Unfair advantages for large, global companies:** Larger (global) companies are able to benefit disproportionately from tax arbitrage while smaller (local) companies cannot. This unfairly and implicitly subsidizes the larger companies at smaller companies' expense and renders these larger companies vulnerable to future policy changes made to correct the imbalance.
- 2. Market distortions differ by industry:** Some industries and sectors benefit disproportionately from the ability to arbitrage tax while others are more effectively taxed at source.
- 3. Unequally shared tax burden:** Tax shortfalls lead to increased government indebtedness and/or a higher tax burden elsewhere in the economy. In the longer term, spending on critical public goods such as infrastructure and education is likely to suffer.
- 4. Intra-country inequalities:** Long-term financial risks can also develop from arrangements that are later deemed to be eroding the tax base of other countries or providing unfair subsidies. Such arrangements may be deemed illegal, with fines and penalties imposed; or new regulations may be implemented which increase companies' tax obligations. At the same time, regulatory bodies are increasingly enforcing existing rules.

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## Taxing Questions: Tax Policy and the Corporate Sustainability Assessment

### Why tax matters for sustainability

We introduced our Tax Strategy criterion to the CSA in 2014, as both the financially material aspects and the sustainability implications of tax policy were becoming increasingly clear. We sought to assess companies' transparency with their stakeholders about tax matters, noting that firms with less aggressive tax planning are likely to be more transparent than those making greater use of tax optimization structures.

Merely including a general statement in the financial report that the company intends to comply with all tax laws and regulations in its countries of operation does not suffice as a sustainable tax strategy.

Legal actions taken against and financial repercussions stemming from companies' tax practices demonstrate the importance of evaluating tax issues and underscore the financial materiality of corporate tax strategies from a sustainability perspective.

### Additional Assessment Tool: Media and Stakeholder Analysis

SAM's CSA is based on corporate self-disclosure and a company's sustainability performance score is primarily based on the quality of responses and supporting data provided. Moreover, CSA data is supplemented with results from a Media and Stakeholder Analysis (MSA) by which RobecoSAM analysts monitor media and NGO reports highlighting controversies surrounding companies' behavior. MSA cases can both reveal and cause legal and reputational risks. As a result, companies' overall sustainability scores are adjusted on the basis of MSA results. The MSA provides an additional credibility check on the information companies report in the CSA to ensure companies are truly "practicing what they preach."<sup>6</sup> Since the Tax Strategy criterion was introduced in the CSA in 2014, there have been a number of instances where authorities have acted to recover lost tax revenues from firms, imposing large settlements that have affected the companies' future earnings. While the highest-profile cases have involved American technology companies operating in the European Union, there have been cases across a range of industries.

### The Results

As part of our tax strategy criterion in the 2018 CSA, we ask companies questions about the following three issues:<sup>7</sup>

- Tax Strategy
- Tax Reporting
- Effective Tax Rate

### Tax Strategy

As tax avoidance strategies are drawn up in a legally sound way, merely including a general statement in the financial report that the company intends to comply with all tax laws and regulations in its countries of operation does not suffice as a sustainable tax strategy. Since 2014, our tax strategy question has sought to determine if a company has a tax policy that articulates its approach to one or more of the following sensitive or high-risk tax issues:

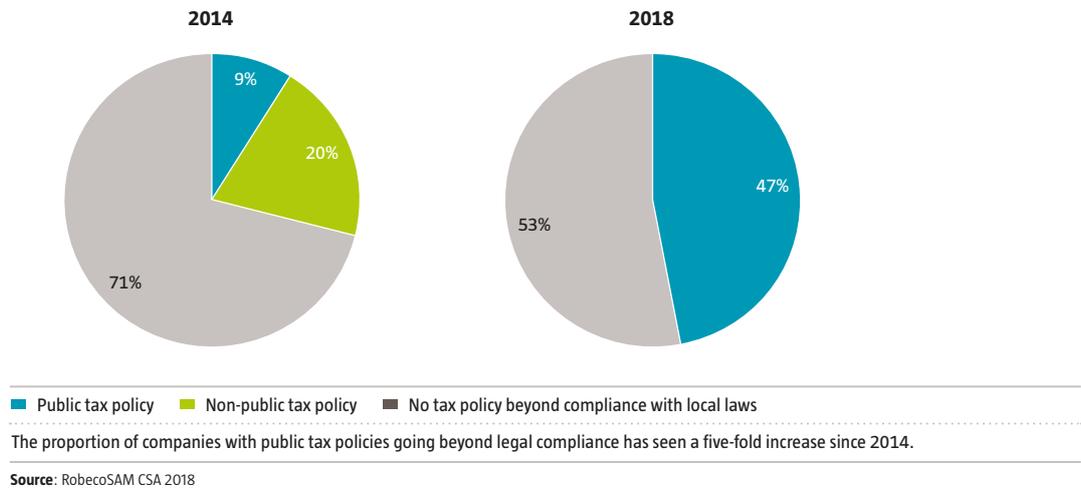
- compliance with the spirit as well as the letter of the tax laws in the countries in which the company operates
- commitment not to transfer value that has been created to low-tax jurisdictions
- commitment not to use structures intended for tax avoidance
- calculating transfer pricing using the "arm's-length" principle
- commitment not to use secrecy jurisdictions or so-called "tax havens" for tax avoidance purposes

Recognizing the emergent nature of the topic, we initially accepted a company's internal tax policies covering the aspects above as well as publicly available information. However, as tax has become a more mainstream ESG topic, and transparent reporting on taxation has become best practice, we now assess tax strategies solely on the basis of publicly available information. Of the 697 companies required to respond to the questions in our tax strategy criterion in 2018, 327 (47%, or nearly half) had a public tax policy specifying a sufficiently sustainable approach to taxation (as defined by these five aspects). As we can see from the chart below, there has been a five-fold increase in the proportion of companies with acceptable tax policies available in the public domain since 2014.

<sup>6</sup> In 2018, amidst broader efforts to shift the CSA's focus from disclosure to performance, we increased the weight/significance of the MSA for a company's Total Sustainability Score overall. The increasing scrutiny of regulators and the ensuing media exposure, highlight the timely relevance/ importance of using the Media and Stakeholder Analysis tool for calculating CSA scores.

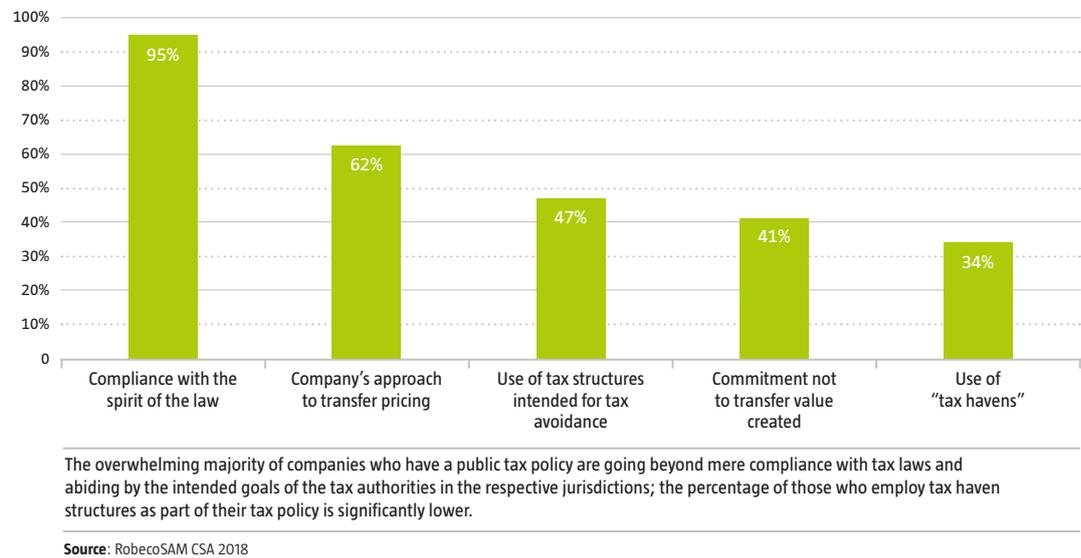
<sup>7</sup> While Tax strategy questions initially applied to companies across all industries, we have reduced the scope of the criterion to the 42 industries where tax is most financially material.

Figure 4: Compliance and Disclosure is Increasing Among Corporates



The chart below shows that of our five criteria, the most frequently included in global companies' tax strategies was compliance with the spirit as well as the letter of the law, followed by a statement about the company's approach to transfer pricing.

Figure 5: Elements Covered by Companies' Publicly Reported Tax Strategies



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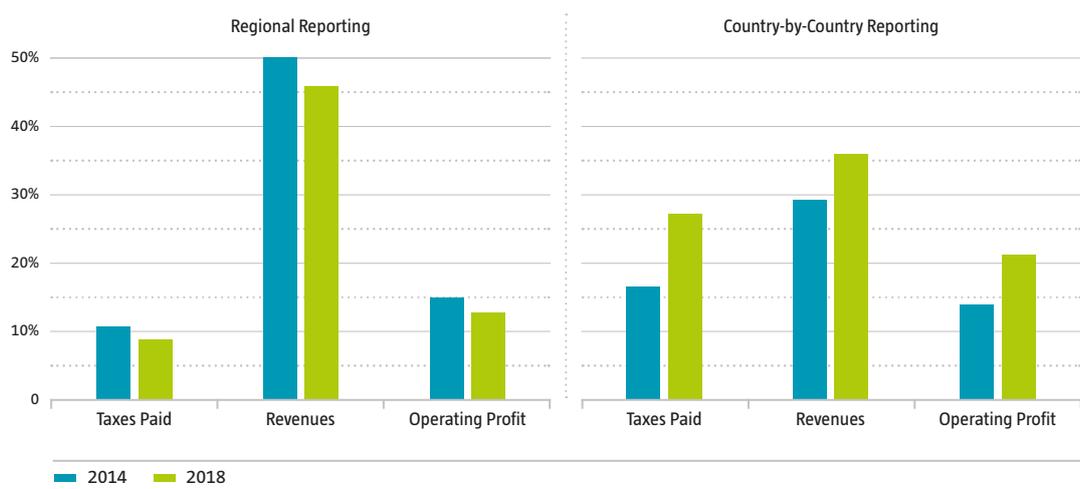
Companies' use of tax havens is by far the least popular aspect to include in a tax policy, covered by only 34% of the firms with public tax policies. This figure plummets to 5% for North American companies, which may be unsurprising when considering that prior to the 2017 US tax reforms, US Fortune 500 corporations alone held around USD 2.6 trillion offshore. While estimates suggest this figure has now fallen by around USD 465 billion<sup>8</sup>, the immense sum of money still held offshore is problematic on multiple levels; most egregious is the fact that this is capital which could arguably be put to more productive uses, such as meeting the UN Sustainable Development Goals (SDGs).

### Tax Reporting

In recent years, global policymakers have supported guidelines to encourage multinational corporations to break down their financial information on a country-by-country basis instead of reporting aggregate figures at the regional or global level. Country-by-country reporting boosts accountability while exposing firms pursuing overly aggressive tax optimization strategies. The results from the CSA below show that over the last five years, an increasing share of companies report taxes paid on a country-by-country basis, thus scoring higher on the Tax Reporting question within the CSA.

Country-by-country reporting boosts accountability while exposing firms pursuing overly aggressive tax optimization strategies.

Figure 6: An Increasing Number of Companies Are Reporting Taxes Paid on a Country-by-Country Basis



While regional reporting has declined over the past 4 years, country-specific reporting across a number of tax metrics has increased. Country-by-country reporting boosts accountability while exposing firms pursuing overly aggressive tax optimization strategies.

Source: RobecoSAM CSA 2018

Corporate Tax Strategy is a useful indicator to identify companies well-positioned to deal with future policy and regulatory changes which could drive corporate tax rates higher.

<sup>8</sup> "Repatriated profits total \$465 billion after Trump tax cuts - leaving \$2.5 trillion overseas," Marketwatch, September 19, 2018

## Effective Tax Rate

We are moving towards a new era of sustainability in which we look beyond companies' policies and reporting

past two fiscal years and compared the lower of the two averages with industry peers.

We are moving towards a new era of sustainability in which we look beyond companies' policies and reporting towards their impact on the world around them.

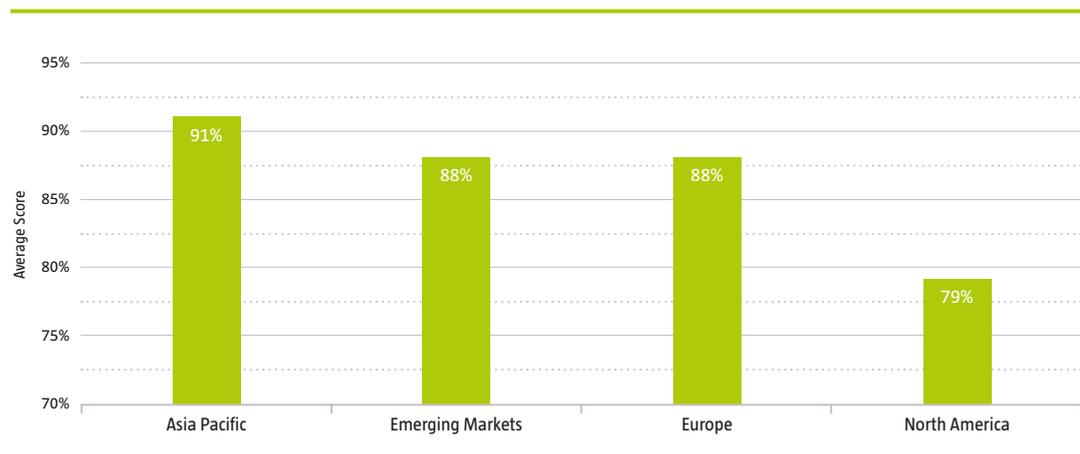
towards their impact on the world around them.<sup>9</sup> As part of our broader effort to shift the CSA's focus from inputs to outcomes and impact, and as the risks linked to tax optimization have become more tangible, we have replaced a previous question related to responsibilities for taxation governance and risks with a new question regarding a company's Effective Tax Rate.<sup>10</sup>

Based on financial data collected by RobecoSAM's Sustainability Investing Research team we established average effective tax rates (taxes due, as provided on a company's income statement) and average cash tax rates (actual taxes paid within the calendar year, as provided on the cash flow statement) across 24 GICS® industry groups and communicated these averages to companies in advance. The question averaged a given company's reported tax rate and cash tax rate over the

Firms with a tax rate below the communicated industry group average were scored based on their deviation below that average. While in some cases discrepancies are legitimate, large deviations from the rates paid in the industry at large can indicate overly aggressive tax optimization. To avoid penalizing companies with reasonable explanations (e.g. treatment of net-operating-losses (NOL)), firms are given the opportunity to explain deviations but are required to provide supporting evidence available in the public domain.

The chart below shows that, taken on average, companies performed well on this new question, in line with our intention to only identify companies which significantly deviated from established industry averages. It was also important that this question was able to detect companies with publicly confirmed tax irregularities. On average, companies that have been the subject of tax-related Media and Stakeholder Analysis (MSA) cases in the past five years scored almost two points lower on the new Effective Tax Rate question than companies with a completely clean tax MSA record.

Figure 7: Effective Tax Rate – Average Score by Region



The data suggests that companies worldwide are not avoiding their tax obligations as indicated by average performance scores on the Effective Tax Rate criterion. Companies in the Asia Pacific scored the best (circa 90%) while companies in North America fared slightly worse (circa 80%).

Source: RobecoSAM Corporate Sustainability Assessment (CSA) 2018

<sup>9</sup> This is reflected in the 2018 CSA: wherever possible, we seek to assess companies on a performance and not policy basis.

<sup>10</sup> General criteria and specific questions within the CSA are continually monitored, and questions revised and replaced when necessary to maintain its relevance and precision in capturing corporate sustainability data.

**Overall Performance by region**

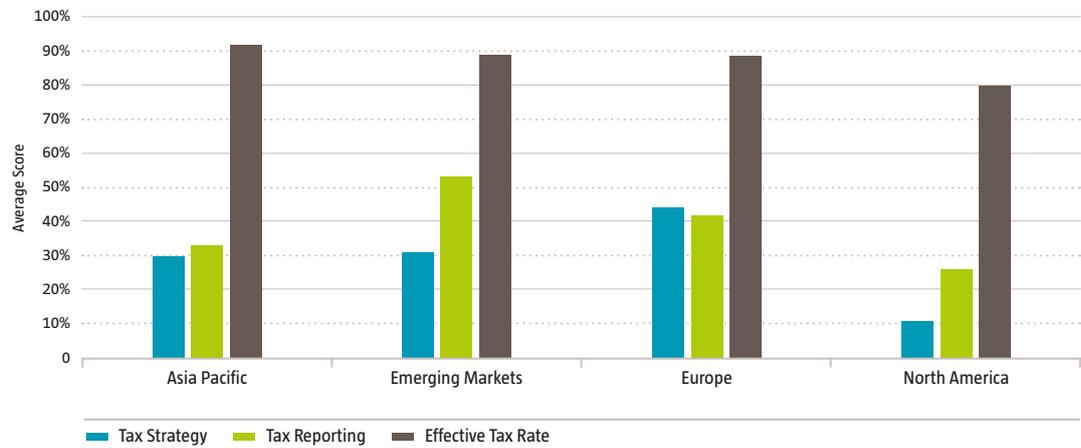
The chart below shows that in the 2018 CSA, European companies led the way with respect to transparent and responsible tax strategies. Emerging markets companies’ tax reporting was most likely to be on a country-by-country basis (at least partially due to more of these companies operating in just one country, making country-by-country reporting easy to

implement), while firms from Asia-Pacific led the way in terms of their scores for effective tax rate. It is also clear that North American firms perform worst across all three questions.

These transparency and disclosure improvements over the past five years as measured by our Tax Strategy and Tax Reporting questions are encouraging, and likely a combination of proactive recognition of policy risks and the realization that nearly all stakeholders are interested in (and critical of) how corporations approach tax.

European companies led the way with respect to transparent and responsible tax strategies.

**Figure 8: Tax Strategy Criterion Overall – Average Score by Region**



Regional performance across each separate tax criterion is shown above. North American firms performed worst across all three criteria. European companies led the way with respect to transparent and responsible tax strategies while Emerging Markets scored the highest on Tax Reporting.

Source: RobecoSAM Corporate Sustainability Assessment (CSA) 2018

## Looking Ahead

For the reasons stated above, we expect further policy coordination with respect to tax accountability in the medium to long term along the lines of the OECD's Base Erosion and Profit Shifting (BEPS) Initiative and the European Union's Common Consolidated Corporate Tax Base project. While one of many causes, the rise of populism has been at least partially fueled by perceptions of inequality in general and an unfairly shared tax burden in particular,<sup>11</sup> further increasing the likelihood of strong policy action on tax both at national and international levels. This policy action brings both opportunities and risks for investors.

As with other topics, our Corporate Sustainability Assessment's Tax Strategy criterion identifies companies

that pursue a corporate strategy that addresses taxes proactively and responsibly. Corporate Tax Strategy is a useful indicator to identify companies well-positioned to deal with future policy and regulatory changes which could drive corporate tax rates higher.

Even in the absence of harsh policy actions, we are encouraged to see that many companies have already begun to make strides, both in terms of transparency and performance, and we are pleased with the CSA's ability to capture and measure it.

**Questions or comments for the author can be sent to:**  
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<sup>11</sup> The Panama and Paradise Papers are simply the most prominent examples of a number of similar cases exposed over the last few years, the consequences of which are still playing out.

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