# The Effective Corporate Tax Rate («ETR»): Quo Vadis?

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## 1. Introduction

The Effective Tax Rate («ETR») is a figure presented in consolidated financial statements of annual reports. It is calculated as Total Tax Expense (i.e. current and deferred) divided by Earnings Before Tax («EBT»). ETR shows the overall (global, blended) income tax burden of a Multinational Enterprise («MNE») in the reporting period. Often, Boards' audit committees want to benchmark their own ETR against its peers operating in the same business and understand both positive and negative factors influencing its height. This article explains, which aspects should be considered, when determining the targeted ETR. The following figure presents the way ETR is calculated.[1]

$$\text{ETR} = \frac{\text{Tax expense (current + deferred)}}{\text{Earnings Before Tax (EBT)}}$$

Figure 1: ETR ratio

## 2. The macro perspective: shareholder vs. stakeholder interests

### 2.1 Shareholder interests[2]

The key determinant of shareholder value according to the current prevalent reporting standards is earnings per share («EPS») ratio, which is usually defined as net profit (i.e. profit after corporate income tax) divided by the count of outstanding shares.[3] Therefore, the effect of having an ETR of 20% means that operating profit is reduced by 20% corporate income tax before it is (at least partly) distributed between shareholders. As a result, due to ETR of 20% any shareholder obtains by 20% less EPS usually in the form of a dividend. Because of the way EPS is calculated, the shareholder value rises with decreasing ETR. Assuming that all other basic conditions remain the same, decreasing ETR should lead to the increase of share price as well. By applying the shareholder theory, ETR should be the Key Performance Indicator («KPI») of any MNE's tax function.

1 IAS 12.86.
2 DATTA, Y.:«Friedman Doctrine: Maximizing Profits Is Neither Good for Society Nor Even for the Shareholders.», Journal of economics and public finance 7.3 (2021): p. 153 et seq.
3 IAS 33.

In other words, from a shareholder perspective the main goal of any MNE's tax department should be the ETR reduction to the lowest possible level with tax planning schemes and other measures discussed in Section 3: Other Aspects.

### 2.2 Stakeholder interests[4]

At the same time, the ETR of a MNE and its minimum required level have been extensively discussed by a broad variety of stakeholders for more than a decade. In the late 2000s, the daily press articles about ETRs below 10% caused by allegedly aggressive tax planning schemes resulted in public protests and boycotts followed by reputational damage of Amazon, Google, Starbucks and Co.[5] As a reaction to the growing stakeholder (e.g., non-governmental organizations («NGOs»), investors, tax authorities, the OECD and G20) demand for more transparency regarding tax payments and overall tax strategy, the first Environmental Social Governance («ESG») standard for tax matters was announced by the Global Reporting Initiative («GRI») on 5 December 2019. With this non-financial reporting regulatory development, tax became part of the ESG strategy. Due to the reporting standard GRI 207, Tax, information about overall tax burden (per country) should be disclosed in ESG reports. Consequently, notably low values of overall tax burden might result in negative publicity and reputational damage.

The following figure depicts the two rival approaches. The shareholder interests are to present as low values as possible, whereas a broad variety of stakeholders expect a «reasonable» level of ETR.

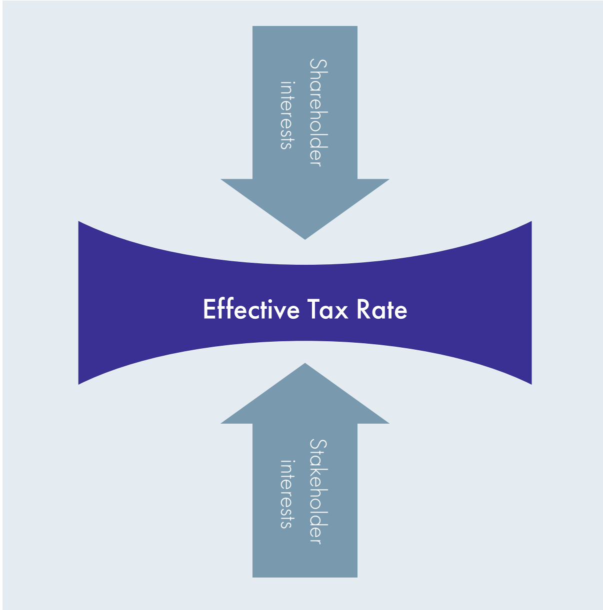


Figure 2: Macro perspective – Shareholder interests vs. stakeholder interests[6]

## 3. The micro perspective: other aspects

It is important to note that, beside the (strategic) macro perspective, there are several operational aspects to be considered – from the micro perspective – too, namely:

### 3.1 EBT

As EBT is the denominator in the ETR ratio, there is a negative correlation between ETR and EBT. In other words, should EBT decrease, for example due to economic recession or impairments and write-offs of assets, ETR will – due to remaining tax obligations based on assessments from last years – rise.

### 3.2 Global blending of EBT

As ETR is calculated as weighted average of tax rates with EBT per country as weights, the global allocation of earnings before tax plays an instrumental role. To make an example, MNEs generating majority of its profits from Germany (with tax rate of ~30%) will report on average higher ETR than MNEs with majority of its profits coming from Singapore (with tax rate of ~17%).

4 PARMAR, B. R. / FREEMAN, E. R. / HARRISON, J. S. / WICKS, A. C. / DE COLE, S. / PURNELL, L.: «The Stakeholder Theory the State of the Art», The Academy of Management Annals, June 2010, p. 3. Available: https://www.researchgate.net/publication/235458104_Stakeholder_Theory_The_State_of_the_Art/citation/download, last access on 30 October 2021.

5 BARFORD, V. / HOLT, G.: The rise of «tax shaming», 21 May 2013, BBC News Magazine, Available at: https://www.bbc.com/news/magazine-20560359, last entry on 29 October 2022.

6 Own creation.

### 3.3 Business model

The global blending of EBT can be positively influenced by the selection of a suitable business model. A good example of a tax efficient operating model, which changes the international allocation of profits, is the principal structure accumulating EBT in a low tax country or sales via digital platforms.

### 3.4 Tax accounting rules

Beyond the tax expert circles, it is less known that an important driver of ETR is the deferred tax expense. In contrast to the current tax, this component of tax expense is cash flow irrelevant. It arises due to the different valuation approaches between the international reporting standards (e.g., IFRS or US GAAP) and statutory accounting (e.g., OR in Switzerland or HGB in Germany) for all balance sheet positions. The creation of Deferred Tax Assets reduces the ETR, whereas new Deferred Tax Liabilities increases it.

### 3.5 Tax reporting quality

ETR is determined in the year-end closing reporting process, during which individual legal entities fill out and submit their reporting packages to the central consolidation and tax reporting teams. The reporting packages usually take the form of predefined schedules, in which data on current and deferred tax expenses and EBT are inserted. In order to achieve the targeted level ETR, personnel responsible for tax reporting in individual legal entities in all MNE's locations has to stay up-to-date as regards tax reporting standards (e.g., IAS 12) as well as other tax initiatives (e.g., the recent UK Tax reform or the OECD Pillar Two). In addition, a robust and reliable reporting system for financial reporting is indispensable.

### 3.6 OECD pillar two / Minimum taxation

Finally, the widely discussed OECD pillar two reform, which will introduce the minimum taxation of 15% in each jurisdiction, will adversely affect ETR of MNEs with global revenues exceeding EUR 750m.[7] It can be assumed that this reform will not enter in force before 2024.

The following figure depicts other (operational) factors influencing ETR.

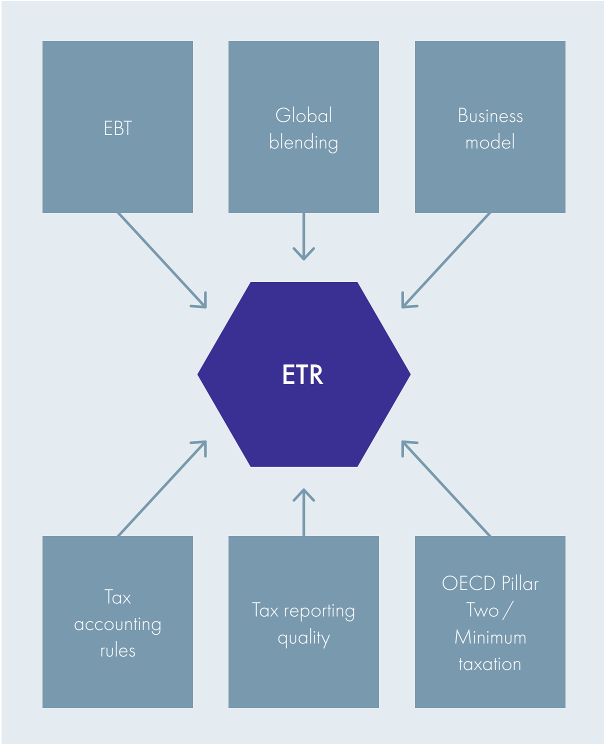


Figure 3: Micro perspective – Other (operational) factors[8]

## 4. Conclusion

Frequently, ETR and its desired level is a topic discussed between the audit committee and the Head of Group Tax or CFO in board meetings. In practice, reported ETRs are benchmarked against competitors and peers for e.g., WACC calculation purposes. Before any decisions are made, attention should be paid to the drivers of ETR and what is realistic to achieve. From a strategic point of view, the interaction between the shareholder interest and ESG goals (e.g., desired ratings) plays an important role. Finally, there are several other (operational) factors influencing ETR, such as: EBT, Global blending, Business model, Tax accounting rules, Tax reporting quality and OECD Pillar Two / Minimum taxation.

7 BERNDT, T. et al., Umsetzung der globalen Mindeststeuer (Pillar 2) in der Schweiz, IFF-HSG Working Paper No.2022-13.

8 Own creation.