Stewart Investors
Sustainable Funds Group

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Tax Approaches

Second Quarter 2016

“To our simple freight forwarder mentality, the difference between the exorbitant amounts of money required to pay the ‘gaggles of accountants and prides of lawyers’ to perpetuate the Byzantine and complex, wildly intricate, tax avoidance schemes and the amount of taxes you’d pay if you just did straight forward, reasonable tax computations isn’t worth the anxiety of what will happen when laws or interpretations change.”

Chairman of one of the world’s leading freight forwarders

We consider the tax rates paid by companies that we might invest in on behalf of our clients important because it impacts our assessment of Quality of Management, Franchise and Financials.

Firstly, given the range of legal and accounting gimmicks available to companies, we view the effective tax companies pay these days as voluntary. One of our favourite examples comes from the US, where Toys R Us set up a Delaware holding company to reduce its tax burden. This scheme involved registering the corporate mascot, Geoffrey the Giraffe, as an asset of that Delaware entity and then charging every store in the US a royalty for its use, effectively shifting profit to that low-tax jurisdiction.

Since tax rates are something of a choice, they can thus be a very useful metric to help us evaluate Quality of Management. We believe that a management team that goes to lengths to minimize tax is cutting a corner in order to boost profits in the short-term at the expense of the long-term. This might also indicate they are likely to do the same elsewhere in the business, whether that be manifested as a safety issue, a balance sheet risk or an accounting scandal that would have severe impacts on long-term returns.

Secondly, we believe tax forms part of a company’s obligation to society. In our view, each company must earn and nurture its social license to operate. This is done through providing socially useful products and services, acting in a responsible way and looking after all stakeholders not just shareholders. We have seen time and again companies endanger their license to operate through gross negligence of the environment, wilful damage to public health, and deceptive marketing practices; it often results in more onerous regulation, loss of trust of customers, and legislative obstacles to continuing that business model. Tax is the most visible and quantifiable way a company can be accused of failing in its broader duty to society. Yet we continue to meet with company executives who obsess about lowering their tax rate as far as is possible.

In the context of increasing societal pressure on corporates to pay their fair share, we feel that any company aggressively avoiding tax risks endangering their social license to operate and thus long-term returns for shareholders. In contrast, we were particularly struck by the CFO of a family-owned building materials company which originated over 100 years ago in Zug, one of the lowest tax cantons of Switzerland. This steward felt that “it would be silly to take a short-term view on these things as governments will eventually get it back from you.” While it would have been very easy to transfer profit home to Zug, with a tax rate of 15%, the company understands that paying reasonable tax is part of earning the right to do business in the many countries it operates in, and so has paid on average 28% over the last five years.

Lastly, we consider a low tax rate to be a very material risk to earnings. A number of years ago we ranked Indian pharmaceutical companies on tax rate paid. We were attracted to the companies paying the highest tax rates. This was because those companies have materially lower risk income statements. India has a fiscal deficit, dire infrastructure and millions of malnourished people; its most globally competitive companies routing profits through Mauritius is unlikely to be tolerated in the long-term. Those companies avoiding tax and paying far below the statutory rate are likely at some point to be forced to comply, meaning the prompt loss of up to 30% of profits! We do not want to be holding shares in those companies for our clients when that happens. For all of these reasons, we continue as a team to monitor tax closely as an issue across the companies that we consider investing in on behalf of clients. We use it as a tool in our analysis and have commissioned bespoke research pieces to look in depth at how listed consumer businesses are able to shift profit to mitigate tax, with an emphasis on identifying those paying a reasonable rate. We continue to actively engage with management where we feel there are issues on tax, to convey the message that as long-term shareholders we would prefer they pay a reasonable rate and sacrifice some profits today in order to protect the business and its profits in the future.

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