Ethos Engagement Paper

Corporate Tax Responsibility

20 YEARS | OF SOCIALLY RESPONSIBLE INVESTMENT

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The Ethos Foundation is composed of more than 220 Swiss pension funds and other tax-exempt institutions. Ethos was founded in 1997 and aims at promoting socially responsible investment as well as a stable and prosperous socio-economic environment.

The company Ethos Services conducts asset management and advisory mandates in the field of socially responsible investment (SRI). Ethos Services offers a wide range of SRI-funds. The company also provides proxy voting reports including voting recommendations, a shareholder engagement programme, as well as sustainability and corporate governance ratings and analyses of listed companies. Ethos Services is owned by the Ethos Foundation and several of its members.

The association Ethos Académie allows private individuals to take part in the activities of Ethos. This non-profit and tax-exempt organisation was launched in 2012 by the Ethos Foundation and has currently about 200 members. It conducts outreach activities in the field of socially responsible investment, including an electronic news service, organising conferences and debates, supporting the exercise of shareholders' voting rights and the funding of studies.

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1 Background

1.1 Tax optimisation issues

The achievement of the various missions of States requires to a large extent that all taxpayers, natural and legal persons, participate in the tax effort by paying their fair share of taxes. The tax revenues thus collected are used to finance government services, whether in the fields of health, education, pensions, infrastructure or defence.

Ethos believes that it is the responsibility of the Board of Directors of listed companies to establish a responsible tax policy ensuring that the company pays its taxes in the jurisdictions where it conducts its business and realizes its profits.

Tax optimisation is not necessarily illegal, nothing prevents a company from seeking means to reduce its tax burden, whether it is with a view to saving money, developing its activities or paying a dividend to its shareholders. However, some methods are widely questioned internationally, to the point of becoming unjustifiable. Often such practices involve minimizing the amount of taxes paid by applying transfer prices for intra-group transactions below the market price or by creating "artificial" structures in low tax jurisdictions where they have no meaningful economic activity. This is called aggressive tax optimisation.

Today, institutional investors are more sensitive regarding the tax strategies of the companies in which they invest. Certain practices constitute a long-term risk for companies and their shareholders both in terms of reputation and financial risk, for example, in the event of a fine or additional tax charges.

1.2 Reputational risk

As several cases have shown in recent years, in the event of aggressive tax optimisation companies concerned are exposed first and foremost to reputational damage. In the age of 24/7 information in real-time, a company's reputation has an important value, estimated by some experts to represent up to a quarter of a company's total value. It therefore seems essential to make compliance with international tax regulation one of the top priorities of executive management and the Board of Directors.

Paying a fair amount of taxes should no longer be considered a competitive disadvantage. On the contrary, companies can promote a civic spirit and socially responsible behaviour that can build trust among employees, customers and investors.

1.3 Financial risk

While reputational risk is a major issue for companies, a company that does not comply with the tax rules of the countries in which it operates is also exposed to litigation and financial penalties by the authorities in charge.

Companies might be in danger of having to pay significant amounts of tax arrears and even to pay a fine, as certain recent cases have demonstrated. All these costs are ultimately reflected in the company's financial performance and are therefore a concern for its shareholders.

1.4 Overhaul of the international tax system

In October 2015, the Organisation for Economic Co-operation and Development (OECD) and the G20 countries approved a complete overhaul of the international tax system. The objective of the "Base Erosion and Profit Shifting" (BEPS, see Annex 3.1) action plan is to enable national tax authorities to effectively tackle "the erosion of the tax base and the transfer of profits internationally"[1]. In other words, the system aims to get companies to pay their taxes in the right place. One of the main measures of the BEPS project is the requirement for multinational companies with consolidated annual sales of at least 750 million euros to introduce country-by-country tax reporting.

As an OECD member country, Switzerland actively participated in the development of the BEPS action plan. In January 2016, it signed a multilateral agreement on the exchange of country-by-country tax reports (signed by 68

[1] http://www.oecd.org/tax/beps/

countries as of 19 December 2017[2]). The text of this agreement and a new law were approved by the Federal Assembly on 16 June 2017. As no referendum was called for within the deadline, both texts entered into force on 1 December 2017.

1.5 Mobilizing investors and companies

Norges Bank Investment Management (NBIM), which manages the assets of Norway's sovereign fund, the world's largest, published in April 2017 a document summarizing its expectations of listed companies [3]. NBIM has the following three expectations:

- Taxes should be paid where the economic value is created;
- The board of directors is responsible for the company's tax policy;
- Companies should make their country-by-country tax reporting public.

In February 2018, the "B Team", a non-profit initiative launched by multinational companies that wish to integrate strong environmental and social responsibility principles into their business practices, published a document entitled "A new bar for responsible tax"[4] which presents 7 principles for corporate tax responsibility. These principles include in particular the following elements:

- The board of directors is responsible for the tax policy of the company;
- Companies publish their tax policy and are transparent about its implementation;
- Companies create entities only for commercial purposes;
- Companies publish information on effective tax rates and taxes paid for all countries where they operate.

Some companies have already decided to publish their tax reports country-by-country on a voluntary basis. This is notably the case for the British company Vodafone. Once criticized for its tax practices, the telecommunications group publishes since 2012, on a voluntary basis, a detailed annual report of its activities country-by-country[5]: turnover, profit or loss before taxes, amount of taxes paid, number of employees. The report also explains the reason for the company's presence in each jurisdiction in which the group has entities.

At present no Swiss company supports the B Team approach. However, some Swiss companies have begun to explain their tax policy by stating their willingness to cooperate with the tax authorities of the countries in which they operate and to comply with changing international rules. For example, in its 2017 Annual Report, Adecco ensures that it does not rely on any "artificial" structures or transactions for purely fiscal reasons.

Of the twenty companies included in the Swiss SMI index, several now have a document - usually published on their website - specifically dedicated to their tax policy. There, they affirm their willingness to comply with tax regulations, to cooperate with the relevant authorities and to pay the fair amount of taxes in each country where they are present. They often state that their reputation or even their social responsibility towards local populations is at stake. Some, like ABB, display their support for the OECD reforms and assert that their transfer prices reflect the principle of free competition. Others, such as LafargeHolcim and Nestlé, publish the amount of taxes paid by region.

For Ethos, it is necessary for listed companies to widely adopt good practices in terms of fiscal responsibility and transparency. In this context, Ethos has been mandated by the members of the "Ethos Engagement Pool Switzerland" to engage listed companies in Switzerland. The following chapter summarizes Ethos' expectations regarding corporate transparency and tax responsibility.

[2] http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf
[3] https://www.nbim.no/contentassets/48b3ea4218e44caab5f2a1f56992f67e/expectations-document---tax-and-transparency---norges-bank-investment-management.pdf
[4] http://bteam.org/wp-content/uploads/2018/02/A-New-Bar-For-Responsible-Tax.pdf
[5] http://www.vodafone.com/content/dam/sustainability/pdfs/vodafone_2016_tax_country_by_country.pdf

2 Ethos' expectations

The Ethos Foundation aims to promote socially responsible investment and foster a stable and prosperous socio-economic environment. As such, it attaches particular importance to business ethics and good governance.

Ethos thus encourages companies to implement a responsible and transparent tax policy and to pay their taxes in the countries where they operate and where they make profits. Ethos also believes that companies whose business models are based on aggressive tax optimisation are more vulnerable to changes in tax regimes than those that adhere to good practices.

Companies have many opportunities to reduce their tax bill and optimize their taxes through fully legal deductions. Ethos however considers that companies should not resort to complex and opaque arrangements or move profits from one country to another for tax reasons. Paying one's fair share of taxes is a central element of corporate social responsibility.

Ethos' five principles of a responsible tax policy

1. Responsibility for the tax policy rests with the Board of Directors
2. The principles of tax responsibility are incorporated in the company's code of conduct
3. The company pays its taxes where the economic value is created
4. Intra-group transactions are carried out under market conditions
5. The company publishes the amount of taxes paid, country-by-country

Ethos expects companies to have a tax policy based on the following five principles:

Principle 1: Responsibility for the tax policy rests with the board of directors

The definition of a company's tax policy is the responsibility of the Board of Directors that must make sure that tax arrangements are in the interests of all stakeholders and are geared towards long-term value creation.

The board of directors must ensure through the audit committee that the implementation of the tax policy is in line with the defined principles. The audit committee must pay particular attention to intra-group arrangements so that they respect market conditions and do not aim at unduly reducing the tax burden.

Principle 2: The principles of tax responsibility are integrated in the code of conduct

The basic principles of the tax policy should be firmly embedded in the company's code of conduct as the code of conduct formally outlines the company's values and sets out the framework within which the company conducts its business. Companies should commit to not create or maintain entities for tax purposes only by making a clear negative statement under a specific point in the code.

The employees must sign the code of conduct and be trained to ensure compliance. It is good practice that the code of conduct also contains procedures for reporting possible violations.

The inclusion of the principles of tax responsibility in the code of conduct is the best guarantee for their effective implementation throughout the company.

Principle 3: The company pays its taxes where the economic value is created

The tax policy must promote prudent, responsible and transparent conduct, which refrains from aggressive tax optimisation. This implies in particular that the company pays its taxes where value and economic substance are created.

This principle is fundamental and precludes any transfer of profits internationally, into jurisdictions with particularly favourable tax regimes.

Principle 4: Intra-group transactions are carried out under market conditions

In companies organized as a group, particular attention must be paid to transactions between group entities.

All these intra-group transactions must be carried out under market conditions ("arm's length" principle). Adhering to the arm's length principle should help to avoid transfers of costs and therefore profits that do not correspond to economic reality, to companies or jurisdictions that benefit from particularly favourable tax regimes.

Principle 5: The company publishes the amount of taxes paid, country-by-country

In light of the importance for governments of taxes paid by companies, it is good practice for companies to publish taxes paid on a country-by-country basis. Such transparency should help to prevent tax evasion, which is easier when tax transparency is lacking.

The country-by-country transparency requirement is currently under advanced discussion within the European Union that aims to incorporate it into the next tax directive (see appendix 3.3. below).

Country-by-country tax reporting allows not only the authorities to detect possible irregularities, but also other stakeholders to become aware of the situation and, if necessary, to address the Board of Directors in this respect. This obliges the latter to justify setting up a tax domicile in a country where the company has very few operations or employees.

Disclosure of the taxes paid country-by-country also enables shareholders to ensure that the companies in which they have invested comply with the tax rules of the countries in which they operate. For companies, this helps to avoid damage to their reputation and being fined.

Finally, the transparency that comes with country-by-country tax reporting encourages self-regulation by distinguishing good from bad practice. Such disclosure helps the company to build stakeholder confidence and to implement its tax responsibility strategy.

3 Appendix

3.1 OECD: "Base Erosion and Profit Shifting" (BEPS) action plan

Developed by the OECD, the BEPS action plan aims to prevent the erosion of the tax base and the international transfer of profits through 15 separate actions. Action 13 is one of the key points of the project. In particular, it envisages the documentation of transfer prices by companies as well as the implementation of country-by-country reporting for companies with consolidated annual sales of at least 750 million euros.

The OECD argues that if some companies manage to evade their tax obligations, it is largely because of the lack of transparency around the activities of their subsidiaries. The purpose of country-by-country tax reports is therefore to provide the relevant authorities with a global view of companies' activities and, consequently, to enable them to measure whether the taxes the companies pay in each jurisdiction correspond to the reality of their local economic activity.

Today, all OECD and G20 countries, as well as a number of developing countries, have committed to implement country-by-country tax reports, whether through bilateral or multilateral agreements or automatic data exchange agreements.

The first exchanges of such reports between countries, covering the 2016 tax year, are scheduled for 2018. Each year, it will be up to the parent entity of a group operating in several jurisdictions to file a country-by-country report with the tax authorities at the company's headquarters. The tax authorities will then be responsible for sharing the said report with the authorities of the other jurisdictions in which the group operates.

3.2 Switzerland's commitment

As an OECD member country, Switzerland actively participated in the development of the BEPS action plan. In January 2016, it signed a multilateral agreement on the exchange of country-by-country tax reports (signed by 68 countries as of 19 December 2017[6]). The text of this agreement and a new law were approved by the Federal Assembly on 16 June 2017. As no referendum was called for within the deadline, both texts entered into force on 1 December 2017.

The bill was generally well received during the parliamentary process[7]. All the more so given that Switzerland has kept to the minimum required by the OECD: the law only applies to companies with an annual turnover of at least 750 million euros, i.e. around 200 companies. Moreover, the law guarantees the confidentiality of data provided by companies, which can only be exchanged between tax authorities[8].

At the end of 2017, Switzerland had around 50 partner states with which it will exchange country-by-country tax reports from 2020 onwards. Multinational companies based in Switzerland will have to prepare their first reports as from the 2018 fiscal year[9].

Information to be included in the country-by-country tax report according to the OECD:

1. The group's turnover
2. Income (or loss) before taxes
3. The amount of income taxes paid by the company
4. Income taxes the company is owed
5. Number of employees
6. Shareholders' equity
7. Undistributed profits

[6] http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf
[7] https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-64643.html
[8] https://www.admin.ch/opc/fr/federal-gazette/2017/3977.pdf
[9] https://www.estv.admin.ch/estv/fr/home/internationales-steuerrecht/fachinformationen/cbcr.html

3.3 European Union: The Capital Requirement Directive IV (CRD IV)

Within the European Union, banks and investment companies are required to publish details of their tax payments on a country-by-country basis since the adoption of the CRD IV Directive in 2013[10]. In April 2016, the European Commission decided, in line with the BEPS project, to extend this practice to all multinational enterprises. A draft directive was adopted by the European Parliament on 4 July 2017.

While the European project also concerns only companies with a turnover exceeding EUR 750 million, it could, however, go further than the OECD standard on another point: it stipulates that country-by-country reports should be made public and accessible to all, free of charge, via the companies' websites, which will enable all interested parties to know the amounts paid.

For the time being, the draft directive has been referred back to parliamentary committees and has yet to be debated between the Commission, the Parliament and the European Council. It could be accompanied by a safeguard clause which would allow companies to request temporary non-publication of their country-by-country tax reports. To do so, companies will likely have to demonstrate that their statement contains commercially sensitive information that could harm their business if it were to be made public.

Transfer pricing

One of the most common practices of companies that use aggressive tax optimisation is transfer price manipulation. These prices are those that the company attributes to the goods and services it exchanges within the group (intra-group exchanges). They are therefore not governed by the laws of the market but fixed by members belonging to the same group.

For the authorities, the risk is that companies manipulate transfer prices for tax reasons only. For example, a subsidiary of a mining company could undercharge its parent company in a more attractive tax jurisdiction for the sale of minerals in order to increase the profits of the mother company to the detriment of the subsidiary. Also, the transport and production costs charged by the parent company to its subsidiary could be inflated in order to reduce the subsidiary's profits. It is therefore not surprising that transfer pricing is at the heart of the BEPS project.

The OECD's objective is twofold: to avoid double taxation of companies while ensuring that they pay their fair share of taxes in each country where they operate. To this end, companies are expected to comply with the arm's length principle; in other words, to apply market prices to their intra-group transactions.

Action 13 of the BEPS project thus recommends that states require companies to document and communicate information concerning their activities and their transfer pricing policy. The information included in country-by-country tax reports will make it easier for tax authorities to determine whether companies have fixed transfer prices with the aim of artificially transferring profits to more attractive tax jurisdictions.

[10] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:en:PDF

3.4 Example of application of CRD IV: The banking sector

European banks are a concrete example of the application of the country-by-country tax report principle. Since the CRD IV Directive was adopted in 2013, all banks operating in the European Union - including Credit Suisse and UBS entities registered in London - are required to publish annually the name and nature of their European subsidiaries' activities, turnover, number of employees, pre-tax profit or loss, amount of tax paid and whether any subsidies were received.

This transparency has shown that some banks use their subsidiaries in low-tax countries to report large profits. According to a study published in March 2017 by Oxfam, an NGO fighting poverty, Europe's 20 largest banks made 26% of their 2015 profits in countries considered as tax havens, whereas these accounted for only 12% of their European turnover and employed only 7% of their staff[11].

The publication of country-by-country tax reports has also enabled Oxfam to demonstrate that not all banks act in the same manner. While some still resort to aggressive tax optimisation, others comply with the new rules of good practice.

[11] https://www.oxfam.org/sites/www.oxfam.org/files/bp-opening-vaults-banks-tax-havens-270317-en_0.pdf

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