COMMENTARY

April 23, 2021

**Dear Clients and Colleagues:**

Governments around the world are incurring record deficits to sustain their economies during the COVID-19 pandemic. These deficits are expected to persist, as revenue will be needed to rebuild infrastructure and support an aging population.

Benjamin Franklin, the inventor, philosopher, politician, and one of the founding fathers of the United States, famously said: "In this world, nothing can be said to be certain, except death and taxes." Yet, in 2018, a record year for corporate profits levels, 91 Fortune 500 companies paid no federal income tax; among them, companies such as Amazon, Netflix, Chevron, GM, and Delta. Even more, their tax rate was -5%, meaning they got a tax refund.[1] The 379 profitable Fortune 500 members paid an effective federal tax rate of 11.3%, almost half of the 21% tax rate established in the 2017 tax revamp. That represented a missing $73.9 billion worth of tax revenue for the federal government. As a result, in 2019, the Organisation for Economic Co-operation and Development (OECD) formally established base erosion and profit shifting (BEPS).

## What is BEPS?

"BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity or to erode tax bases through deductible payments, such as interest or royalties. Although some of the schemes used are illegal, most are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when taxpayers see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers."[2]

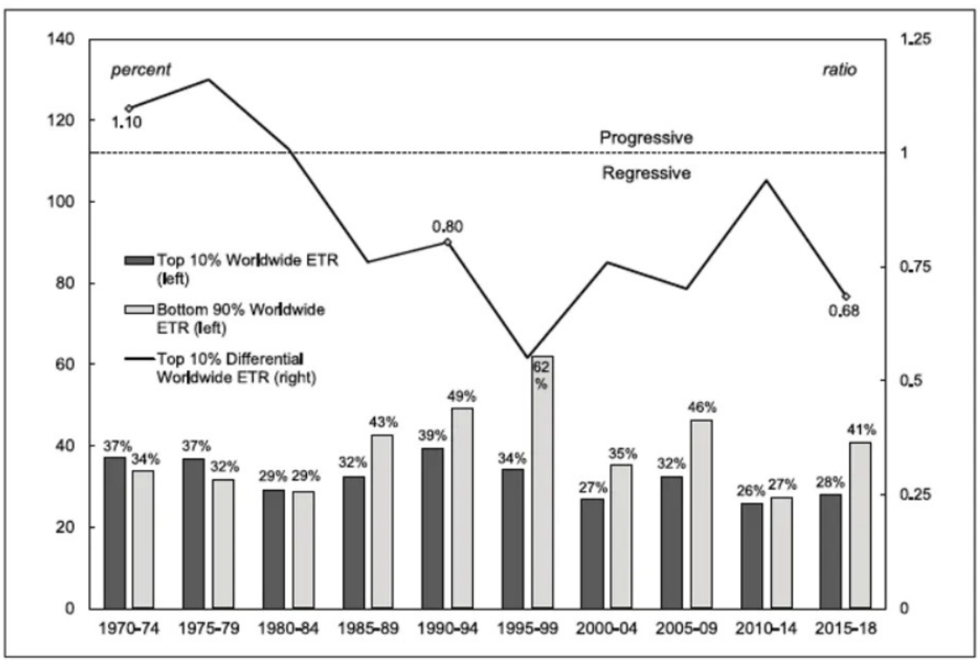
"BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises. Engaging developing countries in the international tax agenda is important to ensure that they receive support to address their specific needs and can effectively participate in the process of standard-setting on international tax."[1]

[1] https://www.cnbc.com/2019/12/16/these-91-fortune-500-companies-didnt-pay-federal-taxes-in-2018.html
[2] https://www.oecd.org/tax/beps/about/

The digital economy giants have been very apt at using BEPS. Looking at cash taxes paid globally by FAANG stocks in 2019/2020, according to Global Alpha's estimates, Facebook paid 12.75%, Apple 14.4%, Amazon 7%, Netflix 7.3%, and Google 11.9%. As an example of BEPS, Google declared $23 billion in revenues in Bermuda in 2017[3]. Until 2015, Amazon was able to declare all its European revenues in Luxembourg.

The significant tax drag caused by these large multinationals was a major issue in negotiations over tax reforms at the OECD, since they were largely US corporations. The stalemate brought many local governments, such as Australia, the United Kingdom (UK), and France, to impose a local tax based on revenues earned in their respective country. That brought retaliation from the US by taxing imports from these countries.

Worldwide effective tax rates




Source: Compustat/Wharton Research Data Services. Sandy Hager/Joseph Baines

[3] https://www.reuters.com/article/us-google-taxes-netherlands-idUSKCN1OX1G9

This graph shows that in the 1970s, the largest corporation paid slightly higher tax rates than smaller ones. By the early 80s, the situation reversed, and the unfair advantage of larger companies has amplified since.

Why should we care? The tax system encourages businesses to consolidate and grow bigger. With a risk, they may abuse their market dominant position. The discussion until recently was concentrating on anti-trust measures. Companies like Amazon, Google and Facebook are currently being investigated by various government entities using anti-trust laws. As the case against Microsoft in 2001 demonstrated, it is hard to win a case against multinationals as current anti-trust regulations focus on the price paid by consumers. Anti-trust cases are overly complex and may take years before reaching a conclusion. Studies show that a minimum corporate tax would be a more effective way to ensure fairness and stable government revenues.

In the last few weeks, US President Joe Biden and his secretary of the Treasury, Janet Yellen, former Federal Reserve chairwoman, have proposed an ambitious plan to arrive at a global framework on taxation, which would stop the race to the bottom and allow countries to fund their needed services to their population.

The Biden tax plan includes the following proposed business tax changes:

- Increase the corporate income tax rate, from 21 to 28 percent.
- Create a minimum tax of at least 15% on corporations with book profits of $100 million or higher.
- Double the tax rate on global income earned by subsidiaries of U.S. firms, from 10.5 percent to 21 percent.

Immediately, countries around the world, like France, Canada, Germany, Japan and many others, welcomed the idea. President Biden went further in supporting the idea of a local tax based on local revenues. There is a high likelihood that OECD negotiations may finally reach a new global tax accord by the end of this summer.

**What would be the impact on stock markets?**

First, we think the large cap US benchmarks would be most negatively affected, as they incorporate most of the large digital companies, which as explained above, have been the biggest users of BEPS. The S&P500 sells at a record price-to-sale ratio and at an extremely high 24x 2021 earnings. Increasing the tax on these earnings by 25% would mean a ratio above 30 times, which is unprecedented. That compares with a ratio of 17 times for the MSCI EAFE index (ex: North America).

Smaller companies, as discussed, pay a much higher tax rate. The impact of revised tax rates will be much smaller. The MSCI EAFE small-cap index sells at 17.9 times 2021 earnings. In addition, the MSCI World small-cap index, which includes the US and Canada, sells at 18.8 times 2021 earnings. The impact should be less for smaller companies, which should drive outperformance. Another aspect that we should mention is the increased importance of ESG in investment decisions.

The environmental impact and carbon footprint of companies is now an important topic for investors. We believe that aggressive tax planning and avoidance may very soon become another important factor that investors may look at.

Have a good day.

The Global Alpha Team