Paying a fair corporate tax rate matters

Paying a fair rate of corporate tax is an important contribution that companies make to society. If companies are proactively seeking to minimise their tax payments, this should be seen as a red flag.

Economists at the International Monetary Fund estimate that global corporate tax avoidance costs governments between US$500 and US$600bn every year.[1] This includes $200bn in revenues being channelled away from low-income economies, which is more than these countries receive in foreign aid each year.[2] These vital resources could be spent on improving education, health and social services, as well as supporting sustainable development and contributing to a fairer and more equal society.

As governments around the world continue to ratchet up higher levels of debt following the Covid-19 crisis, this loss of tax revenue becomes even more critical. Since the 2008 global financial crisis, large companies have been paying lower rates of tax on average.[3] Big tech firms in the US have come under the spotlight for their tax avoidance antics. A study by the UK transparency campaign Fair Tax Mark, found that six of the largest tech firms, including Amazon, Facebook and Google, have been 'aggressively avoiding' the payment of taxes, totalling US$100bn over the past decade.[4] Regulators are starting to pay attention, especially in Europe and the UK. Governments are beginning to roll out digital taxes.

Legal loopholes

Corporations today can legally avoid or minimise their tax bill in various ways. For example, they can set up foreign subsidiaries in tax havens, such as the Cayman Islands, or use transfer-pricing to shift profits from one division to another. These tactics may be seen by some as 'sensible business'. Some investors even celebrate when companies pay minimal tax. On the contrary, we believe that deliberate and systematic tax avoidance strategies can contribute to inequality, weaken our social fabric and reduce the ability of governments to make societies fairer and safer for all citizens.

> As long-term investors, we seek to invest in high-quality companies that are well-placed to benefit from and contribute to sustainable development. We look for companies led by exceptional people, who have strong ethics and long-term time horizons

A low tax rate is a risk

Paying low levels of tax can also be a source of significant risk to future cash flows within companies. In India, for instance, the government has been charging an additional 18% interest rate on disputed balances over years – this can quickly compound into a serious liability.[5] It can also lead to reputational damage for companies. Ultimately, a dollar or rand or rupee of earnings at the legitimate company tax rate is worth more to us than the same earnings at a tax rate half the level or less.

When we come across a company proactively trying to minimise their tax payments, it is a red flag for us.

If the management team is comfortable to cut corners in tax, they may be more likely to cut corners elsewhere.

As such, tax is a key topic that we raise with companies as part of our engagement activities.

We actively engage on tax

One of our most prominent tax engagements in the past decade involved a large pharmaceutical company. This company used complex structures to reduce tax rates to mid-single digits that lasted for nearly a decade. We felt these structures violated the spirit of the law and increased the risk to future cash flows. Lengthy engagement did not lead to much progress and we were left with no choice but to sell our holdings. Today, many years later, governments are demanding half a billion dollars in back taxes from the company. The company is also fighting several antitrust cases and had failed to report a material related party transaction – a stark reminder that governance lapses do not happen in isolation.

Assessing tax rates on their own is obviously not enough to make a full assessment of the quality of the management or the financials of a business. However, it is a very useful piece in the "quality assessment jigsaw puzzle" that investors should consider during their appraisal of a company.

Lorna Logan, Senior Investment Analyst

May 2021

[1] International Monetary Fund, Tackling Tax Havens Finance & Development, September 2019, vol. 56, No. 3.

[2] International Centre for Tax and Development. Corporate tax avoidance and development: opening Pandora's box. September 2014.

[3] Multinationals pay lower taxes than a decade ago. Financial Times. March 2018.

[4] The Silicon Six and their $100 billion global tax gap. Fair Tax. December 2019.

[5] Reducing income tax disputes in India. Deloitte Tax Policy Paper 6. February 2020.

[6] Morningstar Document Research. Form 8-K. Expeditors International of Washington INC - EXPD. March 2013.

Case Study - Transcript from an analyst call with the founder of a global logistics company[6]

"We pay our taxes according to the local tax regulations in each of those countries. We don't enter into glamorous-sounding arrangements to exploit arcane loopholes involving myriads of strange islands in exotic locations.

We repatriate the earnings from our overseas subsidiaries into the United States and declare our full share of taxable income, and rely on whatever foreign tax credits we are allowed by the Internal Revenue Code for earnings already taxed in jurisdictions with which the United States has tax treaties to address double taxation.

When we instituted this policy back in 1993 and began to accrue a full US tax rate on all worldwide income, it seemed to us that we spent an inordinate amount of time fending off "Gaggles" of accountants and "Prides" of lawyers trying to foist upon us all the latest and greatest tax avoidance schemes. From that experience, we came to understand why, where and how so many companies are able to construct wildly intricate tax avoidance schemes by structuring their affairs in such a way that they pay no tax anywhere…or as close to no tax as they can get.

The difference between the exorbitant amounts of money required to pay the "Gaggles and Prides" to perpetuate the byzantine and complex, wildly intricate, tax avoidance schemes and the amount of taxes you'd pay if you just did straight forward, reasonable tax computations isn't worth the anxiety of what will happen when laws or interpretations change.

Of course the "Gaggles and Prides" revel in these changes in taxation rules. Once in their clutches, you're trapped. Each new change or new interpretation provides new opportunities, cast as necessities, for them to layer even more new wildly intricate schemes on top of old wildly intricate schemes, each change geometrically requiring larger "Gaggles and Prides."

Before you know it, your tax department has turned your company into a "Rube Goldberg Tax Machine" whose procedural tentacles have crept into every nook and cranny of your business operations. This complicates and convolutes your business' operational aspects beyond recognition to the business people who are actually attempting to service your customers.

With every single business decision now overshadowed by tax ramifications that no one but the "Gaggles and Prides" understand, you can find yourself in the tax business first and the customer service business second. We think it would be terribly difficult to actually maintain focus on the vital non-taxation parts of your business (i.e. the product development, sales and customer service purpose for which the company actually exists).

Not to be outdone, the Government reacts to these "Rube Goldberg" tax avoidance schemes by passing more complex and more comprehensive laws. This in turn requires more and more government tax auditors and examiners. The "Gaggles and Prides" react by bolting more "wheels and pulleys" onto the already ridiculously complex "Rube Goldberg Tax Machine" that was once your company…and thus you see the vicious circle of regulation and complexity that global taxation has become."

Investment terms

View our list of investment terms to help you understand the terminology within this document

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