WHAT IS TAX FAIRNESS AND WHAT DOES IT MEAN FOR INVESTORS?

DISCUSSION PAPER
THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

PRI’s MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.
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KEY MESSAGES:

• Tax fairness means different things to different stakeholders. The PRI proposes the view that tax fairness can be realised when:
  • sustainability goals and economic prosperity are achieved through effective tax revenue collection and distribution;
  • opportunities for corporate tax abuse (evasion and avoidance) are eliminated; and,
  • new global norms on tax that promote integrity, transparency and accountability are established, within and among all participants in the system.

• Despite the integral role that public policy plays, fair taxation cannot be a matter for individual governments or even intra-governmental organisations to resolve. System-wide change from a wide range of stakeholders is required.

• The pandemic is an opportunity for investors to consider how investment activities can minimise harms from corporate tax abuse and deliver on urgent social and environmental needs. It is in investors’ interest to consider how corporate taxes contribute to stable, well-functioning socio-economic systems that are conducive to achieving investment returns and the Sustainable Development Goals (SDGs).

• For investors, tax risk is financially material at the individual asset level. With tightening regulations and shifting societal expectations, tax avoidance activities of multinational enterprises have attracted large fines and highlighted growing reputational, governance and earnings risks.

• Tax is also a macro-financial or systemic issue that, if not properly managed, could undermine market performance and jeopardise overall portfolio returns. Several leading organisations have documented the adverse impact of tax abuse on competition, economic growth and sustainable development.

• The PRI will work with signatories to move towards practices that align with tax fairness. This includes a model investor policy on tax, supplemental guidance on stewardship and more resources for signatories to contribute to the policy debate on tax transparency and other tax issues. We will also strive to identify metrics to allow investors to better measure progress in their work towards tax fairness.

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ABOUT THIS PAPER

This discussion paper explores the concept of tax fairness, outlines the rationale for investor action and the steps that the PRI intends to take to signatories on this issue. Investors have a spectrum of views on tax issues, depending on their investment beliefs, risk appetite and culture. Our role is to enable investors to move towards practices that align with tax fairness.

We welcome inputs to this paper as we embark on a long-term programme on this topic. Our tax fairness programme seeks to increase the resources available to governments to address sustainability goals (including those related to climate change) and protect the public goods on which investment value relies. We will do this by encouraging investors to adopt and embed fair tax principles in their investment value relies. We will do this by encouraging investors to adopt and embed fair tax principles in their own operations, advocate for fairer public policy on tax, and support their efforts to achieve fairer tax arrangements amongst their investees.

INTRODUCTION

The state of the international tax system came under scrutiny during the global financial crisis of 2008. Over the last five years, the Panama Papers’ revelations and other exposés, including the recently leaked Pandora Papers, have highlighted persistent and deep-rooted profit shifting and financial secrecy in our economic systems.

Although some progress has been made in combating tax avoidance and evasion through increased regulations and transparency, tax leakages and tax-related competition among governments continue to erode tax bases and global tax gaps continue to grow. According to recent research, tax revenues in 60 countries fall below the 15% of gross domestic product (GDP) threshold needed to generate domestic revenues that can be invested in health, education and infrastructure.

IMPETUS FOR CHANGE

International taxation has taken on a renewed relevance as the urgency grows for a sustainable and inclusive recovery from COVID-19. As governments deal with the unprecedented social and economic costs of the pandemic by increasing fiscal spending, government debts have surpassed World War II levels. In the US, fiscal deficits are expected to top USD3 trillion and in Europe, deficits have risen tenfold. Therefore, economic recovery and improving government finances is one of the biggest challenges for governments in the medium to long term.

At the same time, the demands to reinforce investment in healthcare and social services have become even stronger throughout the pandemic as inequalities in terms of incomes and access to basic public services have worsened.

The pandemic has highlighted the important role that government plays in addressing large-scale challenges, and the financial capacity required to do so. Expanding and deepening the corporate income tax base has therefore become an important priority for governments, given its significant contribution to the total tax take.

These conditions have intensified scrutiny on companies’ contributions to societal goals, including through taxation, fuelling a public debate on the need to shift to stakeholder capitalism. Public concern has also translated into regulatory action with some governments restricting financial aid to companies that operate in tax havens.

As a result of these trends, several governments have pledged to deliver a more efficient and more tax system that sustains public assets and supports social justice and a stronger economic agenda. For example, the EU and more recently the US have incorporated tax policy issues prominently in their public policy agendas. The G20 has agreed on a global minimum corporate tax, regardless of where companies are headquartered. Multinationals could also be forced to pay additional taxes on excess profits they generate. These reforms, depending on the final form they take, could create a paradigm shift in the international tax system, enabling governments to access much-needed tax revenues to fund sustainable growth.

IMPLICATIONS FOR INVESTORS

Shifting public expectations and a changing regulatory environment will pose significant reputational and regulatory risks for those companies that have historically engaged in tax avoidance practices.

The pandemic also provides a renewed opportunity for investors to consider how investment activities can minimise harms from corporate tax abuse and deliver on urgent social and environmental needs. It is becoming increasingly clear that a fair and efficient tax system is instrumental to address sustainability challenges and ensuring financial stability. It is in investors’ interest to consider how corporate taxes contribute to stable, well-functioning socio-economic systems that help to achieve investment returns and the SDGs.

5 Shaxson (2019), Tackling Tax Havens
6 Guardian (2016), Panama Papers: A guide to history’s biggest data leak
7 International Consortium of Investigative Journalists (2016), Pandora Papers
8 Haven & Junquera-Varela (2018), Getting to 15 percent: addressing the largest tax gaps
10 Financial Times (2016), European budget deficit tax almost tripled to €1 trillion, report says
11 Deloitte Insights (2021), Greece for the Fiscal Future
12 IMF (2020), Global Monitor 2020
14 World Economic Forum (2020), COVID-19 is reshaping stakeholder capitalism
15 Bloomberg (2020), Taxhaven Companies Should Get Covid Bailout, EU Says
16 See for example: The Taxpayers’ (2020), The Centre's new tax initiative calls for measures to prevent the use of tax havens
WHAT IS TAX FAIRNESS?

Tax fairness means different things to different stakeholders. In general, tax fairness could be understood as the effectiveness of public policy design in reconciling taxation objectives with economic and societal objectives and ensuring tax costs are distributed fairly in society. This is by no means straightforward. However, tax fairness is crucial to ensure that rising inequality can be addressed; that there is reliable access to basic public services including health and infrastructure; and there is sufficient revenue to address sustainability goals – all issues that the pandemic has brought into sharper focus.

Despite public policy being an integral part of the solution, the question of fair taxation cannot be a matter for individual governments alone or even intra-governmental organisations to resolve. We need a system-wide change and action from a wide range of stakeholders.

Companies and investors need to recognise that externalising costs onto others while aggressively reducing their own corporate tax payments is detrimental to broader society. Civil society organisations should not be the only group highlighting the misalignments between tax practices and broader stakeholder interests. Tax advisers, lawyers and industry associations must advise against aggressive forms of tax planning that are not in line with the spirit of the law. Regulators and standard setters also need to bring stakeholders together to reach much-needed agreements on a new set of tax norms and transparency.

In summary, tax fairness calls for a realignment of tax practices in a way that serves global goals – rather than just shifting the actions of individual governments, companies, investors, or their agents.

THE PRI PROPOSES THAT TAX FAIRNESS CAN ONLY BE REALISED WHEN:

- sustainability goals and economic prosperity are achieved through effective tax revenue collection and distribution;
- opportunities for corporate tax abuse (evasion and avoidance) are eliminated; and,
- new global norms on tax that promote integrity, transparency and accountability are established, within and among all participants in the system.

The below table highlights some of the key issues in the international tax system that need to be addressed to achieve tax fairness.

KEY ISSUES IN THE INTERNATIONAL TAX SYSTEM

GLOBAL RACE TO THE BOTTOM

To compete with other jurisdictions in attracting the investment of large corporations, governments have steadily lowered corporate tax rates to unsustainable levels. This focus on tax competition over sustained benefits to society has led to a global race to the bottom. On average, the statutory corporate tax rate in OECD countries has declined from 32.3% in 2000 to 22.9% in 2021. Similar declines in corporate tax rates are also observed across Latin America, Asia and Africa (see Figure 1 below).

COMPLEXITY OF THE INTERNATIONAL TAX SYSTEM

The international tax system has grown organically, but it has created opportunities for companies looking to exploit loopholes and inconsistencies in tax rules. The growth of digitalisation has allowed multinationals to reduce or eliminate their tax contribution in countries where they operate but don’t have a physical presence, undermining the international rules that have formed the basis of taxation over the past century.

The below table highlights some of the key issues in the international tax system that need to be addressed to achieve tax fairness.

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20 OECD (2020), Addressing the tax challenges arising from the digitalisation of the economy.
Multinational companies use many ways to avoid taxes, including shifting profits to low-tax jurisdictions. Academic evidence finds that nearly 40% of the profits that multinationals record outside of their countries are channelled through low-tax jurisdictions. This type of tax abuse has a greater impact on lower-income countries, where corporate income tax is a higher percentage of the total collected tax revenue, and there is limited governance capacity to update legislation and enforce it.

Despite the relevance of low-tax jurisdictions in tax avoidance, there is no consensus on the definition of a tax haven. The EU list of uncooperative jurisdictions is commonly referred to; however, it does not include European Member States and has attracted criticism that it is a politically motivated list and lacks transparency in the way countries are selected for inclusion. The Tax Justice Network’s tax haven and financial secrecy lists a larger number of countries, ranking them based on secrecy concerns, scale of governance risks they pose and contribution to global corporate tax abuse.

LACK OF GLOBAL NORMS

Multilateral and national agencies have supported efforts to tackle tax avoidance and evasion, for example through the Base Erosion and Profit Shifting project and strengthening other related regulations on anti-money laundering and beneficial ownership. Some international principles also touch upon tax issues:

- UN Guiding Principles on Business and Human Rights: Principle 8 addresses policy coherence. States must ensure policy coherence so that their tax and fiscal policies are aligned with their international human rights obligations.
- The OECD Guidelines for Multinational Enterprises: emphasise the role of internal tax control functions and that boards should be informed of material tax risks. It also states that enterprises should comply with the letter and spirit of the tax laws.
- The G20/OECD Principles of Corporate Governance: state that boards should oversee the finance and tax planning strategies management, thus discouraging practices such as the pursuit of aggressive tax avoidance, that do not contribute to the long-term interests of the company and its shareholders.
- The SDGs (Goals 10.4, 10.6, 16.4, 16.6 and 17.1, 17.13, 17.14) also address tax from the perspective of inequality, accountability within institutions and implementation of the goals.


LACK OF TRANSPARENCY

There is also substantial secrecy embedded in the global tax system. The disclosure requirements of companies based on GAAP and IFRS accounting are very limited, and while there are requirements in some countries to disclose subsidiaries in low or no-tax rate jurisdictions, these requirements are often avoided under the guise of immateriality.

There have been several voluntary initiatives that have encouraged corporates to report better tax transparency—most notably the GRI 207 tax standard which provides a reporting framework for tax management and public country-by-country reporting (CBCR). However, these are not mandatory and thus far have had limited impact on tax transparency.

Tackling corporate tax abuse and ensuring better corporate tax standards are increasingly seen as integral to tax fairness. A growing number of investors are integrating the risks posed by tax issues in their investment decisions. Others are also beginning to consider tax issues from an impact perspective, for example as part of shaping sustainability outcomes.

Tax risk is in financial material at the individual asset level. With tightening regulations and shifting societal expectations, tax avoidance activities of multinational enterprises have attracted large fines and highlighted growing reputational, governance and earnings risks. Although artificially shifting profits to low-tax jurisdictions or restructuring for tax purposes could enable companies to reduce their tax liabilities in the short term, such activities have the potential to adversely impact corporate culture and financial integrity, which could have long-term impacts on business and financial success. Also, volatile approaches to tax management and unpredictable tax rates could compromise the sustainability of a business model. Therefore, the view that companies’ tax avoidance activities may serve investors’ interests is at best, questionable.

Figure 2: Comparison of average five-year effective tax rates of large cap and small and medium-sized businesses


![Image of Figure 2: Comparison of average five-year effective tax rates of large cap and small and medium-sized businesses]

26 Financial Times (2020), ‘Is a racer of fairness: squeezing more tax from multinationals
27 PwC (2020): ‘A Legal Framework for Responsible Taxpayer
29 PRI (2020): ‘Engagement guidance on Corporate Tax Responsibility
30 PRI (2020): ‘Engagement guidance on Corporate Tax Responsibility
31 PRI (2020): ‘Engagement guidance on Corporate Tax Responsibility
32 PRI (2020): ‘Engagement guidance on Corporate Tax Responsibility
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38 PRI (2020): ‘Engagement guidance on Corporate Tax Responsibility
39 PRI (2020): ‘Engagement guidance on Corporate Tax Responsibility

Tax revenue losses also widen the financing gap for the SDGs. According to the OECD, the shortfall for developing countries to achieve the SDGs following the pandemic could be as high as USD1.7 trillion. This not only leads to cascading effects on provision of healthcare and social protection but could also create greater susceptibility to other crises created by environmental issues such as climate change and political turmoil. Therefore, action to address tax base erosion and profit shifting becomes doubly important in developing countries that bear a disproportionately higher cost from tax avoidance activities.

Unsustainable tax practices also exacerbate inequality by shifting wealth from poorer to richer sections of society which can have a knock-on effect on the economy. The consequences of inequality have become particularly acute and visible following the fiscal pressures posed by the COVID-19 crisis and the confluence of risks that we urgently need to tackle, from climate change and corruption to human rights issues. Rising inequality could have serious implications for social stability—a risk that cannot be mitigated through diversification of the portfolio.

Impacts are particularly relevant for large universal (long-term, diversified) owners. Given that these investors derive most of their value from market performance, there is a strong case to protect the value of their investments, even when there is a trade-off with firm-specific performance. This means prioritising a robust tax system that fuels economic growth and stability over short-term financial returns achieved by companies through regulatory arbitrage.

Such an approach would also be well aligned with beneficiaries’ preferences and expectations in the current environment. Various global surveys indicate that beneficiaries expect their money to be invested responsibly, considering sustainability impact alongside financial returns.

Based on our research and conversations, investors have a spectrum of views on tax issues, depending on their investment beliefs, risk appetite and culture.

- Some investors have a stronger focus on tax efficiency i.e., ensuring that they and their portfolio companies stay compliant with tax laws, while making use of legitimate tax reliefs and reductions to minimise tax costs. Such an approach could become problematic when certain aggressive, potentially unethical tax strategies are tolerated simply because they exist in a legal grey area.
- Some investors believe that tax avoidance practices have a negative impact on long-term shareholder value and therefore consider it undesirable from the perspective of good risk management and governance.
- Other investors recognise the systemic nature of tax issues, and the impact tax avoidance has on the real economy and the potential to reach global goals. These investors may still undertake prudent tax planning and assess tax risks in their portfolio; however, they would also give due consideration to the societal consequences in judging a business’s tax rate and financial success.

Figure 3: Spectrum of views on tax

Businesses must consider the broader socio-economic consequences of tax issues

A systemic view allows greater recognition of different actors in achieving a ‘fair’ outcome for all; embeds tax efficiency and responsibility

Businesses must minimise taxes to maximise profits

Prudent tax planning as the basis for tax management. Focus on optimising tax costs and compliance with laws
Our role, as the PRI, is to enable investors on this spectrum to move towards practices that align with tax fairness.

Our tax fairness programme seeks to increase the resources available to governments to address sustainability goals (including those related to climate change) and to protect the public goods on which investment value relies. We will do this by encouraging investors to adopt and embed fair tax principles in their own operations, advocate for fairer public policy on tax, and support their efforts to achieve fairer tax arrangements amongst their investees.

EXAMPLES OF INVESTOR ACTION

Over the years, we have seen investors identify tax-related factors that could reduce the value of their investments and integrate those risks in valuation and investment decisions. This has included analysing qualitative data (e.g. media or regulatory scrutiny) as well as quantitative data (e.g. tax gaps, effective tax rates and unrecognised tax benefits) to determine risk exposure and adjust potential returns.

Investors have also used engagement to enhance tax disclosure from companies. Improvements in corporate tax reporting are crucial for better risk assessment. Without granular information on taxes paid and other economic and financial data at a tax jurisdiction level (better known as public CbCR), investors cannot compare companies on their tax practices, pick up red flags or validate tax commitments. Therefore, it is essential that companies strengthen their reporting at a country level and support regulatory changes that make such approaches mandatory for all companies.37

In working towards tax fairness, investors could:

■ Consider the Active Ownership 2.0 framework in addressing unsustainable corporate tax rates and promoting alignment between tax and sustainability issues within investee companies. This could include collaborating across regions and/or sectors to achieve responsible tax behaviour; escalating and voting against board members where engagement progress is limited; funding research where appropriate; and communicating tax expectations to service providers.

■ Articulate a clear set of principles on taxation across their operations, including in relation to their investment structures.

For examples, see:

Brunel's tax policy;
PGGM’s tax position;
ABP’s tax principles and
Danish investors’ tax code of conduct.

■ Engage with policy makers, standard setters and regulators to establish international best practice and global norms around acceptable tax practice.

Below are specific steps that the PRI intends to take to support investor action on tax fairness, enabling a step change in global tax norms and practices.

SUPPLEMENT GUIDANCE ON STEWARDSHIP

We have published a range of materials to enable investor engagement with companies on corporate tax responsibility.38 In 2021, we also published a snapshot on global corporate tax disclosure trends.39 We will supplement this with recommendations for investors on how they can integrate tax issues within their responsible investment and voting policies. We will also consider how tax fairness can be incorporated into wider collaborative engagements such as human rights.

STRENGTHEN POLICY ENGAGEMENT

We have contributed to several policy consultations and regulatory developments on tax transparency in the US and EU. For example, this year, we coordinated an investor letter to encourage the EU to mandate a full, public CbCR, securing 37 signatories and representing USD5.6 trn in assets under management.40 We will increase resources for signatories to contribute to the policy debate on tax transparency and other tax issues.

DEVELOP A MODEL INVESTOR POLICY ON TAX

Investors are increasingly under scrutiny in terms of their approach to taxation of listed and unlisted investments, and their own operations. We believe a clear commitment and transparent reporting from investors will reduce reputational risks and demonstrate consistency in their responsible investment approach. To facilitate this, we will work closely with a group of leading organisations in this space to develop a model investor policy on tax that other investors can choose to adopt over time.

We will also strive to identify metrics to allow investors to better measure progress in their work towards tax fairness.

We welcome contributions from signatories and other stakeholders as we develop this programme.

37 For example, see the PRI-coordinated letter on public CbCR requirements in the EU: http://shyveeBOVE/sfv/2QewRvU/kf/vs/3Investorsignatoryletterpubliccbcr_ signatories_ful.pdf

38 PRI (2021), Tax avoidance

39 FTSE Russell (2021), Global trends in corporate tax disclosure

40 PRI (2021), Public country-by-country reporting (CbCR) requirements in the EU
The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors, in implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org