Taxation 2.0 Thematic Engagement

Final Report – Approved for Public Disclosure
January 2023

The Issue at Hand

After decades of decreasing corporate tax rates around the world and growing public awareness and disapproval of corporate tax avoidance practices, governments have accelerated their international collaboration to reform the global tax system. These efforts have been largely driven by the Organization for Economic Co-operation and Development (OECD), with the aim of stopping the tax “race-to-the-bottom” while also ensuring a level playing field for businesses across markets. This requires adapting the century-old global tax system to today’s modern economy. Such a reform, despite having clear benefits for companies and society, can cause uncertainty and risks for businesses operating in multiple jurisdictions. Business models which rely on aggressive tax planning are particularly exposed to such risks. This is especially true for those businesses with weak corporate governance.

Furthermore, the global pandemic caused already high budget deficits around the world to soar. Therefore, at a national level, governments are now focusing on more robust tax laws and tax law enforcement to fill these budgetary gaps. In addition, it is becoming obvious that aggressive corporate tax practices are not compatible with the broader sustainability discussion and that they are unlikely to be a sustainable and sound business practice. Broad estimates put the annual costs of global corporate tax avoidance somewhere in the range of US$100 billion to US$650 billion per year. As these matters become more mainstream, companies will be expected to address them in their sustainability strategies.

In short, in the current global environment, aggressive corporate tax practices and a systemic lack of tax transparency are a source of material risks for multinational companies and their investors. The Taxation 2.0 thematic engagement program aims to help address these concerns through meaningful engagement with corporations.[1] In particular, we aim to provide investors with active support in favor of tax sustainability and transparency.

2022 Engagement Update

This is the final report on the progress of this thematic engagement which started in January 2020. The purpose if this document is to provide a concise summary of our engagement activities for (i) the period June 2022 to December 2022, (ii) the entire year 2022, and (iii) the three-year period between 2020 and 2022.

[1] Our goal was to engage with 21 large pharma and tech corporations from various geographies. For the purpose of this report these will be referred to as IT 1-10 and Pharma 1-11

June 2022 to December 2022

Our efforts to engage with the companies in scope since the bi-annual report released in June 2022 resulted in 132 outgoing and incoming emails, eight conference calls, two regular telephone calls, four investor letters/emails, and one panel discussion that we organized in December 2022, where seven of the 21 companies attended[2]. In addition, due to low or no response to our repeated engagement attempts, we decided to archive four of the 21 companies, as follows: IT 5, IT 10, Pharma 9, and Pharma 10.

Several developments that happened during this six-month period are worth noting. These include:

- Global environment observations:
    - Following the Amazon tax transparency proposal, which garnered 21% of the independent shareholder votes, shareholders at other large companies have put forward similar resolutions. Cisco (27% of the votes in favor), Microsoft (23% of the votes in favor), Exxon, Chevron, and ConocoPhillips have all received tax transparency shareholder proposals thus far;
    - Governments around the world continue to move forward with the adoption of new legislation, or the implementation of existing regulations, concerning higher tax transparency for large multinationals;
    - Hess Corporation and Newmont Corporation were the first US-based multinationals to voluntarily adopt the Global Reporting Initiative (GRI) 207 country-by-country tax reporting standard. Our view is that this is a major milestone for the US and we expect others to follow suit.
- Engagement specific observations:
    - Pharma 7 increased its overall performance due to the publication of an updated global tax policy which is significantly improved compared to the previous policy;
    - IT 8 scored slightly lower than during the previous period because of a substantial drop in its effective tax rate compared to the previous financial year;
    - Engagement scores for the other companies have not changed. For a visual and consolidated overview of the scoring developments, refer to Chart 1.

[2] The Sustainalytics' online panel on tax transparency and sustainability brought together a diverse group of stakeholders and stimulated an open discussion about (i) the fast-evolving international corporate tax environment, (ii) the momentum behind the broader adoption of higher transparency standards by corporations, (iii) lessons from large multinationals about their tax transparency and sustainability 'journeys' and (iv) the role that stakeholders (e.g., investors, governments, industry peers) play. In addition to the seven multinationals in scope of the Taxation 2.0 thematic engagement, the list of participants included three guest speakers: a representative of the New York office of one of the Big 4 accounting firms, the head of tax of a US based tech company, and the head of tax of a US-based mining multinational. Four other external US-based multinationals attended as well: a US-based online travel shopping company, an investment bank and financial services company, a chemical group, and a mutual insurance company.

December 2021 to December 2022

During the third and last year of this program, our engagement strategy was to increase pressure on low-performance and low-response issuers and seek to raise awareness of this topic among their internal sustainability departments and boards (including their direct reports). To achieve this, we diversified our range of engagement activities and took a more assertive approach where possible.

Our efforts to engage with the companies in scope during 2022 resulted in 253 outgoing and incoming emails, 19 conference calls[3], four regular telephone calls, four investor letters/emails, three voting recommendations, and the panel discussion mentioned previously. In addition, due to low or no response to our repeated engagement attempts, we decided to archive four of the 21 companies, as follows: IT 5, IT 10, Pharma 9, and Pharma 10.

In addition to the events that took place in the second part of 2022 - and which are presented on page 2 - the following pertain to the first part of the year:

- Global environment observations:
  - We noted an increasing interest in the topic coming from stakeholders such as the Big 4 accounting firms, ESG risk rating providers, or purpose driven consultancies;
  - In a first-ever move, the US Securities and Exchange Commission (SEC) rejected Amazon's request to leave a tax transparency-focused shareholder proposal off its 2022 proxy ballot, which many viewed as a milestone for the campaign. The resolution went to vote and earned 21% of the independent votes.
- Engagement specific observations:
  - One of the companies within the engagement scope, namely, IT 1, voluntarily issued a public country-by-country reporting (CbCR) disclosure for the first time. Despite this disclosure being partial because not all countries where the group operates were covered, we believe it was a significant development;
  - We observed misalignments between corporate sustainability strategies and tax practices. For instance, companies would often argue in their sustainability disclosures that they are aligned with certain United Nations Sustainable Development Goals to which taxation is directly or indirectly associated, without supporting these claims with proper tax practices or disclosures;
  - We highlighted that companies still often rely on using jurisdictions associated with tax avoidance despite committing not to engage in such activities in their disclosures;
  - Finally, we highlighted that aggressive tax practices can have a negative impact on the performance of issuers and their stock. We showed a practical example involving Pharma 11.

[3] Including one call that took place in late December 2021 after the 2021 annual report was issued

Taxation 2.0 Final Conclusions

The international corporate tax environment is complex, conservative, and typically driven by regulations. Because of this, behaviour change withing large international businesses does not always happen fast. Therefore, the three-year period since this thematic engagement started is too short to be able to see substantial changes among the issuers engaged.

However, while few of the companies we engaged with updated their corporate tax practices and disclosures significantly, some of them are in a notably better position than in 2020 and appear to be moving in the right direction, albeit slowly. Furthermore, the underlying regulatory and standard setting trends shaping this space are significant and we are confident they will drive more substantial change in the coming years.

Below, we highlight the main conclusions that we draw based on our engagement work performed in the past three years.

Global Environment Observations

Governments and other stakeholders are more committed than ever to curb tax avoidance and increase tax transparency among large multinationals. The evidence supporting this statement is broad, such as: the adoption of GRI 207 reporting standards published in 2019 by many multinationals; the OECD-sponsored agreement reached at the end of 2021 (i.e., Pillar One and Pillar Two) and the ongoing implementation of this agreement in various signatory countries; the Australian 2023 budget which contains proposed rules making public CbCR disclosures mandatory for large multinationals; the ongoing implementation among member states of the EU public CbCR directive; and SEC and FASB consultations/investigations related to public CbCR disclosures. In our view, the likelihood that this trend will continue is high.

Investors have become more active in using their voting rights. In addition to the relative successful voting outcome, the tax transparency proposal at Amazon seems to have opened the door to tax transparency proposals at various other corporations, as explained previously. Also, based on our understanding, it is highly likely we will see other such proposals in 2023 and beyond. While it is too early to draw conclusions, we are of the view that the 21% to 27% range of shareholder votes expressed in favour of higher tax transparency standards (at Amazon, Cisco, and Microsoft) show strong support from investors. Should any such proposals in the future be successful, it will likely represent a tipping point for the broader adoption of higher tax transparency standards among large multinationals in the US and other parts of the world.

In addition to governments and investors, other stakeholders have become increasingly interested in the topic of tax transparency and sustainability. Despite each of these having different (and potentially diverging) interests, we are of the view that their involvement will contribute to higher awareness of the matter and higher tax transparency reporting by large multinationals and the integration of taxation into the broader sustainability discussion.

Engagement Specific Observations

At the beginning of this engagement program, the gap between most US-based multinationals and their counterparts from the APAC region or the EU in terms of how they approach tax transparency and sustainability was obvious. In addition, we noticed a significant difference in terms of how some US corporations viewed taxation compared to overseas peers, i.e., a purely compliance related topic with low materiality relative to sustainability. One reason may have been that the US multinationals believed US investors did not attach significant importance to taxation as a sustainability-related topic. However, this now seems unlikely to be correct as a significant number of the US state pension funds that have already published their voting activity for the Amazon 2022 annual shareholder meeting have disclosed that they voted in favour of the tax resolution. Nonetheless, during the past three years, we noticed a change in approach from some of the US-based companies, which seem to be slightly more aware of the issue and open to engage.

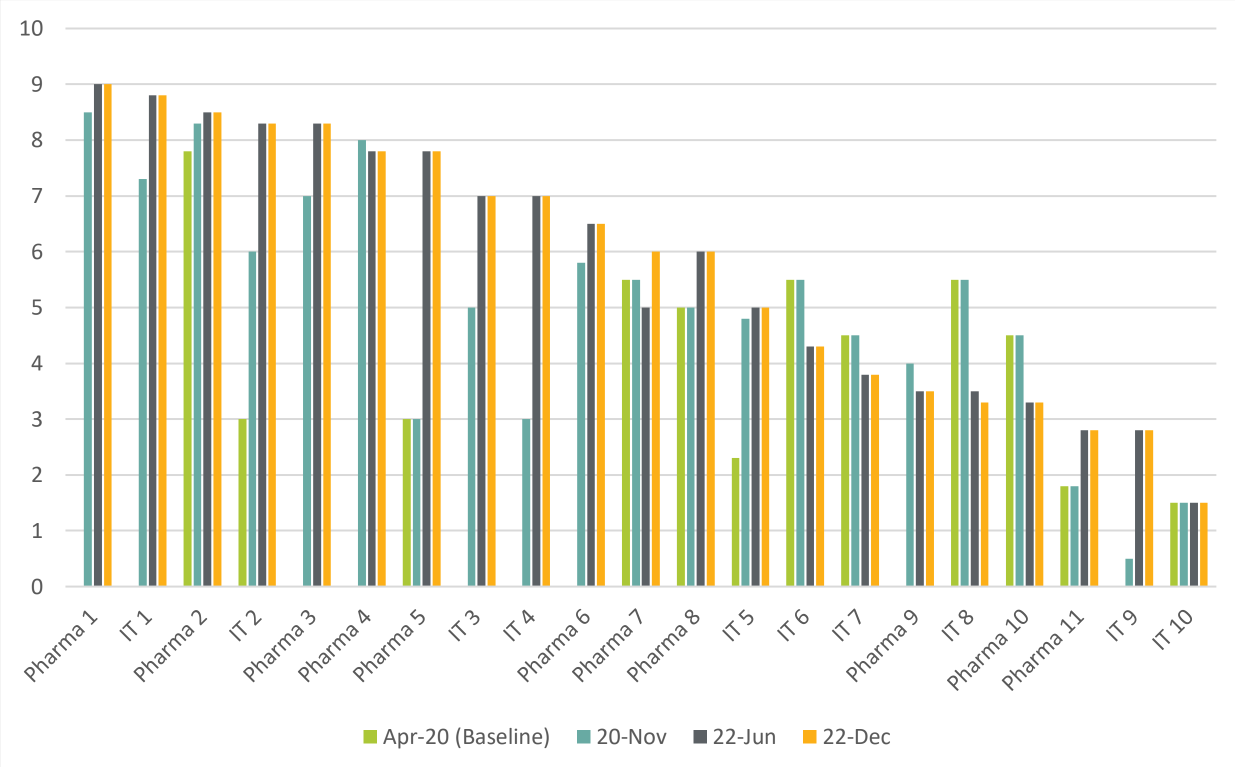
During the three-year engagement period, the aggregate score for 14 of the companies in scope increased and for the remaining seven companies decreased or remained unchanged. In other words, we noticed a 15-20% improvement in the overall score of the pool of companies covered. The multinationals that had the most positive impact on the evolution of the overall score are: IT 1, IT 2, IT 3, IT 4, IT 5, Pharma 3, and Pharma 5. While it is difficult to make a clear link between this improvement and the five KPIs in our scoring methodology, we argue that the primary driver behind this progress has been improvements in KPI 1 – Transparency across many of the companies covered. To support this view, we note some of the companies covered have adopted public global tax policies for the first time and some have improved existing policies.

Another notable event is that IT 1 voluntarily published its first (partial) CbCR report in 2022 and is currently considering adopting the full GRI 207 reporting standard.

Based on our engagement with the companies in scope, we note that tax related sustainability matters are brought to the attention of boards in only a few cases, and most of the time, senior management has discretion over whether and what to share on this matter. While we have little evidence to support this, based on our interactions, we are of the view that some boards may be insufficiently informed on the topic at hand, which is both a risk and an opportunity for investors.

To conclude and complement the above engagement observations related to 2022 activity and the overall thematic engagement program, Chart 1 on the following page shows the progress made by the 21 companies in scope during 2022 and since their individual first evaluation, which was done either in April 2020 or November 2020.

Chart 1: Taxation 2.0 Engagement Companies Three-Year Score Summary



Our Recommendations for Future Engagement

Going forward, investors can play an essential role in creating a level playing field for all issuers, irrespective of geography, which may create long-term investment benefits, e.g., long-term risk reduction, more exact valuations, less volatility, lower reputational risk. The current global environment brings greater chances of success for investors seeking higher tax transparency and a more sustainable way of managing corporate tax affairs from their investees, compared to past years and decades. To build on this tailwind, we recommend investors to continue engaging with the relevant issuers and consider the following when defining their engagement approach and strategy:

- Seek to engage with board members or their direct reports as often as possible;
- Approach tax transparency and sustainability also as a corporate governance matter;
- Examine options for escalation using available tools, such as voting rights and, where available, shareholder resolution filing;
- Seek to collaborate with other investors and stakeholders;
- Seek to engage with relevant government representatives and/or regulators to raise awareness of the topic at hand and support the implementation of appropriate regulations, where possible;
- Incorporate the information made available by corporations in public CbCR disclosures into the investment process and communicate this externally.

About Morningstar Sustainalytics

Sustainalytics, a Morningstar Company, is a leading ESG research, ratings, and data firm that supports investors around the world with the development and implementation of responsible investment strategies. For 30 years, the firm has been at the forefront of developing high-quality, innovative solutions to meet the evolving needs of global investors. Today, Sustainalytics works with hundreds of the world's leading asset managers and pension funds who incorporate ESG and corporate governance information and assessments into their investment processes. Sustainalytics also works with hundreds of companies and their financial intermediaries to help them consider sustainability in policies, practices, and capital projects. With 17 offices globally, Sustainalytics has more than 1,800 staff members, including more than 800 analysts with varied multidisciplinary expertise across more than 40 industry groups. For more information, visit www.sustainalytics.com.

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