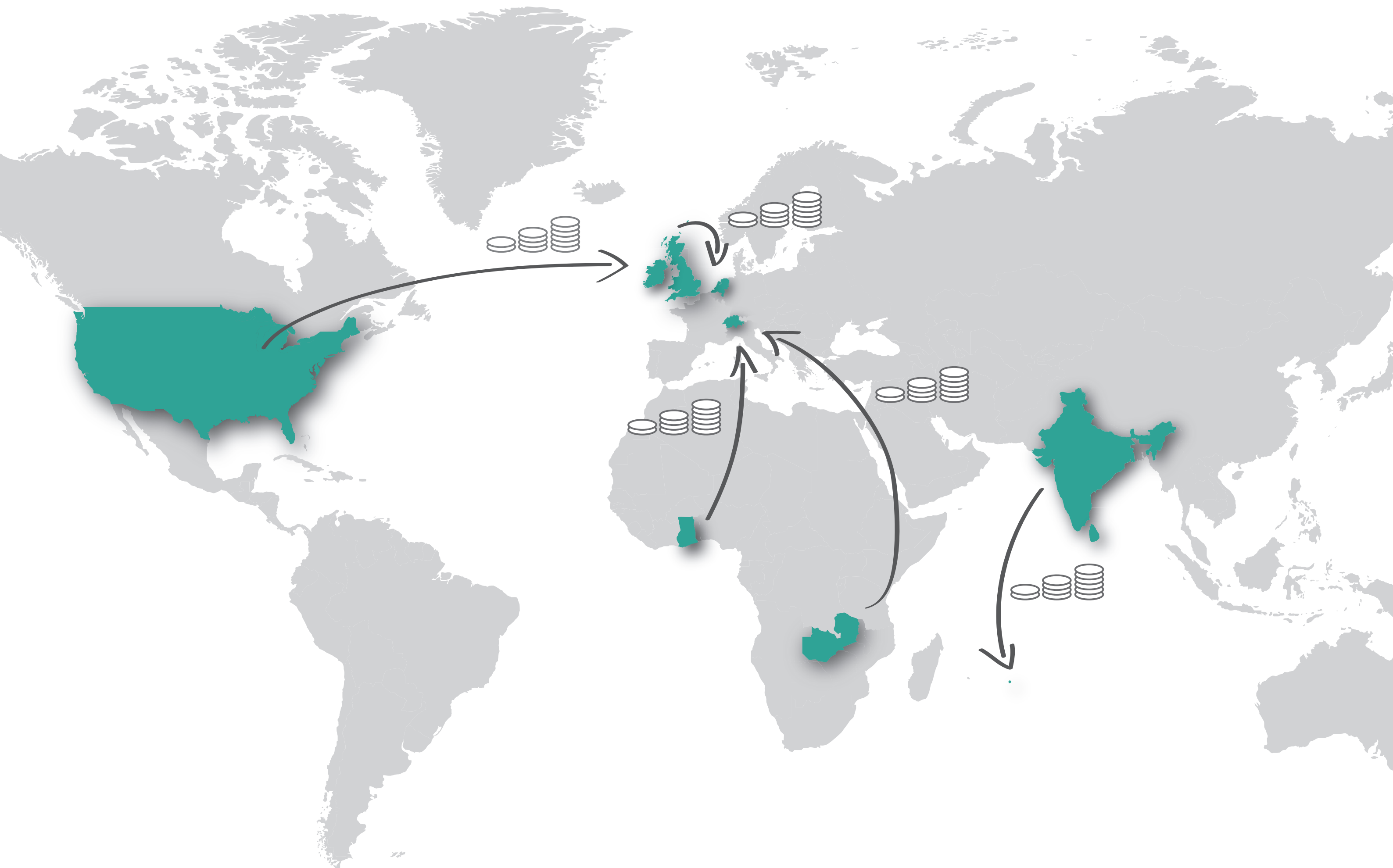
"It's Time to Call For More Responsibility"

Multi-National Corporations and Tax Transparency: Issues for Responsible Investors

June 2013



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Commissioned by Arisaig Partners, this report was researched and written by Zachary Paris of Sustainalytics. The author wishes to acknowledge the contributions of Mike Lewis, Tax Justice Policy Adviser, ActionAid, and Katharine Teague, Senior Private Sector Adviser, Christian Aid, both of whom provided valuable insights during interviews carried out as part of the research for this report.

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"Some forms of avoidance have become so aggressive that I think it is right to say these raise ethical issues, and it's time to call for more responsibility and for governments to act accordingly."

- David Cameron, UK Prime Minister
World Economic Forum, Davos, Switzerland January 2013

"We are not accusing you of being illegal, we are accusing you of being immoral."

- Margaret Hodge, UK Public Accounts Committee Chairman
UK Public Accounts Committee Meeting, UK Parliament November 2012

"It's Time to Call For More Responsibility"

Multi-National Corporations and Tax Transparency: Issues for Responsible Investors

Corporate tax policy, a previously esoteric topic, has crept into the mainstream as austerity efforts across Europe are seen in the context of record corporate profits and falling corporate tax receipts. Increased public interest has raised the reputational risks associated with corporate tax avoidance and spurred politicians and government leaders in Europe and the United States to begin pushing for corporations to "pay their fair share."[1] Multi-national corporations (MNCs) have come under particular scrutiny as they are in the unique position of legally minimising their tax burden by shifting profit recognition to low-tax jurisdictions, a practice that has existed for decades, but has become more pronounced and easier to implement with the digitisation of the global economy and the increased percentage of revenue attributed to intangibles. In emerging markets, MNCs often negotiate tax concessions with the national government, utilise special economic zones (SEZs) and adopt royalty and fee structures that result in tax payments incommensurate with a company's operational activity. These tax strategies minimise a company's corporate tax burden, but they also undermine national development by eroding a country's tax base, an issue that should be of particular concern for companies and investors with an economic interest in the growth of an emerging market consumer class. Preventing aggressive corporate tax practices and mitigating the related risks will require action on the part of governments, regulators and companies themselves. However, due to a current lack of corporate transparency concerning tax policy and practices, investors remain unable to adequately assess company exposure to these risks. This report focuses on the risks related to the tax practices of MNCs in the consumer sector, how these practices have become more aggressive over time, and how investors can engage companies on their tax strategy and performance.

Key Findings

- Tax avoidance strategies have become more common and aggressive. Aggressive tax positions concerning inflated royalty and management fee structures, transfer pricing arrangements, intra-company loans and the location of intangible assets and high-value business functions pose material reputational, operational and financial risks to MNCs.
- Austerity measures and reduced tax receipts have increased public and government scrutiny in both developed and emerging markets, while high-profile media campaigns have exposed the tax avoidance strategies of MNCs like Apple, Starbucks and Google, eroding brand value and leading to multiple protests and boycotts.
- For consumer MNCs operating in emerging markets, tax avoidance strategies pose medium- to long-term risks to profitability by increasing the risk of tax-related penalties, damaging relationships with local governments and eroding the corporate tax base that accounts for a significant portion of the potential and actual government tax revenue necessary for economic development and the growth of a consumer class.
- In emerging markets, the reputational risks can be particularly severe as large MNCs are frequently targeted by protest groups when they are not seen as a being good corporate citizens.
- The global debate is shifting and as regulators look to crack down on corporate tax avoidance, it is in companies' best interests to proactively adopt responsible tax practices. First and foremost, MNCs should not locate group companies in tax havens unless there is a justification based on legitimate economic activity.
- Corporate tax transparency remains inadequate which prevents investors from accurately assessing the risk of corporate tax positions. Steps to improve transparency include a formal tax policy and code of conduct as well as a country-by-country breakdown of revenue and taxes paid.

The Issue

"There is increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes."[2] - OECD

Globalisation has changed the way in which MNCs are structured and managed, creating immense room for discretion regarding the location of subsidiaries and intellectual property, the classification of employees, the use of tax allowances, and prices used for transfer payments between subsidiaries. Company discretion has typically resulted in minimising the tax liability to the greatest extent possible. In April 2012, the New York Times published a lengthy exposé on Apple's tax practices, describing how Apple has been able to keep its international tax burden "in the single digits for the last half-decade" by using the strategies mentioned above.[3] The story followed similar articles regarding the tax practices of Yahoo, Dell, and Google and resulted in a congressional investigation with Apple CEO Timothy Cook called to testify in front of the Senate Permanent Subcommittee on Investigations. However, while the increased reliance on patents and other intellectual property facilitates tax avoidance strategies at technology companies, the practice can be found at many prominent MNCs and is certainly not limited to Apple; in fact an almost identical New York Times exposé had been published about GE nearly a year prior[4] and Reuters published a 2012 special report on Starbucks' tax avoidance strategy, which has enabled the company to pay no corporate income taxes in the UK over the past three years.[5]

98 of the FTSE 100 utilize tax havens[6]

£11.9 billion

Google paid only GBP 10 million in corporation tax in the UK from 2006 to 2011 on revenues of GBP 11.9 billion, making its effective UK corporate income tax rate .08%. From 2009 to 2011, Starbucks reported no profit in the UK and paid no income tax on sales of GBP 1.2 billion. Over the same period, YUM Brands paid taxes of GBP 36 million on sales of GBP 1.1 billion and McDonalds paid taxes of GBP 80 million on GBP 3.6 billion in sales.[7]

The OECD estimates that tax havens cost Africa more in lost revenue than it receives in aid from developed countries.[8]

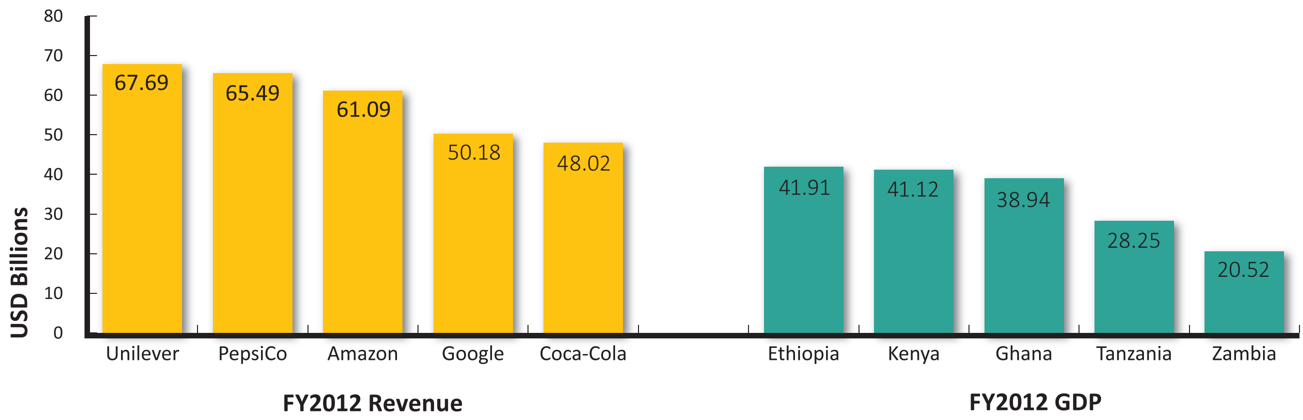
One-third of child deaths in Zambia are caused by malnutrition. From 2007 to 2011, ActionAid estimates that Associated British Food's tax avoidance strategies reduced the Zambian government's tax receipts by a figure equivalent to 14 times the aid provided by the UK government to fight hunger and food insecurity over the same period.[9]

In 2010, the British Virgin Islands were the second largest investor in China (14% of FDI), ahead of the United States (4%).[10]

The majority of such tax avoidance strategies depend upon the use of tax havens, a fact that has received significant attention from both the public and national tax authorities. In 2013, ActionAid released an update to its 2011 list identifying the number of subsidiaries of FTSE 100 companies located in known tax havens. While presence in a tax haven is not itself evidence of a tax avoidance strategy, a number of MNCs on the list with a high percentage of subsidiaries located in tax havens have come under public and regulatory scrutiny in the past: Diageo (31%), SABMiller (29%), British American Tobacco (27%), Unilever (26%) and Associated British Foods (15%).[11] Amidst European austerity measures, the use of tax havens has become particularly unpalatable for the general public. As ActionAid notes, "it is not tenable for any government to impose or increase taxes on ordinary people while there is a perception that the burden is not also falling on businesses and elites." However, the negative impact of tax havens extends beyond European nations looking to increase tax receipts.

"While these corporate tax planning strategies may be technically legal and rely on carefully planned interactions of a variety of tax rules and principles, the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy." - OECD[12]

Taxation is a crucial component of a democracy, and successful state-building efforts in emerging markets depend upon a strong and sustainable tax code that strengthens government accountability and reduces dependence on foreign loans and aid. Corporate income taxes from MNCs account for a significant portion of current and potential tax revenues in many emerging markets. "Ghana, for example, relies on foreign-owned businesses for the lion's share of its corporation tax, which in turn represents almost one-sixth of the country's total tax revenues."[13] By exploiting provisions within tax treaties, negotiating tax concessions and engaging in other tax avoidance strategies, MNCs increase a government's reliance on value-added taxes (VATs, which are viewed by many as regressive) and reduce government tax receipts that can be used to fund education, expand health care, combat poverty, invest in infrastructure, and otherwise contribute to the nation's economic development. In 2009, Rwandan tax incentives alone reduced tax collected by an amount equivalent to 33% of total government revenue and 17% of the total government budget. In 2010-2011, Kenya spent USD 1.1 billion in tax exemptions and incentives, more than double the entire government health budget of USD 461 million.[14] Yet these concessions account for only a portion of lost potential revenue. The use of inflated transfer pricing arrangements and royalty and management fees further reduce government tax receipts. ActionAid estimates that SABMiller's tax avoidance strategy for its African operations alone costs the continent GBP 18.2 million per year in lost tax revenue, including GBP 1.44 million for Tanzania.[15]



Source: Google Finance and IMF

Despite evidence to the contrary, many emerging market countries see a favourable tax environment as a primary factor in attracting foreign direct investments (FDI) and furthering economic development through increased jobs and exports.[16] Tanzania's Minister for Industry, Trade and Marketing summed up emerging market sentiment when discussing export processing zones: "all countries provide these kinds of incentives…if we did not decide to provide them, no investor will come."[17] However, MNCs, in an effort to reduce their tax burden beyond any incentives offered by the government, often locate high-value business functions (management, research and development) in low-tax jurisdictions, which prevent many of the positive spill-over effects upon which such tax concessions are predicated. Small- and medium-sized businesses are also put at a distinct disadvantage from concessions that are not made available to them and tax avoidance strategies that shift a greater percentage of the tax burden onto local businesses. As ActionAid's Mike Lewis notes, "there is a lack of a level playing field for local businesses that don't have the facilities for cross-border tax avoidance strategies."[18] A strong base of small- and medium-sized businesses is a characteristic of most vibrant economies. In the European Union for example, 85% of net new jobs created between 2002 and 2010 were from small- and medium-sized businesses.[19] The unfair advantage enjoyed by MNCs can hinder the growth of important local employers and undermine long-term economic development.

> **"Companies have an important role to play in societies across the world and one of those contributions is tax payments which are vital; it enables governments to provide infrastructure, education to workforces of the future, and pay for essential services."[20]**
>
> - Katharine Teague, Senior Private Sector Adviser, Christian Aid

In addition to reducing government revenue, concessionary tax policies in one emerging market encourage similar policies in other emerging markets, creating a "tax-competition" that is ultimately a race to the bottom. Governments in both developed and developing countries have begun to take notice of the predatory relationship many MNCs have with their host countries. The East African Community (EAC), which includes Kenya, Tanzania, Uganda, Rwanda and Burundi, is currently debating a Draft Code of Conduct against Harmful Tax Competition, which proposes to prevent future tax incentives from being introduced. In February 2013, the UK Chancellor of the Exchequer, George Osborne, stated that the UK intended to use its G8 presidency to "drive a serious debate on tax evasion and tax avoidance," which "will include action to help developing countries collect tax that is due to them."[21] Following a May 2013 G7 meeting, Mr. Osborne noted that "we all agreed on the need for collective actions to tackle tax avoidance and evasion," an objective at the heart of the proposed EU Savings Directive.[22] The trend in both the developed and developing world is toward increased cooperation regarding tax transparency and increased scrutiny of companies employing tax avoidance strategies. Thus the question now becomes what risks are MNCs exposed to as a result of their tax practices and related lack of transparency, and what tools do investors have to affect change in corporate tax behaviour to best mitigate these risks?

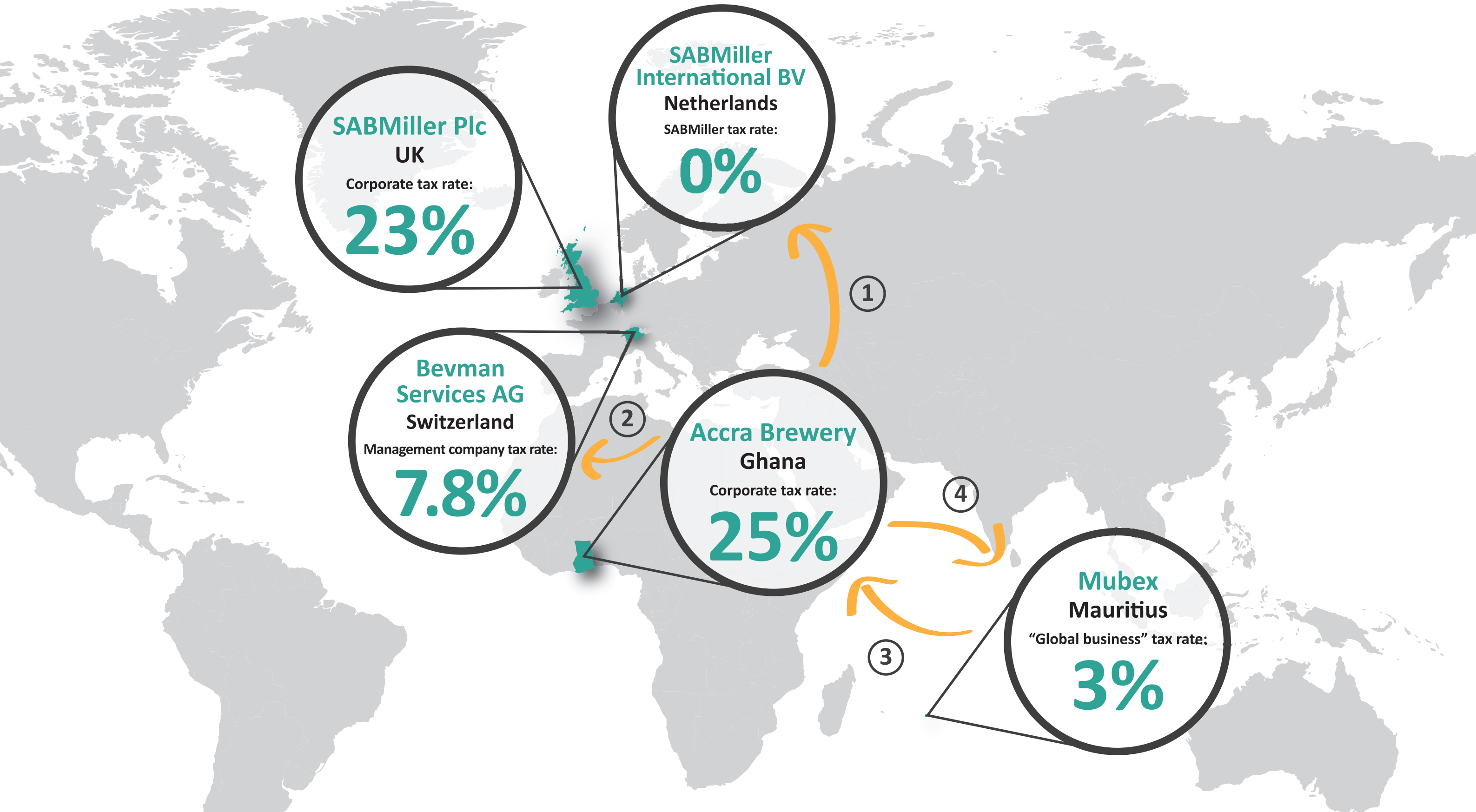
Common Tax Avoidance Strategies for MNCs

Transfer Pricing (Royalties and Service Fees): A MNC will locate supplies, intellectual property and high-value operations in low-tax jurisdictions like Ireland or Switzerland. The MNC will then charge inflated royalty and/or service fees to a subsidiary, which reduces taxable income in the subsidiary country and inflates profit in the low-tax jurisdiction (which is subsequently taxed at a much lower rate). This strategy is supported by a bilateral double tax avoidance treaty between the low-tax jurisdiction and the subsidiary country, which may negate local withholding taxes on management fees, for example.

Negotiated Incentives: Company or industry specific tax incentives and capital allowances that are often negotiated by a MNC with the government or development agency. Such incentives are provided to encourage investment and expansion by MNCs. Since 2008, Zambia Sugar (an Associated British Foods subsidiary) has been subject to a 15% corporate tax rate instead of the regular 35% rate because Zambia agreed to recognize its income as “farming income,” a provision typically allowed only for domestic farmers. The company received a second tax incentive in 2012 that reduced the tax rate on income generated from expanded operations.[23]

Intra-Group Financing: MNCs often provide intra-company loans to subsidiaries. The interest paid on these loans reduces taxable income for the subsidiary. In some cases, a MNC will charge inflated royalty, management or other fees to an emerging market subsidiary, which reduces the subsidiary’s taxable income. The MNC will then provide a loan at a rate that may even exceed market rates. The interest paid on this loan further reduces taxable income in the emerging market and inflates income earned in the country where the loan originated. Starbuck’s provided its UK subsidiary with a 2011 loan at Libor plus 4%, while Starbucks group bonds carry a coupon of Libor plus 1.3%.[24] SABMiller’s wholly owned Mauritius subsidiary, Mubex, serves as a supplier to SABMiller’s Ghanaian subsidiary, Accra Brewery. Upon sourcing from Mubex, Accra Brewery’s gross profit declined dramatically. At the same time, Accra Brewery received a GBP 8.5 million loan that provides a GBP 76,000 annual tax shield. The Ghanaian corporate tax rate is 25%, while MNCs in Mauritius are taxed at 3%.[25]

Treaty Shopping: An umbrella term that refers to the routing of international payments through a third jurisdiction to exploit unique tax benefits. For 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. Bilateral tax treaties can also be exploited to reduce or eliminate taxes on dividends paid by the emerging market subsidiary to the parent. Both systems have been used by Zambia Sugar. The prevalence of routing international payments through tax havens is reflected in OECD statistics on foreign direct investment (FDI). For example, in 2010, Barbados, Bermuda and the British Virgin Islands received more FDI (5.11% of global FDI) than Japan (3.76). That same year, the British Virgin Islands alone were the second largest investor in China (14% FDI), ahead of even the United States (4% FDI).[26]



SABMiller in Ghana

SABMiller uses a number of tax avoidance schemes to inflate taxable income in low-tax jurisdictions. The above schematic details how four of these schemes are employed for Accra Brewery, a SABMiller subsidiary in Ghana.

1. Accra Brewery makes African brand beer including Castle Milk Malt and Stone Lager, to be sold in Africa. However, SABMiller locates the trademarks for its African brands in the Netherlands. From 2007-2010, Accra Brewery paid 2.1% of its annual revenue in royalty fees to SABMiller International BV in the Netherlands.

2. Over the same period, Accra Brewery also paid 4.6% of its annual revenue in management fees to Bevman Services AG, SABMiller's wholly-owned management company located in Switzerland. From 2007-2010, payments made to Bevman and SABMiller International BV totalled GBP 4.57 million or 6.7% of total revenue and 10x the operating profit of Accra Brewery.

3. In addition to these fees, Accra Brewery sources 50% of its supplies from Mubex, SABMiller's wholly-owned supplier located in Mauritius. Accra Brewery sources Belgian malt, South African maize and Brazilian sugar from Mubex. This enables the use of inflated transfer pricing arrangements that increase costs for Accra Brewery and inflate profits for Mubex.

4. Mubex also provides loans to Accra Brewery. The interest payments on these loans can be deducted against income earned in Ghana, further reducing taxable income in Ghana and inflating income in Mauritius.

Info sourced from: Brooks, Richard and Hearson Martin, "Calling Time: Why SABMiller Should Stop Dodging Taxes in Africa," ActionAid, April 2012.

The Business Case for Fairness and Transparency

> **"Fiduciary duty does not require an absolute commitment to minimize cost. Companies are allowed to pay living wages and not break their fiduciary duty and companies make choices all of the time about the level of aggression within their tax planning."[27]**
>
> \- Mike Lewis, Tax Justice Policy Adviser, ActionAid

For consumer MNCs, the business case for tax transparency and paying a "fair" amount of tax is two-fold:

Risk Mitigation: The broader business case, applicable across industries, is risk mitigation. In this context, risk mitigation includes three primary components: reputational risk, risk to the relationship with the host country, and financial risks.

Market Development: The second, but equally important, component of the business case relates to the development of a consumer-class in emerging markets. Such development ultimately depends upon the country's development more broadly, which requires a strong, legitimate and sustainable tax system that can generate consistent funds for education, infrastructure, health care and other necessary inputs for economic growth. The success of consumer MNCs in emerging markets goes hand in hand with the economic development of those markets.

> **"Businesses with a reputation to defend will need to explain how paying the right amount of tax, consistently and in the right places, is in the long-term interests of both their shareholders and society."**
>
> \- Corporate Citizenship, May 2011[28]

Both cases fall under the umbrella of corporate responsibility in that corporate responsibility is a way of doing business, not an add-on, intended to "encompass both the consideration of a business' impact on society and the environment, beyond its obligation to comply with the letter of the law, and the consideration of the potential impact of environmental and social issues on a business' long-term performance."[29] Short-term financial gains from an aggressive tax position may, in many cases, be offset by medium- to long-term repercussions reflected by the following risks:

Risks Related to Aggressive Tax Practices

1) **Reputational Risk:** Increased public and regulatory scrutiny and subsequent brand erosion.
2) **Risk to Relationship with Host Country:** Expansion projects may become subject to approval delays and/or rejection. Companies may lose their license to operate and investigations by tax authorities and/or politicians may become more common.
3) **Financial Risks:** Uncertainty concerning regulatory changes and the flexible use of General Anti-Avoidance Rules contributes to "surprises" and increased earnings volatility.
4) **Economic Development Risks:** Reduced economic growth as emerging market governments receive inadequate tax receipts, local management capacity remains underutilised or underdeveloped, and small- and medium-sized businesses are placed at a competitive disadvantage.

"Don't be evil. We believe strongly that in the long term, we will be better served—as shareholders and in all other ways—by a company that does good things for the world even if we forgo some short-term gains. This is an important aspect of our culture and is broadly shared within the company."

- Google Prospectus 2004[30]

"I can't be the only person here who feels disappointed that such a great company as Google, with such great founding principles, will be reduced to arguing that when it employs thousands of people in Britain, makes billions of pounds of revenue in Britain, it's fair that it should pay just a fraction of one per cent of that in tax."

- Ed Miliband, Labour Party Leader, 2013[31]

Risk Mitigation

Reputational Risk

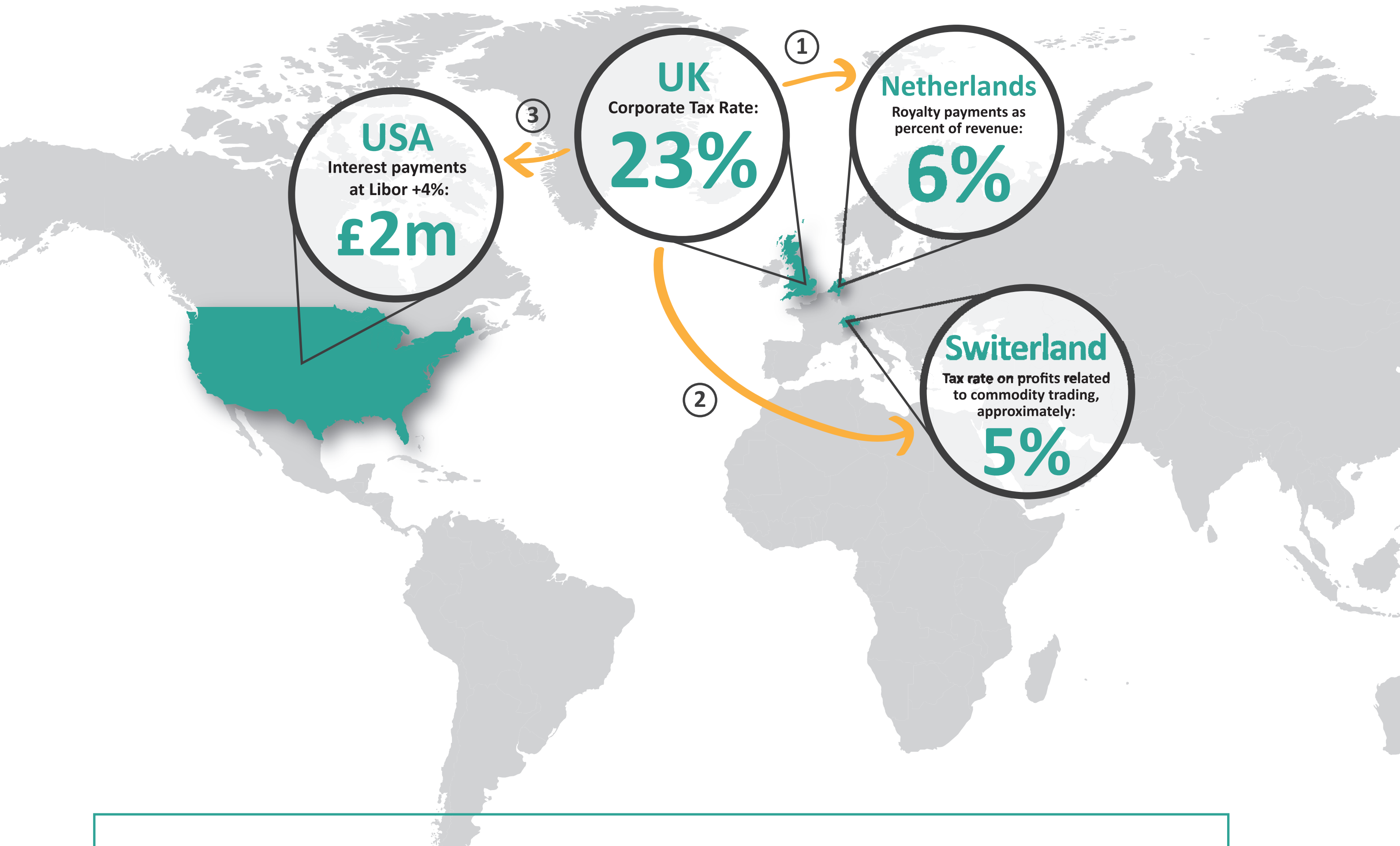
Amidst European austerity measures, corporate tax avoidance has received unprecedented media coverage. In 2009, the UK Guardian ran a two-week "Tax Gap" series, which highlighted the tax avoidance strategies of a number of prominent companies including Barclays, Diageo, Shell, GlaxoSmithKline and Lloyds as well as the role of the "Big Four" auditing companies in facilitating such strategies. The series put company taxes in accessible context such as the number of new schools that could be funded from a company's tax gap. In October 2010, the *UK Uncut* movement sprung up in response to UK austerity measures, resulting in protesters occupying the flagship store of Vodafone and an on-going campaign to publicise the tax avoidance strategies of Starbucks, Diageo, Vodafone, Tesco, Cadbury (Kraft) and Barclays among others. In November 2012, following revelations that in its last 14 years of UK operations, Starbucks had paid only GBP 8.6 million in taxes, in part by reporting a loss every year except one, UK Uncut protesters moved to occupy a number of the company's UK stores, which ultimately required police protection. The same month, representatives of Starbucks, Google and Amazon were called in front of the British Parliament, where Public Accounts Committee chair, Margaret Hodge, stated, "we are not accusing you of being illegal, we are accusing you of being immoral."[32]

Starbucks: Voluntary Tax Payment

Following months of UK Uncut boycotts and high-profile parliamentary hearings over its tax practices, Starbucks attempted to proactively address the criticism from the UK public. In December 2012, Starbucks announced that it would not claim certain legal deductions in 2013 and 2014. By not claiming these deductions, Starbucks will "voluntarily" raise its UK income tax payments by GBP 10 million per year.

Kris Engskov, the managing director of Starbucks in Britain, announced the decision in a speech to the London Chamber of Commerce: "I am announcing changes which will result in Starbucks paying higher corporation tax in the UK, above what is currently required by law."[33]

However, the company's response appeared to be too little too late. Starbucks has yet to disclose an official tax policy and the company remains a target of UK Uncut. Following the company's announcement, a UK Uncut spokesperson reflected general public opinion when noting, "offering to pay some tax if and when it suits you doesn't stop you from being a tax dodger."[34]



Starbucks in the UK

Over the past three years, Starbucks' UK subsidiary has used a number of tax avoidance schemes that have allowed it to pay zero income tax.

1. Despite Starbucks' European President, Michelle Gass, being based in London, the company's European headquarters, Starbucks Coffee EMEA BV, is located in the Netherlands. Royalty payments for the use of the Starbucks brand and business processes worth 6% of sales are paid from Starbucks UK to Starbucks Coffee EMEA BV.

2. Starbucks UK sources its coffee from Starbucks Coffee Trading Co., Starbucks' Global Coffee purchasing unit located in Switzerland. The Swiss tax rate on profits related to commodity trading is approximately 5%. Coffee beans are purchased by the Swiss unit and sent to the Netherlands to be roasted. Starbucks UK pays for both services, which enables the use of inflated transfer pricing arrangements.

3. Starbucks UK is funded entirely by debt. For FY2011, the company paid GBP 2 million in interest to group companies. The intra-company loan is provided at a rate of Libor plus 4%, which is 2.7% higher than the company's group bonds. The interest paid on this loan reduces taxable income in the UK.

Info sourced from: Bergin, Tom, "Special Report: How Starbucks Avoids UK Taxes," Reuters, 15 October 2012, accessed 31 May 2013, http://www.reuters.com/article/2012/10/15/us-britain-starbucks-tax-idUSBRE89E0EX20121015.

Allegations of immorality and the subsequent brand erosion are also found in the developing world, where the impact of tax avoidance is arguably more acute. Public campaigns in emerging markets have increasingly framed tax avoidance as a human rights issue. ActionAid's 2012 report on SABMiller's tax avoidance strategy for its African operations includes quotes from local residents like Ophelia Brakwa of Ghana: "I am appealing to the companies to pay their taxes so that the government can provide our schools, and light and water, because we are the human resources of the future." The report further notes that "the amounts lost in Africa are enough to put a quarter of a million children in school in the countries where SABMiller operates."[35] ActionAid's 2013 report on Zambia Sugar, an Associated British Foods subsidiary, notes that due to low government tax receipts, "it is many of these (Zambia Sugar) workers who have to pay their families' school fees and medicine charges to bridge the gap of inadequate public funding for education and health care."[36] Such campaigns receive attention from investors as well as local consumers who often see tax avoidance by MNCs not only as undermining economic development, but also as a form of exploitation, a charge that easily resonates in emerging markets with a colonial legacy. In late 2012, it was revealed that Coca-Cola had never posted a profit for its Vietnamese operations and thus had not been subject to corporate income tax since it re-entered the country in 1994. Allegations of a tax avoidance strategy centred on transfer pricing arrangements arose and were immediately followed by a national boycott.[37] Similar allegations of tax avoidance through transfer payments have been levied against multi-national subsidiaries in India.

Aggressive tax practices have the additional effect of undermining the sustainability strategies that many MNCs have formally adopted and publicised. Coca-Cola's "Live Positively" and Unilever's "Sustainable Living Plan" strategies both include corporate commitments to economic development projects and sustainable business practices. However, the difference between corporate commitments and practices furthers public distrust and enhances the reputational risks associated with tax avoidance. As was seen in the U.S. and the UK, increased public attention on a company's tax practices can serve as a precursor to increased government and regulatory scrutiny, further brand erosion and possible financial costs, all of which are compounded by an absence of corporate disclosures concerning tax policies and practices.

Increased reputational risk has led some CEOs to try and get out in front:

> **"I really believe one of the reasons we've seen an erosion of trust, broadly, in big companies is they've allowed themselves to be seen as being detached from society and they will float in and out of societies according to what the tax regime is. I think that's completely wrong."**

- CEO of GlaxoSmithKline, Andrew Witty, March 2011[38]

Risk to Relationship with Host Country

Whether the attention of tax authorities is in response to increased press coverage, popular outrage, or a national or local government in need of increased tax revenues, the adoption of an aggressive tax strategy can result in increased government scrutiny, which increases both reputational and financial risks. Google, Amazon, Starbucks and other prominent MNCs continue to be called in front of the British Parliament as part of an investigation into their tax practices and the UK Treasury sent a clear signal to MNCs in February 2013 when it released new standards that ban companies found of partaking in a "failed tax avoidance scheme" from bidding for government contracts.[39] For consumer MNCs in emerging markets, an aggressive tax strategy is unlikely to result in a complete loss of the "license to operate," as can be the case with companies in the extractive industry. More likely is a loss of government buy-in, increased and flexible use of the General Anti-Avoidance Rule (GAAR), which "allows tax authorities to deny tax benefits in transactions or arrangements that they believe have inadequate commercial substance or purpose," and general approval delays and/or rejection of proposed expansion projects.[40] In October 2012, the Vietnamese city of Da Nang refused to approve a 5,000 square meter Coca-Cola production line expansion project. Vo Duy Khuong, the vice-mayor of the city, explained that the "city's authorities won't let it (Coca-Cola) to *[sic]* expand business in the locality because of the behavior of conducting transfer pricing, that makes the city fail to collect tax from enterprises."[41] In India, tax authorities are currently investigating transfer pricing transactions at over three dozen companies including LG Electronics, Cadbury (Kraft) and Vodafone. In one case against Vodafone, India is trying to claim over USD 2 billion in tax from the company's acquisition of an Indian mobile phone company.[42] Political motivations may lie behind many of these campaigns as foreign MNCs are an easy target for local politicians, but they are also reflective of popular discontent and a true need on the part of emerging market governments for reliable tax revenue. When local citizens learn that they are paying more income tax in an absolute sense than MNCs, as was found to be the case with Zambia Sugar, it takes very little political capital to dramatically alter the business environment for an MNC.[43]

Financial Risks

Aggressive tax positions are inherently tenuous. They depend upon the maintenance of negotiated incentives, double tax avoidance treaties, and a general lack of cooperation between national tax authorities, all of which can change given strong enough popular pressure. As ActionAid's Mike Lewis notes, "we are in uncharted territories in terms of the public interest and political impetus."[44] The uncertainty surrounding aggressive tax positions poses a material financial risk to MNCs, particularly as the long-term trend shifts toward increased cooperation among national tax authorities and an increased appetite for pursuing additional tax payments. Following ActionAid's 2012 report on SABMiller's tax avoidance strategy in Africa, 21 Africa Tax Administration Forum (ATAF) members finalised a Mutual Assistance Agreement on Tax Matters, which increases the inter-country exchange of tax information and enables tax authorities to cooperate on cross-border audits.[45] In 2011, the OECD Convention on Mutual Administrative Assistance in Tax Matters was amended to become more inclusive, and 50 countries, including known tax havens like Ireland, have since become signatories or announced their intent to do so. The intent of the Convention is to facilitate administrative cooperation between signatories in assessing and collecting taxes, with a specific focus on preventing tax avoidance and evasion.[46] The OECD also intends to deliver an action plan on base erosion and profit shifting (BEPS) at the July 2013 G20 Finance Ministers meeting.

G8 Summit 2013: Lough Erne Declaration

Corporate tax avoidance was a formal agenda issue at the June 2013 G8 Summit, demonstrating increased interest by major governments to enact change. While a formal action plan was not adopted, the leaders of the G8 were in agreement on a number of key principles related to tax practices[47]:

- Tax authorities across the world should automatically share information to fight the scourge of tax evasion.
- Countries should change rules that let companies shift their profits across borders to avoid taxes, and multinationals should report to tax authorities what tax they pay where.
- Companies should know who really owns them and tax collectors and law enforcers should be able to obtain this information easily.
- Developing countries should have the information and capacity to collect the taxes owed them - and other countries have a duty to help them.

In addition to increased cooperation, countries are becoming increasingly likely to utilise a General Anti-Avoidance Rule (GAAR), "to counteract perceived tax avoidance that might otherwise be legal under the broad rules and principles of a country's tax code."[48] While multiple countries, including emerging markets like China, Chile and India, have adopted GAAR statutes, there is no common definition of a GAAR and there is great flexibility in its application. In 2011, China collected an additional USD 3.1 billion in tax through 207 GAAR cases,[49] while India has delayed the implementation of GAAR to 2016 in an attempt to calm foreign investors.[50] Continued uncertainty surrounding the persistence of aggressive tax positions and their use may result in a number of future "surprises," which increase both earnings volatility and the perception of lower earnings quality for companies thought to be involved in similar practices.

"Arrangements that minimise the amount of tax paid in the short term may be detrimental in the longer term if they prejudice the company's relationship with tax authorities and additional costs are incurred in complex dispute resolution, or if the company's wider reputation is harmed. An aggressive tax strategy might require considerable resources to be applied to manage the positions taken."

- Henderson Global Investors[51]

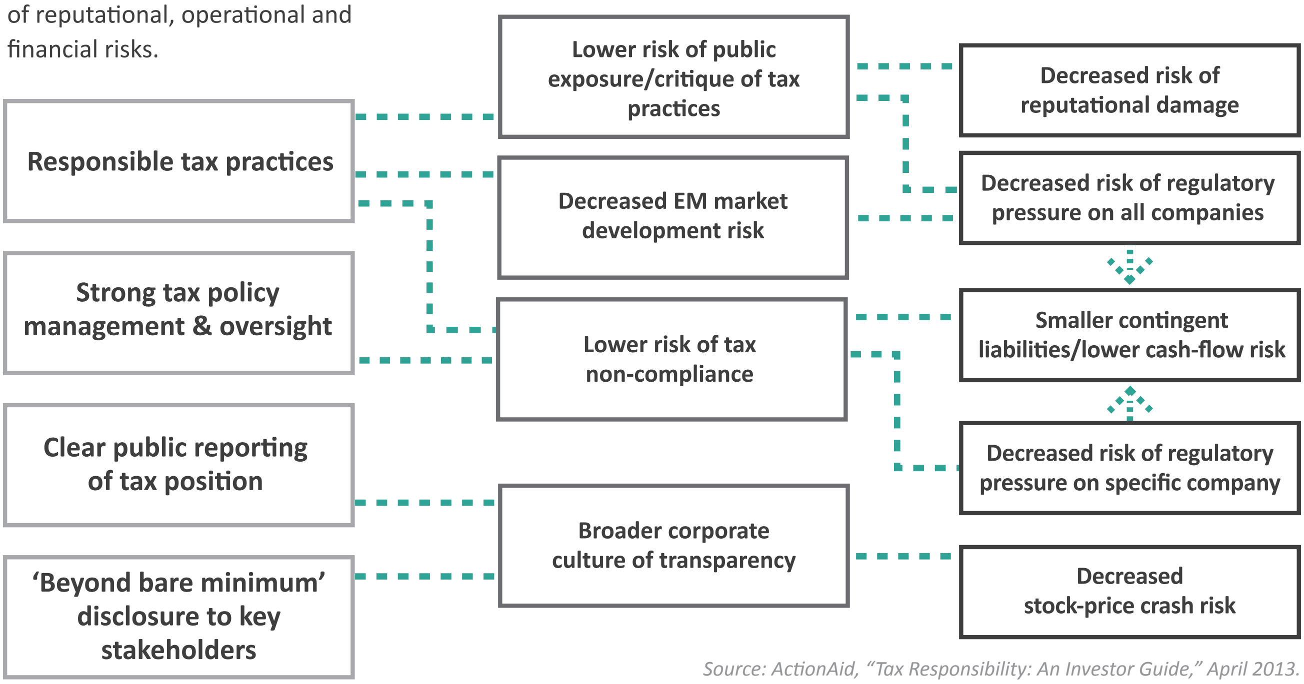
Market Development

"Tax is not a cost; it's a contribution to the societies that we want to see in the future."[52]

- Katharine Teague, Senior Private Sector Adviser, Christian Aid

The strategies employed to reduce the tax burden impact emerging markets in three key ways. First, they reduce the tax revenue collected by the government, which shifts more of the burden onto individuals and foreign aid, and limits the government's ability to invest in basic services (health care, education, infrastructure) necessary for continued economic growth. The OECD estimates that tax havens cost Africa more in lost revenue than it receives in aid from developed countries.[53] Second, the location of high-value functions such as management and research and development in low-tax jurisdictions minimises any positive spill-over effects in the emerging market. This problem is compounded by the use of management fees that reduce the taxable income of the local subsidiary and have the secondary effect of restricting the development of local management capacity. Finally, small- and medium-sized businesses face a competitive disadvantage by paying higher taxes than MNCs due to their inability to receive tax concessions and employ cross-border tax avoidance strategies, which restricts local business and employment growth. All three outcomes undermine the development of an emerging market consumer class upon which the future success of consumer MNCs ultimately depends. While many consumer MNCs, including SABMiller, Unilever, Nestlé and Starbucks, have implemented sustainable development programmes, taxation remains conspicuously absent from most sustainable development strategies. Improvements in short-term return on investment achieved through aggressive tax positions in emerging markets should, thus, be weighed against the potential negative long-term impacts of slowed economic development, such as reduced sales. For investors to ultimately assess these risks and adjust cash flow projections and discount/growth rates accordingly, company disclosures need to improve.

Figure 1: Responsible tax practices can mitigate a number of reputational, operational and financial risks.



Source: ActionAid, "Tax Responsibility: An Investor Guide," April 2013.

Topics for Engagement

The current structure of corporate disclosures concerning tax strategy and taxes paid is inadequate for investors looking to assess company risk and performance. Disclosures are typically provided on a global basis and a tax policy, if any, is often focused exclusively on legal compliance. As investors look to engage their holdings on ensuring coherence between their tax and broader sustainability strategy, focus should be directed toward three core elements: the company's policy, its practices and its disclosures.

"Businesses that do not communicate a position in simple terms will find that others choose the words and define the debate for them. If you do not have a policy, others will write one for you. If you do not describe your position in your own words, others will tell the story for you."

- Corporate Citizenship, May 2011[54]

Policy

The controversial tax avoidance strategies mentioned in this report are all legal. Thus, a statement that a company intends to comply with all tax laws and regulations in its countries of operation is insufficient. Every company, as KPMG states, should "be in a position to give a coherent justification of their approach to key tax issues such as the use of tax minimisation techniques, which is consistent with their approach to other CSR issues."[55] The adoption of a formal tax policy serves to guide company practices and provide investors, regulators and other external stakeholders with an idea of the company's tax risk profile, against which practices and disclosures can be compared. An effective policy should be overseen by the board of directors, crafted in conjunction with relevant senior management, and regularly reviewed to ensure emerging risks are addressed. For example, Diageo's global tax policy is approved by the board of directors and implemented by the group CEO and Finance Committee. A company looking to communicate a low-risk profile will rule out certain high-risk tax practices such as locating intellectual property and high-value business functions in low-tax jurisdictions.

Tax Policy Highlights

Burberry: "Burberry's tax planning is consistent with this responsible approach, and it will not enter into arrangements which could be considered artificial or which have tax avoidance as their sole or main objective."[56]

Unilever: "We do not use contrived or abnormal tax structures that are intended for tax avoidance, have no commercial substance and do not meet the spirit of local or international law."[57]

Diageo: "Our tax management activities only take place in countries where Diageo has commercial substance."[58]

Practices

The level of risk to which a company is exposed will ultimately depend upon its specific tax practices. A strong policy unaccompanied by strong practices does little more than mislead and confuse external stakeholders. In order to best mitigate tax-related risks, companies should implement practices that aim to pay a “fair” tax. While the definition of a fair tax is inherently flexible, it essentially means complying with the spirit as well as the letter of the law. The concept of “fairness” can be extended to negotiations with government authorities, particularly in emerging markets, where the eagerness for FDI may sometimes result in tax concessions that inhibit broader economic development. As Christian Aid’s Katharine Teague notes, “companies can use their power in a much more responsible and progressive way in both developed and developing countries”.[59] Thus restraint on the part of companies at the negotiating table may fit better within a responsible tax strategy than obtaining the lowest rate possible. Companies who intend not to adopt the concept of fairness should clearly state so in order to provide investors and other stakeholders with an accurate sense of the potential riskiness of a company’s tax position. Vodafone’s Tax Risk Management Strategy states that it “believes its obligation is to pay the amount of tax legally due in any territory, in accordance with rules set by governments. In so doing it is not able to determine the ‘fair’ amount of tax to pay.”[60] The risk involved in adopting such a policy has been clearly illustrated by the number of protests and investigations concerning Vodafone’s tax practices. For companies and investors looking to reduce tax-related risk, the following tables highlight the tax practices that should be adopted as well as those that should be avoided.[61]

Tax Practices That Should Be Adopted

- Refrain from locating group companies in tax havens unless there is a justification based on legitimate economic activity.
- Leverage and build local skills and expertise to reduce management fees to the parent.
- Locate intellectual property in country where the brand originates.
- Consider reputational and community impact of lowered tax liability when negotiating tax concessions with emerging market governments.
- Conduct transfer pricing at fair market value.

Tax Practices That Should Be Avoided

- Locating valuable intellectual property in low-tax jurisdictions unless it was predominantly developed there or is predominantly exploited there.
- Moving tax residence to a low-tax jurisdiction without a corresponding shift in economic activity.
- Moving high-value business functions out of developing countries and into low-tax jurisdictions.
- Paying above-market management and agency fees to companies in low-tax jurisdictions.
- Using structured tax planning techniques under which tax allowances on one piece of income are claimed in two different jurisdictions.

Disclosure

"An absence of transparency will be seen as a warning sign both to investors and to consumers that a company has something to hide."[62]

- Katharine Teague, Senior Private Sector Adviser, Christian Aid

As seen with the numerous press reports and public protests, the absence of disclosure itself can constitute a risk. An assessment of the disclosure of MNCs globally reveals that there remains much room for improvement. Of the over 2,000 companies Sustainalytics monitors for tax transparency, fewer than 2% provide a country-by-country breakdown of taxes paid.[63] When ActionAid surveyed the entire FTSE 100 in 2012, only three companies published a "substantial" tax policy or position and none provided a complete country-by-country breakdown of taxes paid.[64] Part of the problem, as ActionAid's Mike Lewis notes is that tax avoidance is "a set of behaviours that have become so central to core business models that getting an individual first mover is challenging."[65] But as Christian Aid's Katharine Teague notes, "there are opportunities for businesses to lead the field."[66] Despite falling short of best practice, Vodafone has emerged as a leader in terms of disclosure. The company provides a country-by-country breakdown for 70% of its tax revenue and discloses a detailed Tax Risk Management Strategy and Policy that outline the company's approach to adopting certain tax positions and how it categorizes the associated risk of those positions. Yet even Vodafone's public disclosures as currently structured fall short. For example, by structuring a country-by-country breakdown in terms of percentage contribution to total company tax revenue paid, investors are not able to see countries where the company may have paid no taxes. Additionally, by not providing accompanying country-by-country financial data, investors are unable to put the tax contributions in context or assess if they are commensurate with economic activity. When engaging companies on their tax disclosures, investors should consider the best practices outlined in the table below.[67]

Tax Disclosure Best Practices

- Publish a tax policy and code of conduct
- Explain steps taken to reduce tax burden
- Provide a declaration of purpose for each subsidiary located in a tax haven
- Assess and disclose the impact of profit shifting activities on tax revenues in individual countries
- Provide a country-by-country breakdown and categorization of tax payments with relevant financial information (sales, revenue, employees)
- Provide downloadable accounts for each company subsidiary

Conclusion

Corporate tax policy as a corporate responsibility issue is here to stay. Like environmental performance and labour rights in the supply chain, issues whose materiality and relevance were once brushed aside, tax is an issue that impacts a company's reputation, its operating environment and its cash flow. Perceptions are shifting globally and "the distinction between evasion (illegal) and avoidance (lawful) has dissolved in the eyes of governments, NGOs and citizens"[68], as emphasized by the recent discussions at the G8 Summit in Ireland. We are moving rapidly toward a point where failing to disclose a position constitutes as much of a risk as the continued employment of aggressive tax practices. As more MNCs move to disclose information concerning their tax policies and practices, those who lag behind risk having their story told for them.

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