TAX

WHY ARE WE TALKING TAX?

Tax continues to be an issue of contention. Once the preserve of accountants and lawyers, the amount of tax paid by corporations, and whether this is 'fair', is undergoing rigorous scrutiny and debate. The State raises tax to pay for collective services that modern society needs – health, education, defence, security, welfare, access to justice, cultural pursuits and overseas aid. The stable environment that a State creates, funded by tax, also allows business to invest, flourish and excel.

IS PROGRESSIVE TAX A GOOD THING?

Taxation and representation are the pivots of a functioning democracy. However, modern states are complex; the UK Government is budgeted to spend £847.6bn in the 2020 fiscal year, with tax accounting for 96% or £811bn of it[1]. Taxation therefore remains the bedrock for funding public services, with any shortfall made up from borrowing. Because the stability provided by a fair and functioning tax regime suits business as much as its citizenry, it is in the interests of business to contribute towards society via the fair payment of tax.

HOW MUCH DOES BUSINESS CONTRIBUTE IN THE UK?

Corporation Tax is a direct tax charged on the profits made by companies and makes up approximately 7% of UK tax receipts[2]. Companies registered and domiciled in the UK pay tax on profits wherever they originate. Companies not based in the UK, but with 'branches' in the UK, pay corporation tax on taxable profits that arise in the UK.

SURELY GOVERNMENT USES TAX AS A COMPETITIVE LEVER?

The tax regime is complex; a system of capital allowances (for plant and machinery), and a suite of other deductions and reliefs obscures the *actual* tax rate, which is often difficult to calculate. Tax is also one method of incentivising inward investment. The UK headline rate of Corporation Tax has fallen from 30% in 2007 to 18% from 1 April 2020 as a deliberate Government policy to encourage business inward investment. Low tax regimes such as Ireland, Switzerland and Luxembourg successfully use their low tax status to encourage companies to relocate in order to benefit from even lower tax rates. For instance, The Republic of Ireland has a headline Corporation Tax rate of 12.5%[3] making it very attractive for UK companies to relocate. Conversely, jurisdictions such as the US have historically had a very high headline rate (35%[4]), leading to US companies keeping cash offshore rather than subject it to tax upon repatriation. This is being addressed by President Trump's tax reforms which has lowered the Federal rate of corporate income tax to 21%.

ISN'T TAX AVOIDANCE ALWAYS WRONG?

Not necessarily. Tax *evasion* is an illegal practice whereby an organisation intentionally avoids paying a required tax liability. This is always wrong and is usually punishable by criminal sanction. Tax *avoidance* is the minimisation of tax by legal means via prudent tax planning. Individuals that invest in ISAs or Premium Bonds are, for instance, employing legal tax avoidance schemes in order to support wider priorities such as encouraging saving. Charities are legally 'tax exempt' from much activity. Tax avoidance is normally achieved through claiming permissible deductions and credits, thereby reducing the headline tax rate. Corporation Tax is a cost or charge on profits, and business has a legal right (but not a duty) to organise its tax affairs so as to take advantage of *legal* allowances and reliefs. As responsible investors we endorse prudent tax management and planning.

SO WHY HAS TAX AVOIDANCE BECOME A BURNING ISSUE?

The nature of globalised capital means that tax is a matter for international agreement and negotiation. Governments have largely failed to respond adequately to the phenomenon of borderless capital, as manifested by the technology giants, with international tax rules failing to keep up with the migration of capital and earnings. In addition, for a multinational 'virtual' company there is no easy way to decide where profits should be taken, and tax paid. We do subscribe to the view that the principle agent responsible for the setting and collecting of tax is the State, and that nationally and internationally Government needs to set the boundaries around what is appropriate, reasonable and ethical when it comes to tax.

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TAX IS A LEGAL REQUIREMENT, IS IT EVER A MATTER OF ETHICS?

We have argued that prudent tax management is legal and legitimate. However, within the definition of tax avoidance, the view has emerged that some specific mechanisms designed to reduce or almost eliminate tax are unethical. The term 'aggressive tax avoidance' has been coined to refer to these schemes. By and large these may refer to contrived, artificial or synthetic schemes that serve no purpose other than to effect a reduced tax outcome or advantage. In short, whilst these schemes may not be illegal, they are perceived as contravening the spirit of the law. Structures that deliberately circumvent or seek out loopholes in the law with the specific aim of lowering the corporate cost of tax, employ tax havens or employ complex intra-business transactions that lower the assessment of profitability have therefore come under close scrutiny. We take the view that aggressive tax planning increases risk financially, and especially from a reputation standpoint, that may be to the detriment of creating long-term shareholder value. We therefore support companies that use legitimate allowances to plan their tax prudently without resorting to aggressive withholding structures.

WHAT ABOUT THE USE OF TAX HAVENS?

The generic term 'tax haven' refers to a jurisdiction that offers little or no tax liability; historically they have also been accused of shielding businesses and individuals by providing limited financial information to overseas tax authorities. Whilst tax havens are generally thought of as offshore entities (Cayman Islands, Bermuda, Bahamas etc.) they can also be low-tax domiciles such as Luxembourg or Switzerland. Many companies have subsidiaries listed in recognisable tax havens, and these become problematic if the principal aim is to avoid legitimate tax payments. The International Monetary Fund (IMF) estimates that governments lose up to $450bn annually to tax haven related activity[5].

WHAT CAN RESPONSIBLE INVESTORS DO?

Debates around tax have been useful in shining a light into a complex, little understood area of corporate finance. However, as we have argued, tax planning per se should not be viewed as wrong. Given there is increasing scrutiny being placed on companies to be transparent in their tax affairs, we endorse the view that companies can and should do more to make their tax affairs better understood through improved disclosure and governance. This could usefully include:

- Creating and disclosing a corporate tax policy that sets out the general criteria for corporate tax planning;
- Ruling in (or out) specific forms of 'aggressive tax planning via artificial mechanisms';
- Disclosing the principles for negotiating tax concessions, especially in weaker (developing) tax regimes;
- Assigning Board oversight and accountability for Group tax policy;
- Considering greater tax transparency in the reporting of tax paid, country by country tax disclosure, achieving the 'fair tax' kite mark etc.

Four companies held in the EdenTree funds have obtained the *Fair Tax Mark*: Marshalls; Pennon Group; SSE and United Utilities.

WHAT DOES EDENTREE DO?

Tax is one element of corporate governance we consider when looking at and monitoring potential investments. On the whole, we prefer transparent and appropriate tax structures, opposing highly engineered, artificial or aggressive avoidance mechanisms. We look for a clearly articulated Tax Policy, and preferably country by country reporting. The use of tax havens should ordinarily be avoided, and where used, should be justified. We consider the published 'effective rate of taxation' as a signal of the overall acceptability of the tax regime in place, and may seek to engage where this is believed to be weak.

Sources:

[1] www.ukpublicrevenue.co.uk

[2] ibid

[3] Irish Tax & Customs www.revenue.ie

[4] www.home.kpmg

[5] www.corporatehavenindex.org

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We have a specialist in-house Responsible Investment (RI) team who carry out thematic and stock-specific research to identify ethically responsible investment ideas for our range of Amity funds. Headed up by Neville White, Head of RI Policy & Research, and supported by Responsible Investment Analysts Esmé van Herwijnen and Jon Mowll, the team is also responsible for creating an on-going dialogue with companies, allowing us to engage on a wide variety of ethical and socially responsible investment concerns. Our ethical and responsible investment process is overseen by an independent Amity Panel that meets three times a year, and comprises industry and business experts, appointed for their specialist knowledge.

We hope you enjoy this RI Expert Briefing and find it useful and informative. For any further information please contact us on 0800 011 3821 or at ifa@edentreeim.com