The ‘Tax Gap’ in the MSCI World

December 2013

Policy change, particularly involving multinational coordination, can be a slow moving affair. In December 2011, we highlighted aggressive corporate tax strategies among our 2012 ESG Trends to Watch as an area we believed would receive greater policy attention and thus represent growing reputational risk. Not waiting around for policy makers to weigh in, media and the public have since singled out some high profile global companies such as Starbucks, Apple, and Google for public shaming given a perceived mismatch between their level of tax payments and revenues earned in countries such as the UK and Italy. So what’s next? In 2014, will the naming-and-shaming game give way to a more systematic push to compel improved tax disclosure, driving investors to question the ability of some companies to keep their tax payments below the norm?

A confluence of factors continued to drive calls for greater tax transparency in 2013: fiscal strain in key OECD economies struggling to fund social programs on a weakened tax base; relatively healthy corporate profits at a time of high unemployment; public mistrust of global companies, reinforced by media and social media exposés of corporate misdeeds. As a result, the OECD[1], the G20[2], the G8[3], and the EU[4,5] have all published separate but related plans in 2013 calling to increase corporate tax transparency and to fight erosion in the tax base. Countries that have proposed changes to close loopholes include Germany and UK[i], Canada[ii], Netherlands[iii], Australia[iv], Ireland[v], India[vi] and the US[vii].

Increasingly, major accounting firms such as Ernst & Young[6] and KPMG[7] are telling their corporate clients to re-examine their tax strategies with a view to mitigating reputational risk and to anticipating greater disclosure requirements on where taxes are paid. We see two areas of vulnerability for companies.

First, even when perfectly legal, companies with large discrepancies between their reported rate of tax payments and the average corporate rate of the countries where they generate revenues make for easy targets by the media, politicians, and activists. This is particularly true if companies generate large revenues from a country where politicians are motivated by major fiscal imbalances and by popular support to invoke ‘tax fairness’ as a policy plank. Second, with far more media attention to the role of tax havens in facilitating tax avoidance, companies with subsidiaries in tax havens are likely to face higher hurdles for justifying their legitimate business activities in those locations.

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[1] Tax Transparency 2013: Report on Progress, http://www.oecd.org/tax/transparency/draft%20annual%20report%202013%20%20for%20GF_2.pdf

[2] Action Plan on Base Erosion and Profit Shifting, http://www.oecd.org/tax/beps.htm

[3] G8 countries agree to tackle tax evasion, http://www.theguardian.com/world/2013/jun/18/g8-countries-agree-tackle-tax-evasion

[4] Fighting Tax Evasion and Avoidance: A year of progress, http://europa.eu/rapid/press-release_MEMO-13-1096_en.htm

[5] Tackling Tax Avoidance: Commission tightens key EU corporate tax rules, http://europa.eu/rapid/press-release_IP-13-1149_en.htm

[6] http://www.ey.com/Publication/vwLUAssets/Tax_Transparency_-_Seizing_the_initiative/$FILE/EY_Tax_Transparency.pdf

[7] http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/tax-morality-transparency-overview-v1.pdf

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Which companies face these vulnerabilities?

For the 1,595 companies in the MSCI World Index[8], MSCI ESG Research compared each company's reported tax payments between 2008 and 2012 to the average corporate tax rate of the countries in which it generated revenues. *See Figure 1*.

- Excluding companies generating a loss during this period, REITs, and mining companies, we found that around 4% of the remaining companies (39 out of 995 companies) paid an average tax rate of less than 10%.

- 21.4% of companies (213 out of 995 companies) paid tax rates that were substantially below the weighted average tax rate of the countries in which they generate revenues. As a group and in aggregate over these years, these 213 companies paid a 19.3% tax rate or the equivalent of USD 450 billion over this period. At 34.3%, the weighted average tax rate of the countries in which these 213 companies generated revenues is nearly 75% more than the actual rate paid by this group over this time-period. The 19.3% rate also compares unfavorably to their peers on the MSCI World Index: the other 782 companies paid in aggregate a rate of 34.0% over this period.

- In our analysis, of the 213 companies with a significant 'tax gap', more than 80% of the companies are currently domiciled or are currently generating more than 50% of their global revenues from G20 countries. With average debt levels at nearly 60% of GDP, the G20 countries as a whole faced large fiscal imbalances, thereby increasing the political motivation to close loopholes on multinational corporate tax payments.

[8] As of November, 2013

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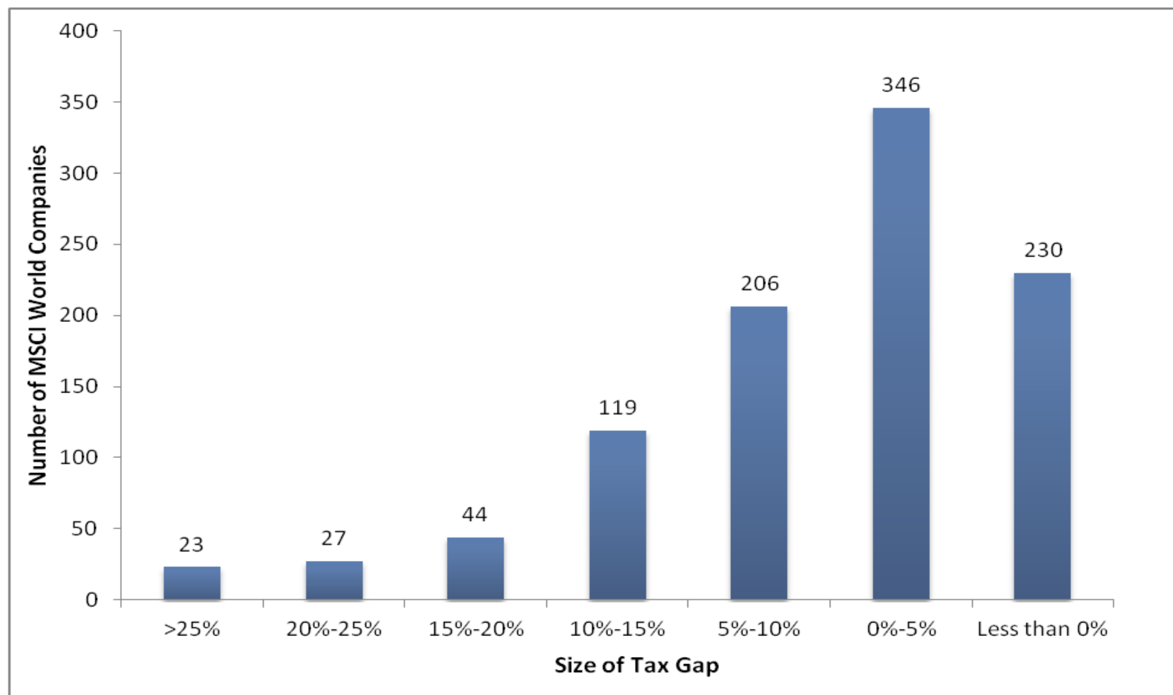
Figure 1: **MSCI World Companies, by Size of 'Tax Gap'**

Gap Between Actual Tax Rate Paid and Weighted Average Tax Rate of Countries Where Revenues are Generated, 2008-2012, for MSCI World Index Companies excluding REITs, Mining Companies, and Companies with Negative Profits (n=995)



Given the media hype over such strategies as the 'Double Irish With A Dutch Sandwich[9], whereby a company can shift profits to low or no tax jurisdictions and avoid paying taxes in the countries in which it generates revenues, a number of organizations such as the Tax Justice Network have published lists of countries that they deem to be 'tax havens'.

Using MSCI ESG Research's securities mapping of issuers to their subsidiaries, we examined the 4,587 entities that are majority-owned subsidiaries of the 1,595 companies on the MSCI World Index in 2013. We matched the country of domicile of these subsidiaries to the list of tax havens compiled by the U.S. Congressional Research Service in January 2013, which combines the work of organizations such as the OECD and the Tax Justice Network.[10]

- We found that 15.6% of MSCI World companies were domiciled in either a 'tax haven' jurisdiction or have at least one majority-owned subsidiary in a 'tax haven' jurisdiction.

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[9] This is a known tax-reduction structure between wholly-owned subsidiaries, which involves transactions in Ireland, the Netherlands and Bermuda. The Irish affiliate has dual residence with Bermuda and moves profits through another Dutch affiliate. Profits go to Bermuda and are not taxed since Bermuda has no corporate income tax. http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2013/130574/LDM_BRI(2013)130574_REV1_EN.pdf

[10] See page 9 of Tax Havens: International Tax Avoidance and Evasion. United States Congressional Research Service. January 23, 2013. http://www.fas.org/sgp/crs/misc/R40623.pdf

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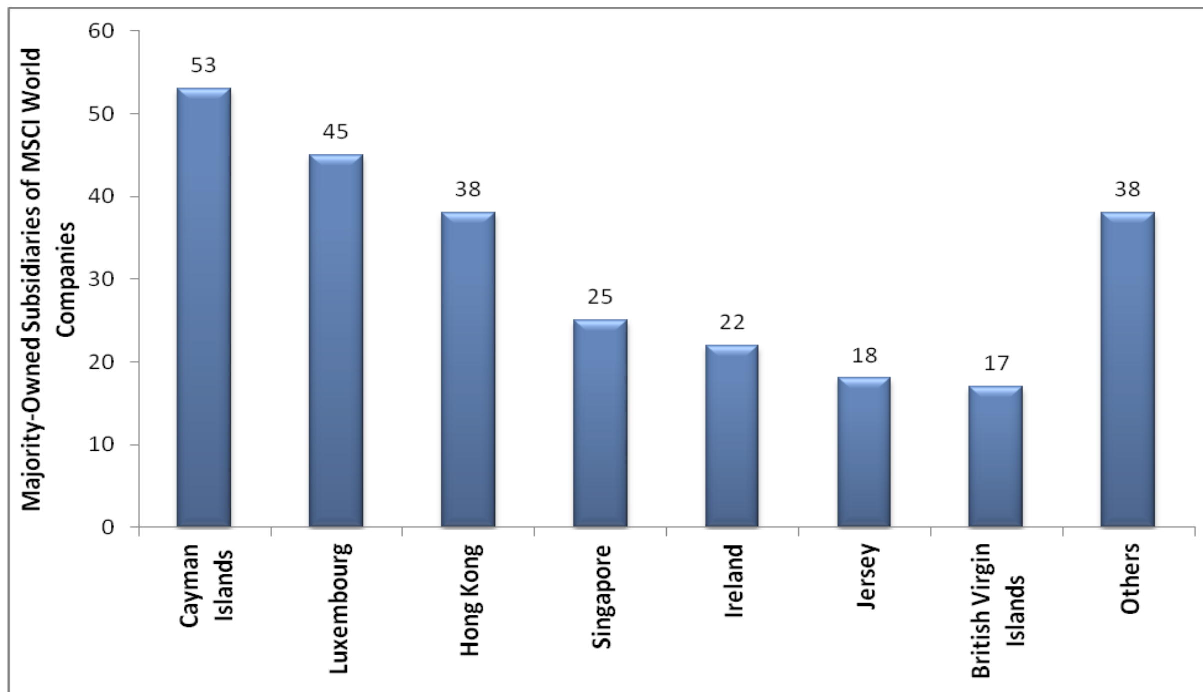
- We found that 10.8% of MSCI World companies had at least one majority-owned subsidiary in a 'tax haven' country in which it is not domiciled. The most popular countries for these subsidiaries, outside of the domicile country, are Cayman Islands and Luxembourg. *See Figure 2.*

- Of the 213 companies that had a significant 'tax gap' as described above, 39 (18%) were domiciled in a 'tax haven' jurisdiction and 32 (15%) had at least one majority-owned subsidiary in a 'tax haven' jurisdiction.

- Of the 39 companies that have paid an average tax rate of less than 10% over the past 5 years, 18 (46%) were domiciled in a 'tax haven' jurisdiction and 7 (18%) have at least one majority-owned subsidiary in a 'tax haven' jurisdiction.

Figure 2: Most Popular Tax Havens for Subsidiaries

Number of Majority-Owned Subsidiaries of MSCI World Companies that Paid Less than 10% Tax Rate, 2008-2010, Excluding REITs, Mining Companies, and Companies with Negative Profits



We conducted our analysis from the perspective of potential vulnerabilities to reputational risk and hence the 'tax gap' could be viewed as a potential trigger for scrutiny by the media or the public, which is not necessarily informed by a detailed understanding of the intricacies of international tax laws and treaties. Tax laws and accounting rules are notoriously complicated, and there is insufficient financial disclosure to ascertain that specific companies' tax strategies may come under scrutiny based on potential regulatory changes especially with regards to tax havens. Any broader tax reform discussion may also consider whether imposing high tax rates on corporations or imposing corporate taxes at all is the most economically efficient or effective source for increasing government revenues.

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Yet, our initial estimates at the aggregate level of the MSCI World Index companies suggested a fairly sizable sum of potential tax revenues that many governments across the world, struggling to contain their budget deficits, may find attractive. The 213 companies with a large 'tax gap' alone would have paid an estimated USD 70 billion per year in aggregate, had these companies been paying taxes at the same rate as their peers on the MSCI World Index (the 782 companies paying a rate of 34.0% over this period, which excludes REITs and other companies paying near-zero to negative taxes) or had been paying taxes at the average rate of the countries in which they generate revenues.

Such payments over this period could have reduced aggregate profit after taxes across these companies by approximately 20%.

Despite gradually improving economic conditions in the major European markets and the US, the continuation of fiscal imbalances coupled with distrust of the corporate sector will likely continue to shine a spotlight on companies' inscrutable tax strategies. Whether regulators will enact tax policy changes, companies may peremptorily begin to make at least some disclosure improvements, perhaps at the behest of investors who need to better quantify the magnitude of risk to their portfolio from tax policy.

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[1] *As of September 30, 2012, as published by eVestment, Lipper and Bloomberg on January 31, 2013* *Apr 2013*

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