



RE-EXAMINING THE TAX GAP

The Tax Gap in the MSCI World

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EXECUTIVE SUMMARY

Since our analysis in December 2013 on the diversity of tax rates paid by MSCI World companies, the regulatory outlook has shifted substantially. In our updated analysis, we identify 243 companies (out of 1,093 relevant¹ companies within the MSCI World Index constituents) as having a large tax gap, paying an average rate of 17.7%, versus 34.0%, if these companies were paying taxes in the jurisdictions where they generate revenues.

KEY FINDINGS

- The 243 companies in the MSCI World with a large tax gap would have paid in aggregate an estimated USD 82 billion per year in taxes, had these companies been paying taxes at the same rate as their peers on the MSCI World Index. If these taxes had been paid, it could have reduced aggregate profit after taxes across these 243 companies by approximately 20% over this period.
- Despite the spotlight on IT companies such as Apple and Google, the healthcare sector has the highest percentage of companies in the MSCI World that are paying significantly reduced tax rates.
- High ‘tax gap’ companies enjoyed a sizable profit advantage over peers despite far smaller pre-tax earnings advantage, suggesting tax strategy played a role in the difference.
- Roughly one in four companies (26%) with a high tax gap has a majority-owned subsidiary or is domiciled in a known tax haven, compared to approximately 16% for its MSCI World peers.
- Using MSCI’s forensic accounting (AGR) scores, we find that companies with very aggressive accounting do end up paying lower taxes, with a significantly higher proportion of high ‘tax gap’ companies represented in the very aggressive accounting categories than the conservative accounting category.

¹ Of the 1612 companies in the MSCI World Index, we have excluded companies generating a loss during this period, REITs, and mining companies from the analytical set

INTRODUCTION

Since our analysis in December 2013 on the diversity of tax rates paid by MSCI World companies, the regulatory outlook has shifted substantially. New country-by-country transfer pricing reporting requirements proposed by the OECD will come into effect in January 2016². Favorable tax deals will likely be scarcer in the near term given the European Commission's investigation of whether 'sweetheart' tax arrangements offered by Ireland, Luxembourg, and Netherlands contravene European competition rules against providing 'state-aid.' Some countries have also proposed specific tax-avoidance legislation explicitly targeting big name multinationals, such as the UK legislation dubbed a 'Google Tax' and Australia's new 'Netflix Tax'.

What has not changed much since our last analysis is the basic issue of transparency - investors still have little visibility into how profits are booked, where taxes have been paid, and how much was paid. To understand their exposure to the shifting policy frameworks, investors are forced to dig for the extra information on a company-by-company and jurisdiction-by-jurisdiction basis. More often than not, investors have to engage companies directly for more granular information about tax and accounting strategy, and about circumstances surrounding specific tax treatment.

While MSCI's 'tax gap' analysis cannot identify instances of aggressive profit-shifting per se given the limited disclosure, it can suggest a more targeted set of companies from a broad, diversified universe for investor engagement by understanding the large gap between the reported tax rate paid and the tax rate of where companies generate revenues.

SIZING THE TAX GAP

- ***One in five companies are paying significantly lower taxes than expected***

For the 1,612 companies in the MSCI World Index³, MSCI ESG Research compared each company's reported tax payments between 2009 and 2013 to the average corporate tax rate of the countries in which it generated revenues (Exhibit 1). After excluding companies generating a loss during this period, REITs, and mining companies from the analytical set, we have arrived at a relevant peer set of 1,093 companies⁴. We defined "high tax gap companies" throughout the report as companies with a 10 percentage point or greater gap

² <http://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf>

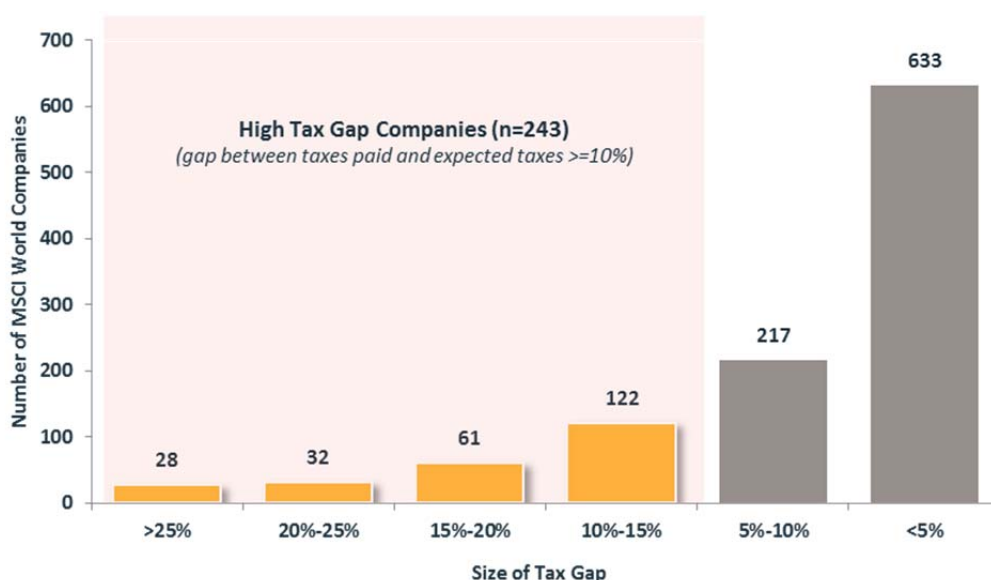
³ As of April 3, 2015.

⁴ We exclude REITs given the special tax structure of REITs which render these companies less comparable to peers in other industries. We exclude mining companies due to the prevalence of specific tax treatments related to mineral rights in different jurisdictions. We exclude any company making a loss during this period (negative profit), in order to reduce noise in the data sample from companies that carry tax credits in different ways. Refer to Appendix 1 for details.

between their expected tax rate (based on where revenues are generated) and actual tax rate paid.

- We found that around 4% of the analytical set (44 out of 1,093 companies) paid an average tax rate of less than 10% over this period.
- 22% of companies (243 out of 1,093 companies) paid tax rates that were substantially below the weighted average tax rate of the countries in which they generate revenues. These 243 companies paid a 17.7% tax rate or the equivalent of USD 448 billion over this period.
- The weighted average tax rate of the countries in which these 243 companies generated revenues (34.0%) is nearly 90% more than the actual rate paid by this group over this time-period (17.7%).

Exhibit 1: Gap Between Tax Rate Paid and Weighted Average Tax Rate of Countries Where Revenues are Generated, 2009-2013



MSCI World Index Companies excluding REITs, Mining Companies, and Companies with Negative Profits (n=1,093)

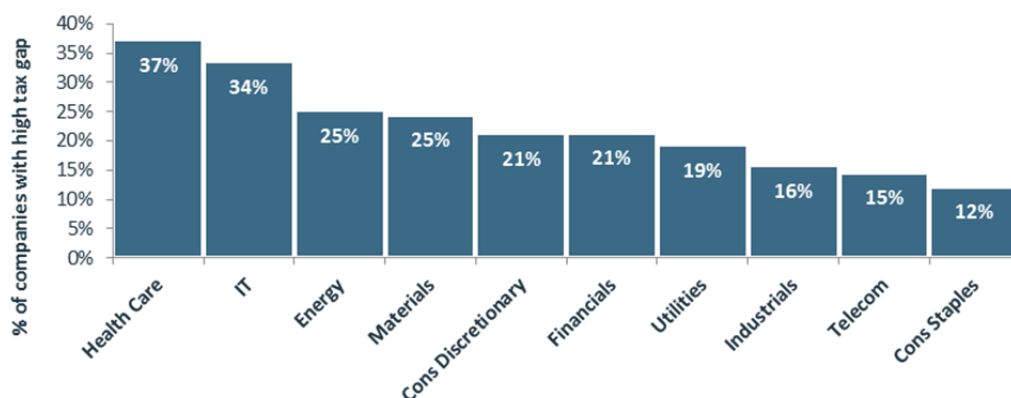
PICKING ON GOOGLE

- *The IT sector is not the leading sector in paying lower taxes*

Judging by headlines and parliamentary inquiries, investors might naturally infer that US-based, IT companies (Google, Amazon, Apple) seem to have a predilection for low tax payments. In fact, the healthcare sector ranks the highest of MSCI World companies, with 37% of the analytical set meeting the high tax gap criteria. Energy and Materials companies

follow closely behind the IT sector, with 1 in every 4 MSCI World companies falling into the high tax gap category (Exhibit 2).

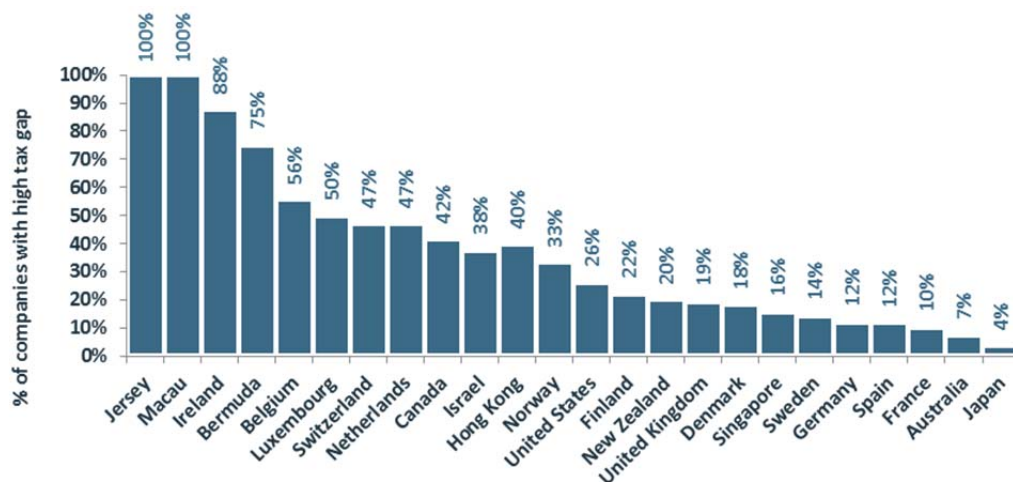
Exhibit 2: Percentage of High Tax Gap Companies by GICS Sector, 2009-2013



MSCI World Index Companies excluding REITs, Mining Companies, and Companies with Negative Profits (n=1,093)

While US companies make up roughly one-third of the 243 high tax gap companies, they represent only 1 in every 4 US companies in the MSCI World analytical set. Norway, Hong Kong, and Canada all have a higher share of companies falling into the high tax gap category. Not surprisingly given the recent controversies related to these jurisdictions, roughly half of all MSCI World companies domiciled in the Netherlands, Luxembourg, Belgium, and Switzerland fall into the high tax gap category. Nearly 90% of companies domiciled in Ireland have a high tax gap, trumped only by companies domiciled in Macau and Jersey (Exhibit 3).

Exhibit 3: Percentage of High Tax Gap Companies by Domicile Country, 2009-2013



MSCI World Index Companies excluding REITs, Mining Companies, and Companies with Negative Profits (n=1093)

COMPANY EARNINGS AND THE TAX GAP

- ***20% of aggregate profits across high tax gap companies could be at risk if the tax gap were closed***

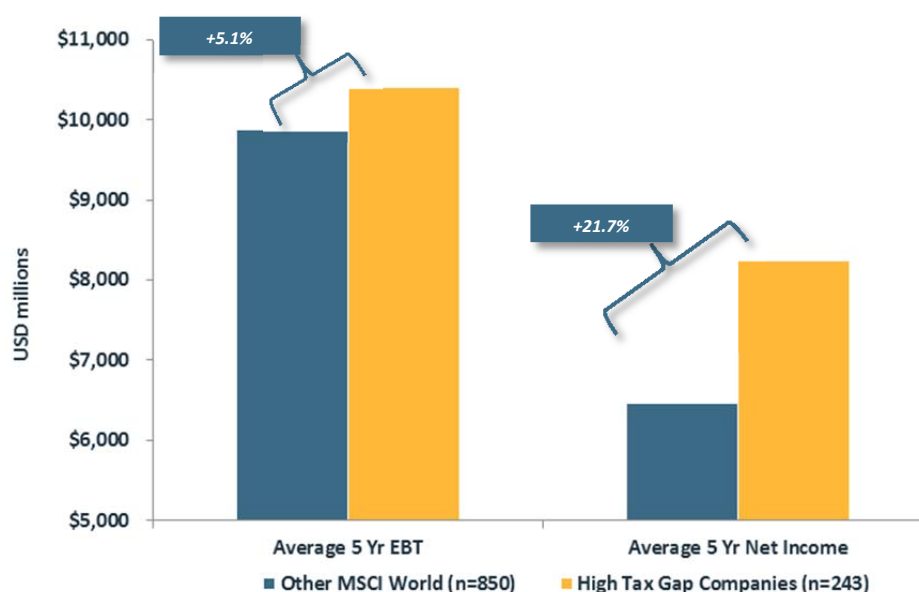
As governments across the world continue to struggle with budget deficits and sluggish economic growth, the hunt for tax revenues has intensified. Closing tax loopholes has become an increasingly popular and populist target for policymakers, particularly in the G20 countries where debt levels currently average nearly 63% of GDP. More than 90% of 243 companies with a significant 'tax gap' are currently domiciled in or generating more than 50% of their global revenues from G20 markets.

- The 243 companies in the MSCI World with a large tax gap alone would have paid in aggregate an estimated USD 82 billion per year in taxes had these companies been paying taxes at the same rate as their peers on the MSCI World Index or had been paying taxes at the average rate of the countries in which they generate revenues.
- We estimate that had these high tax gap companies made aggregate payments of USD 82 billion per year over this period, it could have reduced aggregate profit after taxes across these 243 companies by approximately 20%.

From an individual company perspective rather than an aggregate view, we analyzed the size of reported tax payments relative to earnings and found that the 243 companies with a high tax gap generated pre-tax profits that were modestly higher (5.1% more) than their MSCI World peers over this period (please note that the analytical set excludes all companies making a loss over this period)⁵. However, the modestly higher profits pre-tax were magnified significantly post-tax as the high tax gap companies' net income averaged nearly 21.7% more than their peers (Exhibit 4).

⁵ These Earnings Before Tax (EBT) and Net Income calculations do not take into account of sector differences. The sector make-up of the high tax gap group is skewed towards healthcare, IT, energy and materials (see Exhibit 2). Hence profit differences between high tax gap companies and the rest of the MSCI peer set are also driven by differences in profitability of sectors over the period 2009-2013.

Exhibit 4: Comparison of Earning Before Tax and Net Income between High Tax Gap Companies and Rest of MSCI World Index Companies⁶, 2009-2013



Excluding REITs, Mining Companies, and Companies with Negative Profits (n=850)

Our results suggest that employing different tax strategies than their peers could have been a main driver of the large net income advantage enjoyed by these high tax gap companies over this period. There are two perspectives that investors can take in light of this analysis. On the one hand, whatever tax strategies these companies employed clearly worked over this period in that these companies reported much higher net income than they might have otherwise. On the other hand, the higher net income may have resulted from maneuvers unrelated to the quality of the core business operations, where the advantages enjoyed by these companies over their peers seem to be more modest.

From either an aggregated level (where the gap between expected tax and paid tax is estimated around USD 82 billion) or from an individual profit margin level (where high tax gap companies' after-tax earnings are boosted through low tax payments), one thing is clear: governments are likely to continue their search for loopholes to close. We analyzed two primary methods used by companies to manage tax burdens – tax havens and accounting strategies – to understand which companies could see an increase in tax risks to earning in the event of a policy shift.

⁶ We arrive at "Rest of MSCI World Index Companies" (n=850) by subtracting High Tax Gap companies (n=243) from the relevant MSCI World Index companies (*Excluding REITs, Mining Companies, and Companies with Negative Profits (n=1,093)*)

ARBITRAGING THROUGH TAX HAVENS

- ***One in five companies with a high tax gap is affiliated with a known Tax Haven***

The intricacies of tax maneuvers such as the ‘Double Irish With A Dutch Sandwich’⁷ no longer remain the purview of transfer pricing analysts, as the media and public have come to understand over the past several years the widespread use of profit shifting to low tax jurisdictions.

We updated our analysis of the majority-owned subsidiaries of the 1,612 companies on the MSCI World Index in 2015⁸. We matched the country of domicile of the 4,592 subsidiaries of these companies to the list of tax havens compiled by the U.S. Congressional Research Service in January 2015, which combines the work of organizations such as the OECD and the Tax Justice Network.⁹

Luxembourg and Ireland are included in the list of tax havens, based on this data source. Additionally, due to the current EU talks to disclose country tax policies and the controversies implicating the Netherlands, in addition to Ireland and Luxembourg, we have included a mapping of subsidiaries to that jurisdiction in this year’s analysis. Netherlands, however, is not considered a ‘tax haven’ based on our data source¹⁰. We found that:

- 7.1% of MSCI World companies had at least one majority-owned subsidiary in a ‘tax haven’ country in which it is not domiciled, a reduction from 10.8% in the analysis using 2013 data.
- The most popular countries for these subsidiaries, outside of the domicile country, remain the Cayman Islands and Luxembourg (Exhibit 5).
- If we include companies domiciled in a ‘tax haven’ in addition to those with at least one majority owned subsidiary in a ‘tax haven’, the proportion of companies affiliated with tax havens increases to 16.3% of MSCI World companies, in line with the 15.6% in the analysis using 2013 data. Adding Netherlands to this list of known ‘tax havens’ would increase the number of companies to 20.5%, or about one in every five MSCI World company.

⁷ 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](http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2013/130574/LDM_BRI(2013)130574_REV1_EN.pdf)

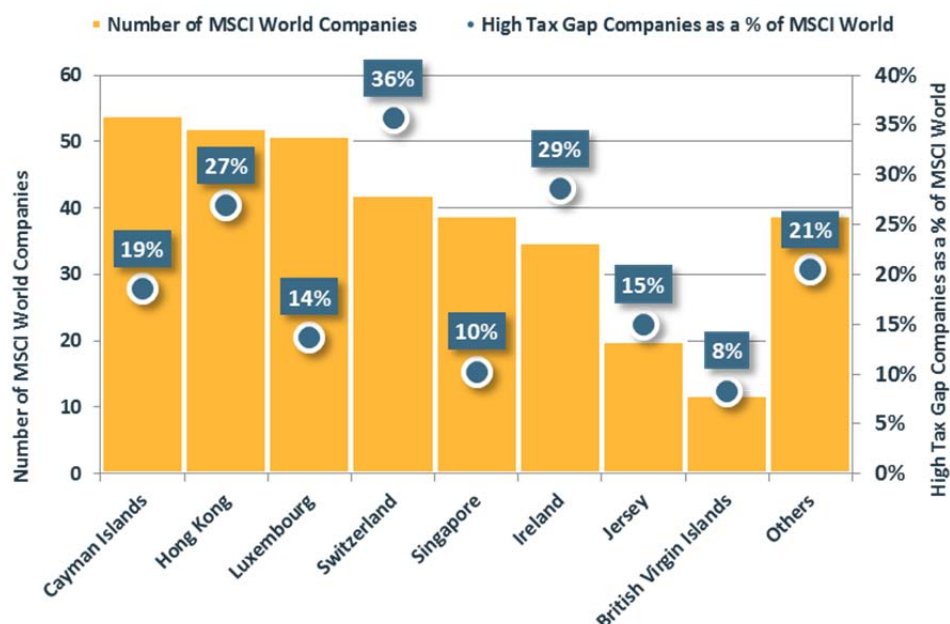
⁸ As of April 3, 2015.

⁹ See page 4 of Tax Havens: International Tax Avoidance and Evasion. United States Congressional Research Service. January 15, 2015. <http://www.fas.org/sgp/crs/misc/R40623.pdf>

¹⁰ The US Congressional Research Service’s report notes that ‘A country not on the list in Table 1, but which is often considered a tax haven, especially for corporations, is the Netherlands.’ On page 6.

- Of the 243 companies that had a significant 'tax gap', 20% (48 companies) were domiciled in a 'tax haven' jurisdiction and 15% (36 companies) had at least one majority-owned subsidiary in a 'tax haven' jurisdiction. This compares with 7% and 11% for companies without a high tax gap.

Exhibit 5: Number of MSCI World companies domiciled in or with at least one majority-owned subsidiary in a tax haven, 2009-2013



Excluding REITs, Mining Companies, and Companies with Negative Profits (n=344 unique subsidiaries location across 263 MSCI World Companies domiciled in or with at least one majority-owned subsidiary in a tax haven. Refer Appendix 1 table for more information)

EMPLOYING AGGRESSIVE ACCOUNTING

- One in four companies assessed as having very aggressive accounting strategies had a high tax gap**

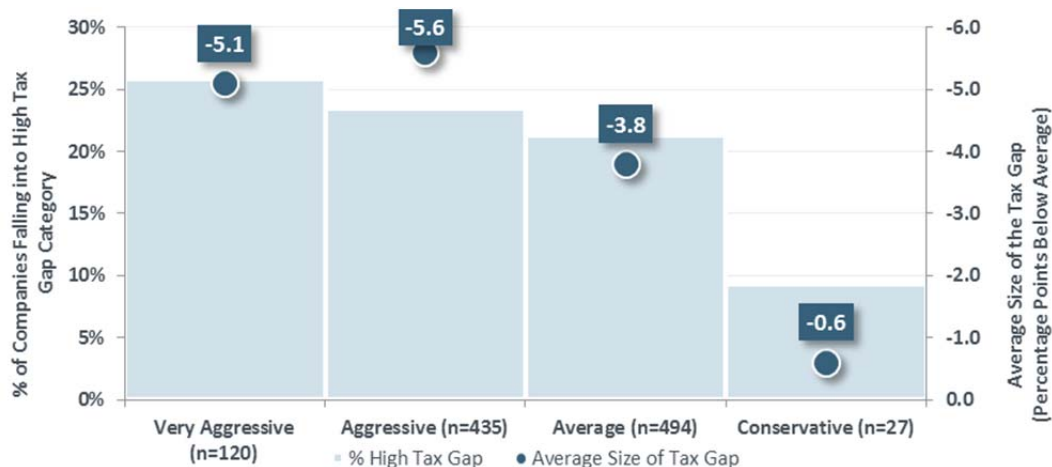
While the use of tax havens – a hotly debated topic with insinuations of dubious legality – is one key method to tax reductions, a second may be much more straight-forward. Using our forensic accounting data, the MSCI AGR scores, we have a numeric percentile ranking of companies that indicates a higher or lower probability of accounting abnormalities based on historical patterns and peer comparisons of key accounting ratios (see Appendix II for a brief summary of the AGR methodology). Scores range between 0 and 100, with assessments classified as Very Aggressive (up to 10), Aggressive (scores between 11 and 35), Average (scores between 35 and 85), or Conservative (scores above 85). While AGR scores aim to be

forward looking indicators of potential fraud¹¹, we found no indication that links high tax gap companies with Very Aggressive accounting to instances of fraud during this period of analysis. Instead, in this context, the scores serve as a useful barometer for accounting strategy.

While companies with high tax gaps tend to be less likely to exhibit 'Conservative' accounting practices, they were not significantly more likely to be in the 'Aggressive' categories for accounting. However, we found that among the MSCI World companies in our analysis, companies exhibiting more aggressive accounting practices did, on average, have larger tax gaps than more conservative peers across all peer groups (see Exhibit 6).

- Over the past four years, companies displaying more aggressive accounting were more likely to pay lower taxes than their peers. The Very Aggressive and Aggressive groups averaged roughly 5 percentage points lower in reported tax rates than MSCI World peers.
- We find that a greater proportion of companies displaying more aggressive accounting tactics fell into the high tax gap category. Roughly one in every four companies designated as having Very Aggressive accounting also faced a high tax gap.

Exhibit 6: Tax Gap characteristics of companies designated as having Very Aggressive, Aggressive, Average, or Conservative accounting (2009-2013)



MSCI World Index Companies excluding REITs, Mining Companies, and Companies with Negative Profits (n=1076 companies of 1093 MSCI World companies for which MSCI ESG Research's Accounting and Governance Risk (AGR) data was available. For more information on AGR refer Appendix 2)

¹¹ See, for example, 'Forensic Accounting in Global Stock Selection,' 14 May 2015, Deutsche Bank Markets Research.

APPENDIX I: ANALYSIS USING 2008-2012 V. 2009-2013 DATA

5 year Period for Analysis	May 2015 Analysis 2009-2013	Dec 2013 Analysis 2008-2012
Total companies in MSCI World Index	1,612	1,595
Companies excluded from analysis: experienced negative profit in any year during the analytical period	473	504
Companies excluded from analysis: REITs, Mining sectors	46	96
Total companies in the analytical set (minus REITs, Mining, and companies making negative profit)	1,093	995
Number of companies paying tax at less than 10% rate	44	39

'High Tax Gap': Number of companies paying tax rates that were more than 10 percentage points lower than the weighted average tax rate of the countries in which they generate revenues	243	213
<i>Out of 'High Tax Gap' companies:</i>		
Number of companies domiciled in a tax haven	48	39
Number of companies with at least one subsidiary in a tax haven	36	32
Number of companies either domiciled in a tax haven or having at least a subsidiary there	64	56
% of companies deriving more than 50% of revenues from G20 nations	76%	81%
% of companies domiciled in G20	81%	83%

<i>Out of MSCI World Index companies:</i>		
Number of companies domiciled in a tax haven	149	142
Number of companies with at least one subsidiary in a tax haven	188	173
Number of companies either domiciled in a tax haven or having at least a subsidiary there	263	249

APPENDIX II: AGR METHODOLOGY

MSCI ESG Research produces Accounting and Governance Risk (AGR[®]) ratings on over 27,000 companies in developed and emerging market regions. AGR analyzes and rates the integrity of a firm's financial reporting and corporate governance. Investors may use AGR to help them quantify risks around financial disclosures.

MSCI ESG Research examines both accounting information and governance practices. Our objective is to use publicly available data to help identify companies with potential accounting risks. The basic steps for computing company AGR rankings are as follows:



Within each geographical region (North America, Western Europe, Japan, Asia - Pacific, and Emerging Markets) we report the AGR in percentiles from 1 to 100, worst to best and also classify them as:

- Very Aggressive – highest risk companies, comprising 10% of the total universe
- Aggressive – high risk companies, comprising 25% of the total universe
- Average – moderate risk companies, comprising 50% of the total universe
- Conservative – low risk companies, comprising 15% of the total universe

We have developed a taxonomy that imposes a logical structure onto the more than a hundred metrics we track. Three categories of accounting risk and two of non - accounting risk form the highest level of the taxonomy. They are: Revenue Recognition, Expense Recognition, Asset-Liability Valuation, Corporate Governance Events, and High Risk Events.

Each metric is examined for unusual values along three analytic dimensions. It is often not the absolute level of a ratio that imparts the most insight, but its trend and persistence over time. Likewise, comparisons to similar companies adds context.

The statistical process examines hundreds of metric operations which could be valuable in identifying aggressive accounting behavior. Accounting and governance profiles of companies that have been subject to SEC Accounting and Auditing Enforcements are examined to detect patterns that can be used to indicate a heightened probability of aggressive accounting. Metric operations are flagged if two conditions apply; the metric is extreme in value and the extreme value has been associated with periods of fraudulent behavior as identified by SEC actions against companies. The fundamental assumption is that companies that exhibit extreme values in their metric operations (top or bottom 20% of all values) represent a heightened risk of aggressive accounting.

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