2020: An inflection point in global corporate tax?

#PositiveImpact
1. State finances are precarious yet companies are in great shape. That is partly because corporate tax rates have almost halved over several decades. Prominent US and European politicians have made higher corporate taxes over the medium term a key part of their election platforms.

2. Over 100 countries are working on OECD proposals for a globally coordinated model of corporate taxation. Corporates may have to pay tax in each country where they have activities and minimum tax rates may apply. Agreement on the next stage is due in 2020.

3. To prepare for higher taxes in the medium term, corporates should consider their strategies around decentralisation, capital expenditure, mergers and acquisitions, and changing performance metrics to prioritise ‘return on assets’.
Abstract

Just as the world has a debt problem, it also has a corporate tax problem. State finances are becoming increasingly precarious, yet while companies are in great shape, the headline tax rates they pay have almost halved in rich countries over the last three decades.

The conditions appear set for an inflection point over the medium term. Politicians with higher corporate taxes in their sights are gaining in popularity – Elizabeth Warren in the US is just one example. Meanwhile, the incoming President of the European Commission, Ursula von der Leyen, says she will target firms that “play our tax system.”

Key events over the coming 12 months will be closely watched and will help determine whether there will only be a risk of a slow reversal in a near 40 year trend of lower taxes or a more abrupt change to the corporate landscape. These include next year’s US presidential election. Similarly, the upcoming UK election will be fought by the opposition Labour Party with a platform of higher corporate taxation. Also key will be the OECD’s proposals for global tax coordination which it aims to have approved in 2020. They include calls for a minimum corporate tax rate1.

Some argue that actually implementing higher corporate taxes will be too politically difficult and, in countries like the US, require too much cross-party consent. These concerns are valid, however, it is the direction of travel that is important. 2020 may end up being a near miss on many of these big events but if momentum builds towards support for politicians who advocate higher corporate taxes and towards the OECD proposals, we could still be at a turning point.

Indeed, corporates should carefully watch progress on the OECD proposals for a globally coordinated corporate tax regime. This will require companies to pay tax in every country in which they sell goods, not just the countries where they have a base. Some US cities have already taken up this baton and levy their own additional taxes on corporates. In the EU, similar pressure is building. Over the medium term, global tax coordination should lower the incentive for countries to ‘compete’ with each other on corporate tax rates. As a result, it will become easier, both politically and practically, for countries to raise corporate taxes without having to worry about scaring away future investment.

There are several things corporates can do to prepare for higher taxes. The first is to consider both domestic and international decentralisation. This may include establishing or boosting resources in countries outside their home base. Second, capital expenditure strategy may change if corporate tax rates rise in different countries at different times. In addition, insourcing may be optimal, while medium-term merger and acquisition targets and timing should be considered.

Finally, companies should consider changing performance metrics. A globally-coordinated new tax regime will encourage higher capital intensity. That makes it critical that companies focus on reversing the two-decade decline in their return on assets.

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Some see it as odd that just as the world has a debt problem, it also has a corporate tax problem. This apparent dissonance means that the state of government finances, new international tax laws, and the increasingly vocal populist mood, are seeding the conditions for higher corporate tax rates over the medium term – a reversal of the multi-decade trend.

The pressures of global debt are made all the more worse by low levels of economic growth, particularly in developed countries. In addition, stubbornly-stagnant inflation is keeping interest rates at depressed levels, and low productivity growth remains the great economic mystery of recent decades. And that is before considering that most developed countries face demographic problems that may have a terrifying impact on pension and healthcare costs that have to be funded somehow.

Even if interest rates stay low or fall, many developed countries can expect their debt to continue to rise. The following charts show various scenarios for the US and UK that point to an inevitable rise in the government’s debt stock even under very advantageous conditions.

Yet, while countries’ debt has been increasing and economic conditions worsening, many countries have been cutting corporate tax rates (as shown in the following chart).

**Race to the bottom**
Corporate income tax rates have fallen significantly over the past three decades. (combined corporate income tax rates by country group, in percent)

Of course, the above chart is based on headline tax rates and most companies pay less than this. However, decreases in the headline rate do have a flow on effect to a government’s overall corporate tax take. The below charts show the effects for the US and UK. Most notably, the US tax cuts from late 2017 are quite visible.
Corporates are in good shape – that puts them in the spotlight

Despite, and partly because, of the tax breaks corporates have received over the last few decades, they are generally in relatively great shape. As the following charts show, US corporate profits have comfortably outstripped economic growth and wages. Similar trends exist in many other developed countries.

Partly, corporates have experienced outsized growth due to the decrease in competition that has occurred over the last few decades. In particular, the US has witnessed a trend of declining entrepreneurship. Firm entry rate (new businesses formed each year as a proportion of the existing number of total businesses) has been declining for over 30 years and has halved from nearly 15 per cent in the late 1970s to eight per cent more recently.

Along with declining start-up rates, consolidation among existing players has reduced competition. In the mid-1980s, the US issued a revised set of merger guidelines that loosened the criteria used to evaluate consolidation deals from an anti-trust perspective. What has resulted is an increase in industry concentration across a whole host of sectors. Census data show the proportion of manufacturing sectors where the top-four firms control over half the market rose from 30 per cent in 1992 to 40 per cent in 2007. No wonder firms’ net profit margins have continued to grow.

Source: Haver Analytics
Political support for higher corporate taxes

Corporations have become a rallying point for some politicians and activists. Elizabeth Warren, who has become a leading Democratic candidate for next year’s US presidential election has proposed that companies should pay additional tax on every dollar above $100m that a company reports in profits. Warren estimates this will raise $1tn over the coming decade. She has also discussed boosting the tax rate on foreign earnings to 35 per cent, and expanding Medicare with taxes on corporates and high-income individuals.

Of course, if President Trump wins re-election, it is likely the current status quo of corporate tax will remain for now. It is true that Trump has discussed a second round of tax cuts but a formal plan has not been nailed down and, in any case, the chance of passage is low as long as the Democrats keep control of the House. That said, there are some reasons why President Trump may agree to the principles of a globally-coordinated corporate taxation system as we discuss below.

The UK is seeing similar political rhetoric. Just weeks away from the December general election, the opposition Labour party is running on a platform of higher corporate taxation. The party claims this will be good for British business as multi-nationals will not have a cost advantage due to their lower tax expense. Ahead of the election, polls indicate Labour’s Jeremy Corbyn is unlikely to become prime minister, however, the current strength of his support highlights how changes could be made to the current low-tax regime. Separately, the Liberal Democrats have also proposed a higher corporate taxation rate.

In continental Europe, the incoming President of the European Commission, Ursula von der Leyen, has said that businesses will have to pay more tax. She has singled out digital businesses and other brick-and-mortar industries that “play our tax system.” Specifically, she believes that where firms benefit from “our education system, our skilled workers, our infrastructure and our social security … they have to share the burden.”

Despite the calls from opposition politicians for higher corporate taxation, some argue that actual implementation will be too politically difficult. For example, major change to the US tax code will likely require support from both the House and the Senate. Alternatively, attempts to raise corporate tax could also run up against the concerns of those who fear higher corporate taxes will make the country less attractive to foreign investors.

These concerns are valid, however, it is the direction of travel that is important. If politicians who advocate higher corporate taxes are gradually elected, the public support on which they ride will make it increasingly difficult for opponents to dissent. Furthermore, if small, iterative change is gradually implemented, and the result is not an exodus of corporates overseas, then the fears of such will be lessened. Further change could then be hastened.

Some also argue that a globally-coordinated tax system (such as the OECD proposal, discussed below, which will raise corporate tax bases) cannot function without US support, and that may not be forthcoming given it will subject some US companies to higher foreign taxes. After all, when France moved to implement a digital tax, which would have affected US technology firms, President Trump threatened economic retaliation.

Yet, in some cases the US may be a net beneficiary. The OECD’s proposals discussed in the following section may allow the US to levy a minimum level of tax on global profits if foreign profits are kept in a non-agreement jurisdiction. This would be a net benefit to the treasury.

Furthermore, President Trump has also indicated he is willing to consider the concept of higher or broader taxes on technology companies. True, he has also said the US should be the country implementing the taxes. But while the US may lose some taxing rights for its companies that make sales abroad, the Treasury will also consider what it can gain. The potential here has already been illustrated by critics of the OECD proposal. Their analysis argues that advanced countries will be the biggest beneficiaries of a globally-coordinated corporate tax system, and thus, richer countries will be incentivised to back the proposals (detailed country-level data is not available).
Bear in mind that a tax increase does not necessarily have to come from merely raising the headline corporate tax rate. In the US, various indirect taxes have been discussed including a tax on foreign investment, potentially in the form of a withholding tax. Some argue this will lead to a beneficial depreciation in the dollar. If enacted, this type of tax could lead to an increase in the cost of capital over the medium term. Furthermore, tax increases could be generated by widening the tax base.

Popular support has already contributed to change. Take inversions, where a parent company becomes the subsidiary of a foreign firm in order to change its tax residency. Around the time Burger King announced its $12bn inversion to Canada in 2014, using Tim Hortons as a vehicle, public awareness intensified. Consequently, new rules and legislation disincentivised inversions even before the 2017 tax reform reduced the benefits. Since the recent tax reform, though, a new level of concern has arisen, particularly after the jump in share buybacks that followed.

Some cities have already implemented new corporate taxes. Last year, the city of Portland in Oregon increased the tax rate for business licenses if the chief executive of the company is paid more than 100 times the median employee.

There are two reasons why other cities or states (in the US or elsewhere around the world) may follow Portland’s example. The first is that many are in a tight fiscal position and if a corporate tax hawk is elected at next year’s presidential election, they will likely add to the momentum to impose additional corporate taxes.

The second reason why cities, states, and countries, will be less afraid to raise corporate tax is that the assumption that low corporate taxation benefits the wider economy is being increasingly questioned. A growing body of evidence shows that tax cuts do not provide the expected boost to revenues in the medium term. Of course, there are arguments for the opposite but the point is that the benefit of tax cuts are being increasingly questioned.

Social media has fuelled public involvement and protest tactics have increasingly focussed on an organisation’s financials. A tangential example comes from Deutsche Bank research\(^2\) which shows that, over the last 12 months, one-third of Americans and Britons have boycotted a company after seeing a post on social media about that company’s detrimental environmental policies.

It is true that many corporates are responding to public pressure to be more socially aware. The recent decision by the US business roundtable to ditch the “shareholder first” mantra is just one example. But the pace of public activism, fuelled by technology, is far greater than the pace of the corporate response.

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2 [https://www.dbresearch.com/PROD/RPS_EN-PROD/PROD00000000000500285/Climate_change_and_corporates%3A_Past_the_tipping_point.PDF](https://www.dbresearch.com/PROD/RPS_EN-PROD/PROD00000000000500285/Climate_change_and_corporates%3A_Past_the_tipping_point.PDF)
Those who are unconvinced that corporate tax rises are on the horizon should look to the tax reform proposals from the OECD in early October. Indications are that these have the backing of the leading economies in the organisation – in-principle agreement from the G20 will be sought by January 2020. A minimum corporate tax rate has also been proposed. The IMF has also issued proposals to limit international profit shifting.

The OECD’s work has broad support. The 129 members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting agreed in May this year to push ahead with the work for the proposal. That means corporate tax may look very different in the medium term. First, it will be increasingly coordinated at a global level. That is to say, individual countries will take up the right to tax company activities even if the company has no physical presence in the country. The problem with most countries’ current tax regimes has been well-known for some time. The principles behind tax rules were created at a time when a physical presence was required to operate in a country. Globalisation, communications, and digitalisation have changed that.

This new tax regime does not just apply to digital companies, although they will certainly see a significant financial effect. Any company that is “consumer facing” or sells a good into another country from a base elsewhere will see an impact (there are some carve outs, for example, extractive industries). Essentially, the “nexus” between the company and its liability for the new tax regime will be largely based on sales, even though the tax will be applied to “residual profits” after appropriate cost allocations are made. Enforcement may be made via a withholding tax.

There are some who say that reallocating taxes is a zero-sum game and thus, as some countries will win and others will lose, there will never be agreement to implement globally-coordinated tax policies – which would have to happen simultaneously across countries. There are three reasons why countries are incentivised to implement this tax.

The first is that the new regime will not necessarily be a zero-sum game. Some corporates will simply have to pay more tax. And many of the largest countries stand to benefit – this is something even opponents of the OECD’s scheme admit. It is true that some low-tax countries may lose some tax revenue but if the largest, richest countries support the initiative, the momentum will be hard to stop.

Second, some of the largest, most affected companies support it. Amazon itself has said the system is “an important step forward”. Of course, some companies may make similar noises simply to promote good public relations but that only gives weight to our earlier point that public opinion is an increasingly powerful voice in corporate debates.

Third, and perhaps most importantly, the new regime will lessen the competitive pressure that exists between countries to lower their tax rate. As corporate profits will be taxed in the country in which the business activity takes place, it should (in theory) matter little where a company has its headquarters or legal domicile. Without the pressure to be ‘competitive’ on corporate tax rates, politicians will not only find it very easy to respond to the electorate’s request for higher corporate tax, but they will also likely be boosting government coffers without the risk of companies threatening to move countries and export local jobs.

How corporates can prepare for higher corporate taxes

There are several steps companies can take to prepare for higher corporate taxes, both in the country they are headquartered, and in the countries in which they sell their product.

1) Set up a physical presence in key countries

Whether countries eventually adopt the globally-coordinated proposals of the OECD, IMF, or other political organisations, multinational companies will face a taxation system that revolves around allocating corporate profits to the countries in which they do business. As a consequence, it may make sense for companies to consider opening or boosting their physical presence in these countries.

Boosting physical presence has obvious associated costs, however, there are financial benefits that will help offset this cost. For starters, it will allow the company to determine its own level of costs in a particular country. This is crucial as the firm will otherwise have to allocate more uncertain imputed costs to determine its taxable income. With imputed calculations, there is a higher likelihood of disputes with local tax offices. Furthermore, as the tax benefits of not having an office in a country in which the firm does business will no longer apply, a firm can benefit from being closer to its customers. It will also find it easier to hire local employees who understand customers better than people working in a remote office.

It will not make sense for all firms to boost their physical presence in every country in which they operate. For example, companies that are pure digital distributors may find the cost of opening an office cannot be offset, to a meaningful degree, by the tax certainty it will offer.

Yet, there are many companies that are already considering decentralisation and, for them, the additional benefits of tax certainty could hasten the process. Indeed, almost two-thirds of business leaders predict a shift towards a more decentralised business model over the next 12 months, according to research cited by Deloitte. Another survey found that three-quarters of global organisations are moving towards a more decentralised structure and devolving autonomy to various operating units.

Aside from the centralise/decentralise trends, the fashion for which has oscillated over the course of several business cycles, the threat of government protectionist policies is a key motivation for decentralisation. This may be seen as a ‘tail risk’ in some jurisdictions, but there increasing awareness about how quickly this can change. Consider that in 2012 after the re-election of President Obama and the London Olympics, the US and UK were generally seen as being flag bearers for liberal trade and globalisation. Just four years later, these policies in both countries witnessed dramatic change.

Politicians have also become increasingly keen to promote ‘local jobs’ – something a globally-coordinated taxation system could enable. In some cases, firms that operate in a country, but have little in the way of infrastructure of employment on the ground, have been singled out by governments. Others have unwittingly found themselves the subject of media attention, particularly about the amount of tax they pay to a certain country.

2) Decentralise within countries

It is not just decentralising to different countries that firms should consider. Given cities, such as Portland, have implemented tax increases on companies, and more cities will certainly follow suit, a firm may diversify its risk by opening offices in multiple cities within the same country. This is not to suggest firms should engage in ‘tax arbitrage’ between jurisdictions. Rather, it is to guard against the risk of having one large hard-to-move headquarters within the city’s jurisdiction. If, instead, the firm has multiple bases around the country, a future, populist city leader may be less motivated to impose punitive levels of corporate tax on firms it knows cannot move easily.

For all these reasons, planting more decentralised, local offices is becoming a key consideration for firms, particularly those with a global presence, despite the additional risks that can arise from delegating decision making and risk control functions.
3) Consider capital expenditure strategy

Many countries offer accelerated up-front tax deductions for capital expenditure. This tax break was most recently displayed in the US when the corporate tax cut in late-2017 was accompanied by additional up-front tax breaks for investment. In some cases, companies can deduct the entire cost of an item of plant and equipment in the year of purchase. That compares with claiming the expense on taxes for five or more years under the old rules.

In most countries, the higher the corporate tax rate, the higher the tax deduction on capital expenditure. That means that a firm taking a tax deduction now may be missing out if corporate tax rates rise in the near future. So, firms with plans for large capital outlays that allow for up-front tax deductions should consider the timing of this investment. Of course, the timing of our predicted higher corporate tax rates is uncertain. Also uncertain is the order in which countries may raise their rates. What we can watch out for, though, is the consensus that appears likely to emerge by January 2020 on the OECD’s tax proposals. Timing indications will help companies decide their own timing of future capital investments. The decision on rolling out new offices should also consider the tax deductibility of capital expenditure.

4) Consider medium-term merger and acquisition strategy

When the US cut taxes in late-2017 many expected a jump in M&A activity and, particularly, carve outs. The theory went that lower taxes would allow companies to crystallise gains at a lower tax rate. It did not work out this way. One reason put forward for the muted uptick in M&A activity that was experienced was the low cost of funding. As it was (and remains) very cheap to raise debt, many companies took the option to increase their leverage rather than generate cash through selling assets.

However, in a world with more normalised bond yields, the level of the corporate tax becomes a much greater consideration for M&A. Companies may find it beneficial to prepare by earmarking their divisions that would otherwise be considered for sale if it were not for low funding costs. As periods in 2013 and 2016 showed, bond yields can climb unexpectedly fast. Should higher corporate taxes be announced, preparation will be key to a successful asset divestment before higher rates kick in.

5) Insourcing of previously-outsourced business functions

The OECD proposals to add more global coordination to tax are based on taxing “residual profit” and not the “normal profit” on routine assets. Therefore, a business may wish to insource currently-outsourced functions, particularly in foreign jurisdictions. This will help the firm drive the conversation in calculating the “routine profit” from “routine assets”.

The issue here derives from the fact that many firms gain cost efficiencies by outsourcing certain business functions, used by various offices around the globe, to a single service provider based in one country – usually the country in which the firm has its headquarters. The costs for these services can be difficult to apportion to different countries. Thus the potential exists for the tax authorities in two different countries to both make different calculations of allocated costs. This will leave the firm stuck in the middle. Of course, there will be dispute resolution mechanisms but for the amount of management time and effort, not to mention potential interest payments and/or fines, firms may find it easier to calculate their allocated costs by simply having them in individual countries.

6) Adopt corporate strategy to include fewer efficiencies

While decentralisation will unwind some cost efficiencies, there are many non-financial factors that must be considered. Many involve staff. For starters, the workforce and team structures will change as staff are sent or hired outside the firm’s headquarters. That will involve the rearrangement, or partial dismantling, of the shared service centres many firms operate for functions including, finance, technology, procurement, human resources, and others.

Technology strategy will become particularly important as a decentralised system can increase the risk of malicious attacks, as well as the risk that systems in different locations will not maintain consistent standards, versions, or levels of interoperability.
A third issue concerns the threat to company culture from operating disparate offices. This is not just how people think and feel about the company. It extends to the potential inefficiencies that can result from inconsistency in how things are done. The potential for legal and compliance risk also increases.

7) Change performance metrics

As a result of the suggestions above, it is very likely that some companies will change their business models somewhat to become more capital intensive. This will be a big change. The following chart shows the capital intensity of US firms has more than halved over the last two decades (where capital intensity is tangible non-current assets as a proportion of total assets).

### Median non-current tangible assets as a proportion of total assets

While falling capital intensity has certainly been the vogue business model over the last few decades, it does not automatically follow that rising capital intensity is a bad thing. That said, it will certainly be a bad thing if firms and investors do not adapt their performance metrics and thus the behaviour by which managers are incentivised.

A metric that is currently ignored, but will be absolutely critical as capital intensity rises, is return on assets – sales as a proportion of assets. The following chart shows how RoA has been falling for the last couple decades. A lack of management focus on RoA is a key reason why some firms have underperforming returns on equity (see our piece “The alpha in asset turnover”).

### Median asset turnover excluding cash

Managers have escaped scrutiny of their RoA as they have propped up company returns with both additional leverage and higher operating margins. But as these two avenues for return are largely exhausted, scrutiny will return to RoA. And that scrutiny will only be amplified as business models become more asset heavy.