

Taxing Times

Are corporate tax planning structures at risk?

- **What's New** — An increasing focus on corporate tax avoidance from media and politicians may lead to changes in tax laws. The G20 has endorsed an OECD action plan to counter tax avoidance. Certain tax arrangements commonly used by multinational companies may be at risk, potentially increasing P&L and cash tax rates. In this report we explain widely used tax planning structures, and screen for companies which may be at risk from tax changes.
- **Will countries act against tax planning structures? So far, actions speak louder than words** — Countries compete on tax and some countries, such as Ireland, have benefitted from investment from overseas due to a favourable tax regime. These considerations may deter politicians from acting on the anti-tax-avoidance rhetoric. We note that the UK recently watered down its anti-avoidance rules significantly (changes to Controlled Foreign Company rules effective from 2013) in response to companies such as WPP moving tax residence out of the UK.
- **Multinationals commonly use "hybrid entities"** — The OECD has highlighted the use of hybrid entities (which are taxable in one jurisdiction but "transparent" in another). Using hybrid entities may result in a group getting an external tax deduction on purely internal debt interest (see page 4 for example). We believe these structures are key to many European multinationals' low tax rates, so any changes to these rules could be significant.
- **Lack of transparency** — Very few listed companies disclose any information about their tax planning arrangements. Tax information in financial statements is generally inadequate for investors to understand how low tax rates have been achieved or assess the level of tax risk. Even if governments do not take significant action against tax planning, we think that there may be a shift towards greater transparency about tax.

Sarah Deans
+44-20-7986-4156
sarah.deans@citi.com

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Taxing Times: more focus on tax avoidance

Will governments crack down on tax planning schemes?

In previous Taxing Times reports¹, we have highlighted the uncertain tax outlook for corporates. In this note, we focus on tax avoidance, and the risk that governments will crack down on more aggressive tax planning schemes. We also include screens for companies with lower than expected tax rates, which may reflect the use of tax planning strategies.

Introduction

Corporate tax, and in particular corporate tax avoidance, has been a high profile topic in recent months, with both journalists and governments taking an increasing interest in the amount of corporate tax paid by multinational groups.

G20 has endorsed OECD action plan to address tax avoidance

This month, the G20 endorsed² an action plan by the OECD³ to address tax avoidance. The Financial Times has also reported that the EU has contacted Ireland, Luxembourg and the Netherlands over tax deals with multinationals, which may potentially be contrary to the EU's state aid rules⁴.

Multinational companies generally have greater opportunities to lower the effective tax rate than domestic companies. These opportunities may arise due to intra-group financing (including the use of "hybrid entities"), transfer pricing, moving the tax residence of the parent company, shifting the group towards lower tax jurisdictions, or use of tax incentives.

Tax planning structures using intra-group financing are common

This report focuses on the effect of intra-group financing arrangements and in particular the use of hybrid entities, which may create two tax deductions for one interest payment or generate tax deductions without corresponding income inclusions. This is a common method applied by many companies, in our view, and can result in significantly lower tax rates than expected. The OECD Action Plan proposes a number of potential actions which could "neutralise the effects" of these structures and if successful, could significantly increase some companies' effective tax rates. However, we think that making internationally coordinated tax changes would be very difficult, and countries may not wish to act unilaterally due to the impact on competitiveness.

Screening for low tax companies

In this report we also provide crude screens to identify companies with much lower than expected tax rates, by comparing companies' actual tax rates (both historical and forecast) with the expected tax rate calculated using companies' disclosed geographic revenue exposure.

¹ *Taxing Times: An Investors' Guide to Corporate Tax*, dated 16 December 2011, and *Taxing Times Update: Identifying Corporate Tax Winners and Losers*, dated 11 December 2012.

² G20 Leaders Joint Statement, September 2013, www.g20.org.

³ The Organisation for Economic Co-operation and Development (OECD) has issued a number of reports on corporate tax avoidance, most recently with the catchy title of *Action Plan on Base Erosion and Profit Shifting*, issued in July 2013. The OECD is responsible for maintaining model tax treaties used by tax authorities when negotiating for tax co-operation between countries. We show a summary of the OECD's proposed BEPS Action Plan in Appendix 1 on page 7.

⁴ Financial Times: *EU probes corporate tax sweeteners*, 12 September 2013.

Corporate tax 5-8% of total tax in France, Germany, Italy, Spain and UK

How significant is corporate tax?

Figure 1. Corporate tax as a percentage of total tax for selected countries

	2004	2005	2006	2007	2008	2009	2010	2011
France	6%	5%	7%	7%	7%	3%	5%	6%
Germany	4%	5%	6%	6%	5%	4%	4%	5%
Ireland	12%	11%	12%	11%	10%	9%	9%	no data
Italy	7%	7%	8%	9%	9%	7%	7%	6%
Japan	14%	16%	17%	17%	14%	10%	12%	no data
Luxembourg	15%	15%	14%	15%	14%	15%	15%	14%
Netherlands	8%	10%	8%	8%	8%	5%	6%	no data
Spain	10%	11%	11%	13%	9%	7%	5%	6%
Sweden	6%	8%	8%	8%	6%	6%	8%	8%
Switzerland	8%	8%	10%	11%	11%	10%	10%	10%
United Kingdom	8%	9%	11%	9%	10%	8%	9%	8%
United States	10%	12%	12%	11%	8%	7%	11%	10%

Source: OECD

Figure 1 shows that corporate tax generally represents a low proportion of the total tax take in most countries – eg between 5-8% in the larger European countries. Countries may compete through lower corporate tax rates, incentives, or weaker anti-avoidance rules to attract additional investment. This may be rational for individual countries, but may contribute to a “race to the bottom” whereby multinationals can legally pay very little or no corporate tax. Whether the G20 and OECD initiative can achieve international action to prevent this is unclear in our view.

Key methods of tax avoidance

There are a large number of ways in which companies reduce their tax burden or shift profits to lower tax jurisdictions. These are often based on the interaction of tax rules in different countries, and generally aim to move profits to where they are taxed at lower rates (or possibly not taxed at all) and move expenses to where they are relieved at higher rates.

Tax jurisdiction

Tax jurisdiction is determined on an individual company (rather than group) basis. The interaction of domestic tax systems can lead to overlap, whereby income is taxable in two jurisdictions, or to gaps, with income not taxed in any jurisdictions. There are a number of methods through which mismatches between countries’ tax systems are used:

- **Hybrid entities** – A hybrid entity is a company that is treated as taxable in one country, but is transparent in another country. This is a very common method of tax planning, which we go into in more detail on page 4.
- **Hybrid financial instruments** – Similarly to hybrid entities, hybrid financial instruments are treated differently by different countries.

Multinational companies may also make use of subsidiaries in tax havens. Many countries try to address this, for example through Controlled Foreign Company rules, which may treat undistributed profits in a tax haven subsidiary as taxable in the home country. Other more general anti-avoidance rules may also be used to tackle the use of tax havens.

Interaction of different tax systems can result in income not being taxed in any jurisdiction, or a double tax deduction for the same expense

Transfer pricing is supposed to be based on arm's-length principle

Transfer pricing

These rules govern how international intra-group transactions are treated by the relevant tax authorities, for example how to determine the cost of goods moved between locations as part of a manufacturing process. Transfer pricing is generally based on the arm's length principle, ie transactions are priced as if they were between independent parties. However, this can be difficult to establish and the OECD acknowledges that transfer pricing rules do not always result in profits being allocated in accordance with value creation. The OECD report highlights the particular transfer pricing difficulties associated with intangible assets.

Interest payments are tax deductible, favouring debt financing

Leverage

Returns paid on debt and equity financing are treated differently by tax authorities. Debt interest payments are generally tax deductible and equity dividends are not tax deductible⁵, ie debt financing is more tax efficient. Many countries have rules on "thin capitalisation" which restrict the tax benefit on interest payments if the level of debt financing is deemed excessive. (Typically interest is only tax deductible on debt within a specified limit, eg a maximum debt: equity ratio.)

Example of common tax planning structure for UK group with US business

Example of hybrid entity structure

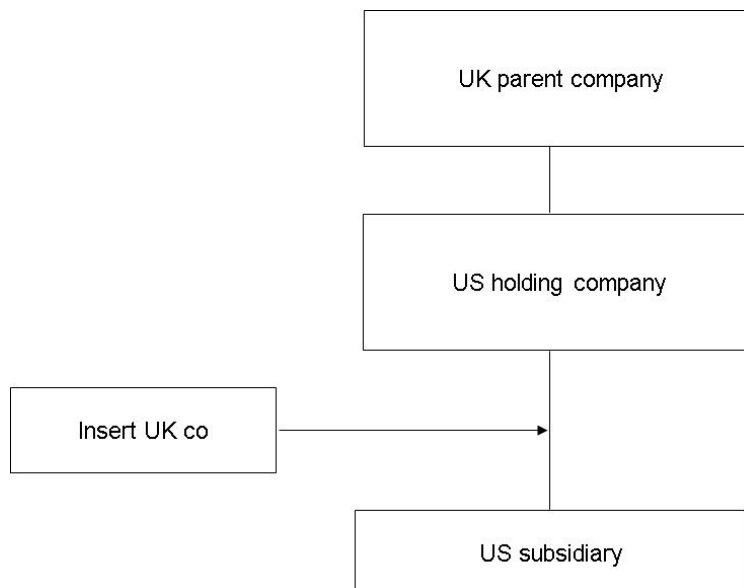
As mentioned earlier, we believe that hybrid entities are often used as part of tax planning arrangements by multinationals.

We provide below an example of a typical hybrid entity structure for a UK multinational with substantial US operations. The US has a federal corporate tax rate of 35% (with additional state taxes the average corporate tax rate may reach 40%), however the use of the structure described below is likely to reduce the effective tax rate very significantly.

In our example, we take a UK parent company which owns a US holding company which in turn owns US subsidiaries (Figure 2). A new UK company would be inserted into the US structure.

⁵ Note that Belgium gives a notional interest deduction on equity financing.

Figure 2. Setting up a hybrid entity structure

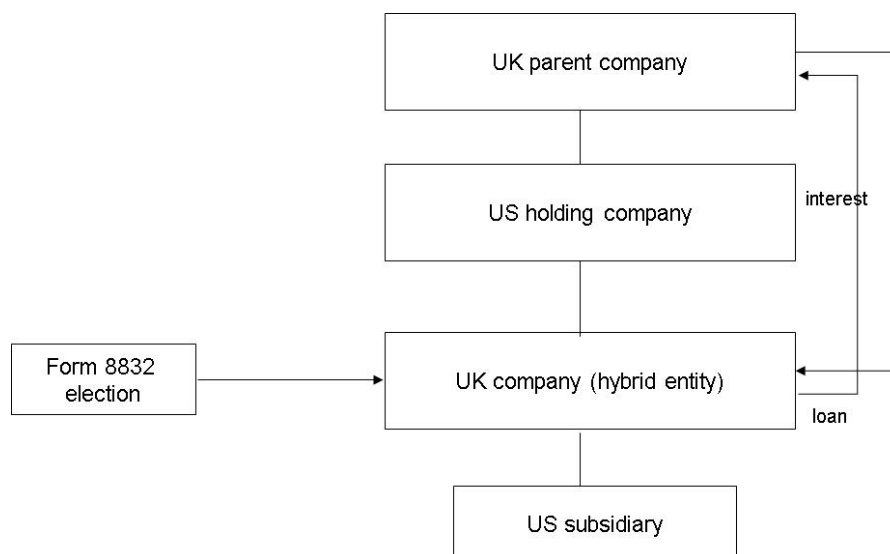


Source: Citi Research

Form 8832 election creates hybrid entity

An election would be made on Form 8832 for US tax purposes for this entity (the new UK company) to be “disregarded as an entity separate from its owner”. For UK tax purposes, the hybrid entity would be regarded as a normal company. However, due to the Form 8832 election, for US tax purposes, any transactions in the hybrid entity would be regarded as happening in its parent company, the US holding company. The UK parent company would then make a loan to the hybrid entity as shown in Figure 3. Interest would be paid from the hybrid to the UK parent company.

Figure 3. Tax planning structure using a hybrid entity



Source: Citi Research

Structure results in a tax deduction for interest on purely intra-group financing

The consequence of these actions for UK and US tax purposes would be as follows:

- The UK tax authorities would regard it as a UK company making a loan to another UK company within the same group.

- The interest income would be taxable in the UK but the interest paid would be tax deductible in the UK and the net result would be no taxable income in the UK.
- From the perspective of the US tax authorities, a US entity (US holding company) has paid interest to a UK company and this interest would be tax deductible.

In total, the interest income would be taxable **once** but the interest payment would be tax deductible **twice**; the global outcome is a net interest deduction for purely intragroup financing.

This can be used to substantially reduce the tax payable in the US for the US group. We have found many European companies with large US activities report substantially lower than expected tax rates, as shown in Appendix 2. We understand, from discussion with corporates and tax experts, that such structures are commonplace.

OECD wants to tackle such schemes, but may be risky for countries to act unilaterally

The OECD report suggests a number of ways in which this type of tax planning structure may be addressed, such as tax changes to deny a deduction for a payment that is also deductible in another jurisdiction. This may however be unattractive for many countries. For example, the UK recently significantly watered down its Controlled Foreign Company rules (which seek to limit the tax benefits associated with using entities in tax havens) due to UK companies relocating to Ireland, Switzerland, or other countries. It therefore seems unlikely, in our view, that the UK would act unilaterally to prevent a tax deduction for the interest payment in the above structure, because this might also encourage UK companies to move abroad for tax purposes.

Better Disclosure Needed

In Appendix 2, we have screened for companies with lower than expected tax rates, but we have not generally been able to establish the extent to which this reflects tax planning structures.

Very limited disclosure about tax planning structures

Companies are required by IAS 12 to provide disclosures that “enable users of financial statements to understand whether the relationship between tax expense (income) and accounting profit is unusual and to understand the significant factors that could affect that relationship in future” (IAS 12 paragraph 84). In our view, in many cases the tax reconciliation which is supposed to fulfill this requirement is wholly inadequate. For example, we suspect that the impact of tax planning structures has been included within reconciling line items such as “tax effect of items not recognised in consolidated financial statements”.

Although various commentators have identified the need to improve disclosure about tax by multinational companies, we think substantial progress could be made if companies provided tax reconciliations which fulfilled the spirit of the IAS 12 disclosure requirements, ie more disaggregated reconciliations with more meaningful descriptions of each line item, combined with some meaningful qualitative discussion of the extent to which a lower than expected tax rate is sustainable.

Appendix 1: OECD Tax Action Plan

Figure 4. Summary of the BEPS (Base Erosion and Profit Shifting) Action Plan

1. Address the tax challenges of the digital economy
2. Neutralise the effects of hybrid mismatch arrangements
3. Strengthen Controlled Foreign Company (CFC) rules
4. Limit base erosion via interest deductions and other financial payments
5. Counter harmful tax practices more effectively, taking into account transparency and substance
6. Prevent treaty abuse
7. Prevent the artificial avoidance of Permanent Establishment (PE) status
8. Assure that transfer pricing outcomes are in line with value creation: intangibles
9. Assure that transfer pricing outcomes are in line with value creation: risks and capital
10. Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions
11. Establish methodologies to collect and analyse data on BEPS and the actions to address it
12. Require taxpayers to disclose their aggressive tax planning arrangements
13. Re-examine transfer pricing documentation
14. Make dispute resolution mechanism more effective
15. Develop a multilateral instrument

Source: OECD. Note that the OECD foresees taking action on each point with deadlines ranging from September 2014 – December 2015.

Appendix 2: Low tax screens

We have screened for European companies with significantly lower than expected tax rates. We have taken the universe of European companies covered by Citi Research and identified those with low P&L tax rates (forecast and historical) compared to the expected tax rate, which is calculated using headline country corporate tax rates and each company's disclosed geographic allocation of revenues (from the most recent annual report). Where necessary we have estimated tax rates for regions (eg Europe) using GDP weightings. Figure 5 shows the screen based on forecast (1 year) P&L tax rates and Figure 6 shows the screen based on historical (5 year) P&L tax rates.

Clearly this is a very blunt tool and further investigation will be required on a case-by-case basis to determine the reason(s) for the low tax rate, which may not be due to tax planning structures. If you would like to receive the full spreadsheet, please email sarah.deans@citi.com.

Figure 5. Weighted average expected P&L tax rate compared to forecast P&L tax rate (1st forecast year)

Name	WAV expected tax rate	FY1E P&L tax rate	Difference	Name	WAV expected tax rate	FY1E P&L tax rate	Difference
Basilea Pharmaceutica AG	29%	0%	-29%	Straumann Holding AG	32%	17%	-14%
Renault SA	30%	1%	-29%	Senior	34%	20%	-14%
Lancashire Holdings	31%	3%	-28%	Tecnicas Reunidas	28%	14%	-14%
CIR - Compagnie Industriale Riunite SpA	30%	2%	-28%	Diageo	32%	18%	-14%
Algeta	28%	0%	-28%	RHI	31%	17%	-14%
3i Group Plc	29%	1%	-28%	Paddy Power	27%	13%	-14%
Lamprell	30%	2%	-28%	Cobham	34%	20%	-14%
Air France-KLM	30%	3%	-28%	Colt Group SA	28%	15%	-14%
Jazztel	30%	5%	-25%	APR Energy	32%	18%	-14%
Centamin Egypt Limited	25%	0%	-25%	DSM NV	28%	15%	-14%
Groupe Eurotunnel	28%	4%	-25%	Credit Agricole SA	31%	17%	-13%
London Mining	30%	5%	-25%	Lonza Group AG	32%	19%	-13%
Marshalls PLC	23%	0%	-23%	Ahold	34%	21%	-13%
Severn Trent PLC	25%	1%	-23%	GKN Plc	31%	18%	-13%
Big Yellow	23%	0%	-23%	GAM Holding Ltd	29%	15%	-13%
Seadrill	28%	6%	-23%	Geberit AG	27%	14%	-13%
BBA Aviation	35%	14%	-22%	Sampo Oyj	26%	13%	-13%
ASML Holding NV	27%	5%	-22%	Wolters Kluwer NV	33%	20%	-13%
STMicroelectronics	25%	4%	-21%	Micro Focus International Plc	34%	21%	-13%
Mediaset España SA	30%	9%	-21%	Pearson PLC	34%	21%	-13%
Randgold Resources Ltd	27%	6%	-21%	Richemont	30%	17%	-13%
AB-InBev	33%	13%	-20%	Continental AG	30%	18%	-12%
Novartis AG	34%	14%	-20%	Invensys	32%	20%	-12%
Lagardere Groupe	30%	11%	-19%	Amlin Plc	30%	18%	-12%
Sonova Holdings AG	33%	14%	-19%	Ryanair	25%	12%	-12%
Salzgitter AG	30%	11%	-19%	Catlin Group Ltd	25%	13%	-12%
UBM plc	32%	13%	-19%	Swiss Re	32%	19%	-12%
Portugal Telecom	30%	11%	-19%	Ladbroke	24%	12%	-12%
Zooplus	29%	10%	-19%	Givaudan AG	30%	18%	-12%
Delhaize	37%	19%	-18%	Daimler AG	32%	20%	-12%
Hiscox Ltd	32%	14%	-18%	Banco BPI	28%	17%	-12%
Carillion	24%	6%	-18%	Go Ahead Group	30%	19%	-12%
Actelion Ltd	33%	15%	-18%	Roche Holding AG	33%	22%	-12%
Infineon Technologies	30%	13%	-17%	Babcock	25%	13%	-12%
Freenet	30%	13%	-17%	William Hill	24%	12%	-11%
Tate and Lyle	37%	20%	-17%	Meggitt Plc	33%	22%	-11%
Henderson Group Plc	25%	8%	-17%	Bank of Ireland	21%	10%	-11%
Drax Group Plc	23%	6%	-17%	Yara International	31%	20%	-11%
QinetiQ	31%	15%	-16%	CRH PLC	31%	20%	-11%
Nyrstar NV	29%	13%	-16%	Regus	31%	20%	-11%
SES S.A.	29%	13%	-16%	Investec PLC	30%	20%	-10%
Sanofi SA	33%	17%	-16%	Wolfson	30%	20%	-10%
Dufry AG	34%	18%	-16%	Sorin	32%	22%	-10%
Banco Bilbao Vizcaya Argentaria SA	31%	15%	-16%	Zurich Airport	30%	21%	-10%
Akzo Nobel NV	29%	14%	-16%	Ipsen	30%	20%	-10%
Syngenta AG	34%	18%	-16%	Moneysupermarket	23%	13%	-10%
Ziggo N.V.	25%	10%	-15%	Swedish Match AB	29%	19%	-10%
Genel Energy	15%	0%	-15%	Alstom	30%	20%	-10%
EFG International	28%	13%	-15%	Husqvarna	32%	22%	-10%
Ferrovial, S.A.	27%	13%	-15%	Kingspan	26%	17%	-10%

Source: dataCentral, DataStream, IMF, KPMG. Citi Research analyst forecasts of P&L tax rates. Forecast data as of 25 September 2013. We have excluded companies with forecast tax rates that are negative.

Figure 6. Weighted average expected P&L tax rate compared to historical P&L tax rate (5 year total)

Name	WAV expected tax rate	5Y actual P&L tax rate	Difference	Name	WAV expected tax rate	5Y actual P&L tax rate	Difference
Reed Elsevier NV	32%	1%	-31%	Legal & General	30%	14%	-17%
Intercontinental Hotels Group Plc	31%	0%	-31%	Dufry AG	34%	18%	-16%
Carphone Warehouse	30%	0%	-30%	Banca Monte dei Paschi di Siena SpA	30%	15%	-16%
Lamprell	30%	1%	-30%	Seadrill	28%	13%	-16%
Lancashire Holdings	31%	2%	-29%	Actelion Ltd	33%	17%	-16%
Randstad	31%	2%	-29%	Swiss Re	32%	16%	-15%
Infineon Technologies	30%	1%	-29%	BBA Aviation	35%	21%	-15%
SCOR	31%	3%	-29%	Sanofi SA	33%	18%	-15%
Kabel Deutschland	30%	1%	-28%	Aviva PLC	27%	13%	-15%
Royal Bank of Scotland Group PLC	29%	1%	-28%	Ahold	34%	20%	-15%
UCB SA	33%	6%	-27%	Meggitt Plc	33%	19%	-14%
ATRESMEDIA	30%	3%	-27%	Randgold Resources Ltd	27%	13%	-14%
Thales	31%	4%	-27%	Richemont	30%	15%	-14%
Commerzbank	30%	3%	-26%	Invensys	32%	18%	-14%
London Mining	30%	4%	-26%	Husqvarna	32%	18%	-14%
Informa PLC	32%	6%	-26%	Drax Group Plc	23%	9%	-14%
Spirent Communications Plc	34%	9%	-25%	Carillion	24%	9%	-14%
Tate and Lyle	37%	12%	-25%	Banco Bilbao Vizcaya Argentaria SA	31%	17%	-14%
Lufthansa	29%	4%	-24%	Greene King	30%	17%	-14%
Banco BPI	28%	5%	-24%	Melrose	32%	18%	-14%
KBC	30%	6%	-24%	Belgacom SA	34%	21%	-13%
Trinity Mirror PLC	23%	0%	-23%	Firstgroup PLC	29%	16%	-13%
Groupe Eurotunnel	28%	6%	-22%	Micro Focus International Plc	34%	20%	-13%
Banco Popolare	31%	9%	-22%	Diageo	32%	19%	-13%
Wienerberger AG	25%	3%	-22%	Gottex Fund Management Holdings Ltd	14%	1%	-13%
Callin Group Ltd	25%	3%	-22%	Wolters Kluwer NV	33%	20%	-13%
ERG Group	30%	8%	-22%	Paddy Power	27%	14%	-13%
SES S.A.	29%	8%	-22%	Cobham	34%	21%	-13%
Glencore Xstrata PLC	29%	8%	-21%	ING Groep NV	31%	19%	-13%
Porsche Automobil Holding SE	30%	8%	-21%	AB-InBev	33%	20%	-13%
Mediaset España SA	30%	9%	-21%	Roche Holding AG	33%	20%	-13%
Experian	32%	12%	-21%	Ryanair	25%	12%	-13%
SSAB	31%	11%	-20%	Enel Green Power	32%	19%	-13%
ITV PLC	24%	4%	-20%	PGS	31%	18%	-13%
RHI	31%	11%	-20%				
Sonova Holdings AG	33%	13%	-19%	Prudential Plc	31%	19%	-12%
Amlin Plc	30%	11%	-19%	Senior	34%	22%	-12%
Hiscox Ltd	32%	13%	-19%	AXA SA	31%	19%	-12%
Inmarsat plc	32%	13%	-19%	Babcock	25%	13%	-12%
Novartis AG	34%	15%	-19%	Telenet Group Holding NV	34%	22%	-12%
Ipsen	30%	11%	-19%	Smiths Group	34%	22%	-12%
Lonza Group AG	32%	14%	-19%	Volkswagen AG(pref)	29%	18%	-12%
GKN Plc	31%	13%	-18%	Tecnicas Reunidas	28%	16%	-11%
GAM Holding Ltd	29%	10%	-18%	Straumann Holding AG	32%	20%	-11%
ASML Holding NV	27%	9%	-18%	Air France-KLM	30%	19%	-11%
Balfour Beatty	30%	12%	-18%	Investec PLC	30%	18%	-11%
Banco Espirito Santo	30%	13%	-18%	Banco Santander	30%	18%	-11%
Deutsche Bank	30%	13%	-18%				
Syngenta AG	34%	16%	-18%	Marston's	23%	12%	-11%
Sonaecom	25%	8%	-17%	CRH PLC	31%	20%	-11%

Source: DataStream, IMF, KPMG. Historical annual report data retrieved 25 September 2013. We have excluded companies with forecast tax rates that are negative or where five years of historical data was not available.

Notes

Notes

Appendix A-1

Analyst Certification

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