Taxation 2.0

2021 ANNUAL SUMMARY

– APPROVED FOR PUBLIC DISCLOSURE

Taxation 2.0 Thematic Engagement

In recent years, there has been an increasing focus on whether and where multinational companies pay 'their fair share' of corporate tax. Consequently, aggressive tax avoidance practices by large international corporations have come under the scrutiny of various stakeholders, such as: governments, media, NGOs, the public, or investors. The goal being to regulate and mitigate such behavior widely seen as damaging to the broader society and unsustainable.

Taxation 2.0 Thematic Engagement was designed in response to investors interest in understanding the associated risks and in taking an active involvement with regards to mitigating these risks. More precisely, the goal of this initiative is (i) to engage in a dialogue with a select group of large international pharma and IT groups, (ii) to raise awareness about the impact of existing and emerging international corporate tax trends and associated risks and (iii) to encourage the adoption of more transparent and sustainable corporate tax practices. Calendar year 2021 was the second year of this Thematic Engagement.

Developments in 2021

The COVID-19 crisis continued to affect the world and put pressure on governments to maintain the increased level of public spending needed to manage the pandemic and its broad economic and societal impact. Pre-pandemic (elevated) public deficits further increased significantly and forced governments to quickly develop existing sources of income and/or find new ones. To finance said deficits, improving corporate tax collection, especially from large multinationals (many of which have greatly benefited from this crisis), is one of the options available to governments. In this respect, governments are trying to make progress in two ways: at supranational level, states accelerate and increase cooperation to curb international corporate tax avoidance and create a more sustainable global tax system, and, at national level, governments aim to discourage multinationals from shifting profits overseas by way of national legislation. In this regard, as outlined below, a few important related developments that occurred during 2021 stand out.

Taxing Rights and Global Minimum Corporate Tax Rate

In the context of the Base Erosion and Profit Shifting (BEPS) global discussions, the Economic Cooperation and Development (OECD)/G20 Inclusive Framework previously agreed on a two-pillar proposed approach to address the tax challenges of the modern global economy.

<u>Pillar I</u> aims at setting rules that prevent multinationals of a certain size to pay tax in geographies other than those where they sell goods and services, regardless of any physical economic presence. This goal endorsed again by the G20 in October 2021.

<u>Pillar II</u> contains several proposed measures, including a global minimum corporate tax rate. This idea drew increased support from many governments around the world during 2021, including the US. Following negotiations led by the OECD, a hundred and thirty-six countries, representing 90% of the global GDP, agreed in October 2021 to take a big step towards a fairer and more sustainable international corporate tax system. The proposed solution proposed is a global minimum corporate tax rate of 15% to be applied to the largest multinational groups with annual turnover of minimum EUR 750m or equivalent. The aim of this measure, expected to be implemented in national legislation in the coming years, is to make it impossible for these multinationals to artificially benefit from lower or no corporate tax rates offered by some jurisdictions around the world.

EU Public Country-by-Country Reporting (CbCR)

After years of discussions and negotiations, the EU Member States reached a political agreement followed by a vote in the EU Parliament, in November 2021, which formally approved the EU Directive requiring (qualifying) large multinational companies doing business in the EU to make certain tax disclosures available publicly. This EU Directive will enter into force before the end of December 2021 and Member States have until June 2023 to transpose it into national legislation. The rules will apply (at the latest) from the starting date of the first financial year starting on or after June 2024.

US Made in America Tax Plan

President Biden's Made in America Tax Plan, intended to help finance the American Jobs Plan, put forward US tax code amendments meant to promote job creation and investments in the US, stop artificial profit shifting to tax havens, and ensures that large corporations pay their fair share of corporate tax. These tax code amendments should, among others, stop the decades long global race-to-the-bottom which allows countries to gain a competitive advantage merely by becoming low or no tax jurisdictions.

On of such tax code amendments, the Disclosure of Tax Havens and Offshoring Act, requires large corporations to disclose basic information on each of their subsidiaries, and country-by-country financial information that sums together all their subsidiaries in each country (including profits, taxes, employees, and tangible assets). It initially introduced in February 2020 but did not receive sufficient political support. In May 2021, after being brought in line with President Biden's Made in America Tax Plan this proposal was reintroduced in the House and Senate and passed the following month.

Global Trends in Corporate Tax Disclosure

Another noteworthy development refers to the Global Reporting Initiative Tax Standard (GRI 207) which was approved by the Global Sustainability Standards Board (GSSB) in September 2019. The standard, is the first and only globally applicable public reporting set of rules focused on tax transparency. It sets expectations for disclosure of tax payments on a CbCR basis, alongside tax strategy and governance came into effect on 1 January 2021. Among the early adopters of the GRI 207, on a voluntary basis, are Philips, BP, Ørsted, Allianz and Newmont.

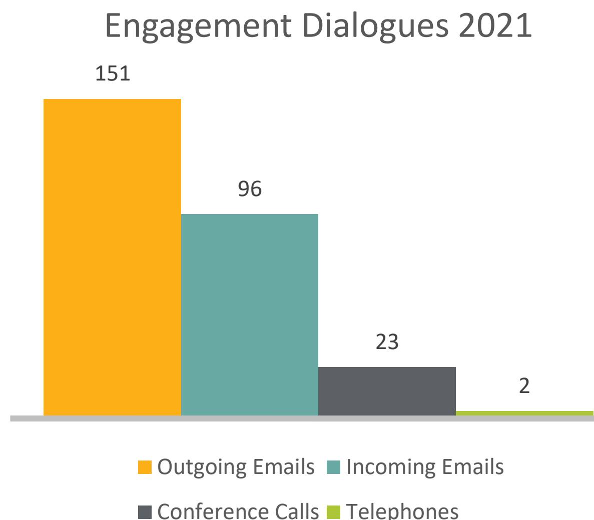
Despite the concept of sustainable corporate taxation gaining more and more traction at various levels of our society, i.e., at supranational organizations level, national governments level, investor level, public opinion level, progressive tax-related practices and disclosures significantly lag other sustainability issues within corporations. FTSE Russell and UN Principles for Responsible Investment (PRI) studied disclosures of 1,380 large companies worldwide and identified that only 34% publish statements on taxation vs. 87% on climate change and 98% on health & safety. Board oversight of the respective issues is reported only by 23% of companies for taxation, while it is 52% for climate change and 41% for health & safety. The biggest gap was identified in the quantitative disclosures: only 7% of companies in the sample publish data to address responsible taxation area, and climate change and health & safety related data is available for 74% and 63%, respectively[1].

[1] https://www.unpri.org/download?ac=13650

Engagement Update

Since the baseline report published in April 2020, Sustainalytics reached out to thirty-one companies to encourage participation in the Taxation 2.0 Engagement Theme. Following two rounds of dialogue initiation, twenty-one of the thirty-one companies have agreed to participate.

During calendar year 2021, Sustainalytics continued to engage with all twenty-one companies. Since the previous annual report issued in January 2021, Sustainalytics conducted 23 conference calls reaching a total of 53 conference calls from the start of this Thematic Engagement. In addition, our dialogue with companies during this period has also been conducted through 247 outgoing and incoming e-mails reaching a total of 699 emails from the start of this Thematic Engagement.



Company Performance[2]

To have a more appropriate perspective when understanding a company's performance, it is worth highlighting that companies active in the pharma and IT industries have been known for engaging in some of the most aggressive tax avoidance practices employed globally for many years. Having said this, the overall dialogue with the firms in the engagement universe during 2021 contributed to some encouraging developments. Broadly speaking, twelve out of the twenty-one of companies showed some overall improvements and three of the twelve stood out for significant improvements in the overall score. Several companies were able to discuss proposals for policy changes and disclosures, made by Sustainalytics, with their audit committees and other relevant internal stakeholders, in order to make disclosures in their proxy statements or annual reporting.

In terms of company performance and behavior, the following developments stood out:

- Six of the firms engaged adopted responsible taxation language. Two of these did it specifically after discussions with Sustainalytics, alongside other considerations.
- Several companies showed increased curiosity about the behavior of their peers.
- Low-performance multinationals admit to feeling pressure to boost tax transparency.
- Conservative companies consider that general codes of governance or unwritten internal rules provide a sufficiently robust framework to promote tax transparency and sustainability.
- EU based companies are starting to consider tax as a broader sustainability matter (as opposed to considering it a siloed topic) and encouraging their tax and sustainability departments to work together and incorporate taxation into corporate sustainability strategies.
- Traditional tax consultants are starting to catch up with the broader sustainability agenda and may contribute to the adoption of sustainable tax behaviors among corporations. However, it is yet to be seen how the conflict of interest may impact this trend (The same advisers supported and guided corporations to implementing aggressive tax planning structures in the past).

[2] Companies have been assessed solely on public disclosures.

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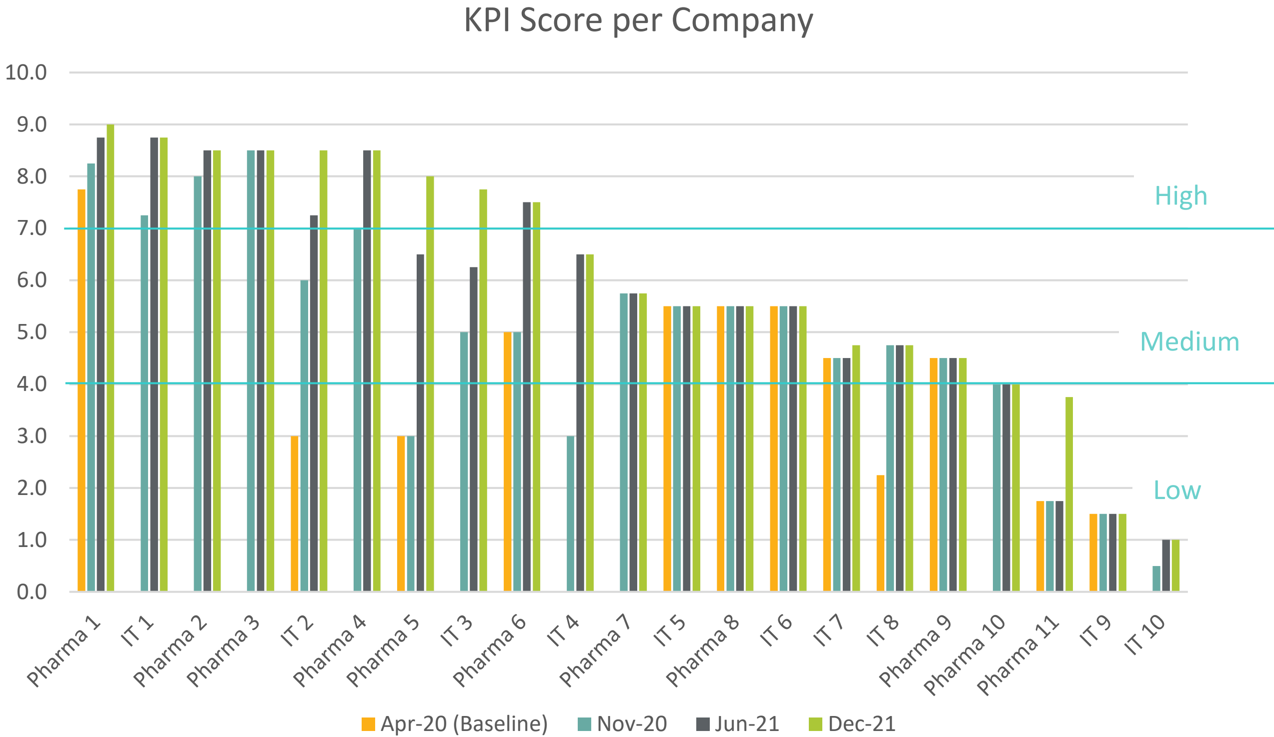
- The speed at which some of the previously mentioned 2021 developments happened took many (if not all) of the companies engaged by surprise of. While these developments are a positive factor from a corporate tax sustainability point of view, there is a chance they may overwhelm tax professionals in their attempt to keep up with everything that is going on and cause a slowdown in progress. In addition, many companies are reluctant to address any of these developments ahead of more legislative clarity and regulatory guidance for fear that they may end up at a competitive disadvantage, among other reasons. For example, one of the challenges companies are subject to with regards to the EU public CbCR framework is insufficient clarity as to what needs to be reported and how. This makes it more difficult to devise communication campaigns aiming to educate external stakeholders on the nature of the (sensitive) information to be disclosed and its potential impact
- The improved performance compared to the previous annual report and the revised baseline is noticeable. The average revised baseline score was 4.1, as of April 2020, and increased to 5.0 at the date of the previous annual report. A year later, December 2021, the average score improved to 6.1. The gains are largely the result of half of the firms increasing their public disclosures since the beginning of this engagement. Among the improvements we observed, the most notable are the inclusion of anti-tax-avoidance language in the policy of one company and the improvement in the effective tax rate in another. Within the low performance cohort, we saw no notable improvements since the last reporting period. For a visual representation of these developments since the previous annual report please refer to the graph below.



Case Study: US based multinational (IT2)

The company's tax policy and related disclosures have improved significantly and consistently during the first two years of this thematic engagement, as shown in the graphical representation above (the company is labelled as IT 2). The company is now, on a relative basis, a top performer in this engagement having moved from the low performance bracket compared to the baseline. For example, the company added language related to responsible taxation, banning artificial tools to reduce the company's tax rate.

Furthermore, the company showed a relatively higher level of oversight. However, further tax transparency is strongly encouraged. In addition, the assessment of tax-related incidents has been upgraded given that the latest accusations date back to Panama Papers. In November 2021, the company agreed to reconnect during 2022 to continue the dialogue and discuss taxation as a broader sustainability topic.

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