ICGN Viewpoint

Corporate Tax Policy
June 2016

Taxation of international companies continues to be an issue of much public debate given the tax practices of individual companies being exposed. The Panama revelations on the abuse of offshore centres and the collapse of the proposed Pfizer/Allergan merger due to the US government clamp down on so-called tax inversions; have only served to fuel the debate. Growing scrutiny in this area is damaging corporate reputations and public trust in business. This raises question of both business ethics and business risk, and is a matter of corporate governance for companies, directors and their investors.

The pressure on investors is intense. International trade unions have urged investors to do more to prevent companies in which they invest from committing tax abuse. End-beneficiaries – including beneficiaries of pension funds- increasingly want to see fair play. Investors are also aware of a potential negative share price impact on companies that are caught aggressively exploiting loopholes given reputational impact on companies, even when what they are doing is technically legal.

Long gone are the days when it seemed as though the moral duty of companies was to minimise tax payments because these were ultimately a cost to shareholders. Yet for investors themselves, the issue of tax is complicated, and one where it may not always be clear on how to exercise stewardship obligations.

The ICGN Business Ethics Committee has thus made taxation a priority, as part of ICGN’s overarching policy focus on culture, ethics and risk. While there remain open questions beyond this Viewpoint report that need to be addressed about taxation-- both at the governmental and individual company level-- the Committee has drawn some preliminary conclusions about how shareholders can play a constructive role in engaging on tax policy with companies. These conclusions drew from attendance at public debates and conference calls with experts. The aim of this Viewpoint is to share some of these thoughts on the key links of taxation to corporate governance with the broader ICGN membership on the understanding that we are dealing with a fast moving situation to which it will be necessary to return on a regular basis.

The key principle is that shareholders can and should ensure that the companies in which they invest have a responsible approach to tax practices which takes into account the broader economic and social view.

There are many reasons why taxation is an intractable problem. One is the conflicted attitude of many governments who seek to have a low tax rate in order to attract
investment and then find themselves complaining about how little tax companies pay. Another is the unusual approach of the US which both levies a high rate on corporate profits (of around 38 per cent) and taxes individuals and corporate entities on their worldwide income as opposed simply to the income generated within the confines of the US itself. This is widely seen as tending to distort companies’ approach to finance, for example by parking profits in low tax jurisdictions abroad and borrowing at home to fund share buybacks, or by using the funds parked abroad to undertake takeovers that are primarily driven by tax considerations.

In this way the tax regime directly introduces a range of governance issues. Arguably, one strategy for shareholders confronting a general problem could be to get involved in the policy debate in order to improve the basic climate. If it were not for the behaviour of governments, we might not have seen the development of quite such a large industry dedicated to the reduction of tax, with all the problems we are now experiencing.

Arguably, the behaviour of governments has spawned a whole industry dedicated to the reduction of tax. Another larger problem is the determination of governments around the world to levy tax on profits, which are themselves hard to define, while leaving interest payments on debt untaxed. One possible subject for discussion would be shifting the burden away from profits to debt interest, which can be clearly measured. This would need careful debate but it might help address the problem as well as discouraging companies from building up excessive gearing in order to improve their earnings.

Once again, wholesale change looks unlikely, though some countries such as the UK are starting to limit the tax deductibility of interest. From the shareholder perspective, it is important, however, to consider the wider issues in the debate as well as the more technical ones set out below, and be prepared to make views known to policymakers.

The taxation of multinationals is technically complicated because, by definition, they operate in a range of different jurisdictions. It can be difficult, if not impossible, for tax authorities or other outsiders to assess exactly where multinationals make their profits. For example, a software company may incur a large amount of research expenditure in California and have a large market for its products and services in Europe. The profits it earns in Europe may appear large because, on a pro forma basis, they do not allow for the cost of the intellectual property. Allocation of this cost is more of an art than a science, but it needs to be taken into account.

Companies naturally like to incur high costs and low profits in jurisdictions where their profits are most heavily taxed. For a US company it makes sense to hold cash offshore and to lend it to its US operation rather than repatriate it as profits. The debt interest reduces the US tax bill and still enables the group to mobilise its cash.
resources. One purpose to which the funds could be used is share buy backs which would then have a positive effect on earnings per share and may often flow into the assessment of performance targets linked to the remuneration of the top executives.

Companies can use their offshore cash holdings to merge with another organisation in a transaction which ends up with a change in domicile, thereby reducing their US tax liability for ever. Pfizer’s proposed transaction with Allergan and previously with Astra Zeneca came into this category. The US authorities have now clamped down on such inversions, but in such a way that has also caught up legitimate funding of their US subsidiaries by overseas multinationals.

Even where companies trade internally, the price of the transactions can be manipulated to reduce profits in high tax jurisdictions and channel them to places where tax is lower. The price companies charge other parts of the group for components and raw materials should be determined at arm’s length. This is not always the case and transfer pricing is often used to minimise the tax burden.

Against this background it is very difficult for shareholders or other outsiders to determine definitively whether a company is paying as much tax as it should. Almost all practices that are perceived as tax evasion by multinational companies are actually within the law, and conciliatory payments, such as those made by Starbucks to the UK in the wake of complaints about its low tax rate are arbitrary and have no basis in law. Some experts describe them as a charitable donation!

This does not mean, however, that shareholders should sit on their hands and do nothing. The key issue is whether the company is taking a responsible approach, and the questions to ask are about process rather than technicalities. They might include the following:

- Does the company have a policy on taxation? What does it say, and how does the board monitor compliance?
- Has the company chosen a given location, or is it moving to a particular location to gain the benefit of a favourable tax regime even though this will affect governance by limiting shareholder rights?
- Would the company decline to undertake a transaction purely for tax purposes, when there was no long term commercial benefit to be gained? Does the board scrutinise transactions, including proposed mergers and acquisitions from this perspective?
- What the company’s overall tax rate and how does it compare with its competitors?
- Can the company provide assurances that its internal transactions are genuinely at arms’ length?
- Does the company hold funds or have subsidiaries in offshore tax centres? If so what is the motivation for this?
Does the company's remuneration policy create incentives to reduce the tax burden (i.e. because the incentives are based around after tax earnings)?

How does the company ensure that their auditors retain their independence and proper oversight of tax accounting and planning if the audit firm is also providing tax advice?

A major unresolved question relates to disclosure. The Organisation for Economic Cooperation and Development has agreed that companies should report details of their business on a country-by-country basis (including turnover, and numbers of employees) to the tax authorities in each jurisdiction where they operate. This should enable the authorities, working together, to calculate whether the rates of tax paid in each jurisdiction are fair.

These disclosures are not required to be made public, but the European Union has gone further after pressure from the European Parliament, requiring public disclosure of data for each EU country in which businesses operate as well as in key offshore centres. The weakness of this proposal is that it will only give a partial picture as outsiders will not be able to see figures for major markets outside the European Union. Even so it has been fiercely opposed by some major EU members, including Germany.

Country-by-country disclosure is an important issue for shareholders closely linked to the debate over corporate tax policy. The concept is in keeping with arrangements than already exist for the extractive industries and the data, if published on a global basis, could give investors and the general public a much better overall picture than that under existing segmental reporting.

An argument in favour of public disclosure of country by country reporting is that it will help give better direction to policymakers. Companies are very reluctant to publish this information both because they fear it will be misunderstood and because it may put them at a competitive disadvantage, for example, by revealing information about their supply chain.

ICGN recognises that country by country reporting may provide greater insight on company tax practices—and this form of transparency may also serve as a form of discipline to encourage companies to undertake prudent tax policies. At the same time ICGN also recognises that the complexities of cross border business and taxation can make it difficult for investors to develop an accurate understanding of a company's tax policies through country by country reporting alone. Indeed, there would seem to be ample scope for both false positives and false negatives, so some caution is warranted in terms of to use such information.
Investors have not traditionally focused on tax policies as a matter of corporate governance, and as this issue gains further prominence they will need to reflect on how they would use country by country reporting in investment analysis and/or company engagement. There may be scope in promoting an international accounting standard aimed at providing consistency relating to tax policies. The decision depends as much on whether national tax authorities can be trusted not to do sweetheart deals for favoured companies as on whether companies can be trusted to pay what they owe. The hurdle is a high one because trust is at the heart of the matter, and secrecy is the enemy of trust. Shareholder pressure on the board oversight of tax practices in their investee companies might go some way to restoring trust on this matter.

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