Mind the Tax Gap

How companies could help beat poverty

Contents

Key findings	2
Summary	4
What is the Tax Gap?	8
Is there a Tax Gap?	14
Why is tax not paid?	25
Where tax is paid?	27
Deferred tax	29
The standard of reporting	33
A benchmark for comparison: The Co-operative Bank	36
Appendix 1: The companies in the report	39
Appendix 2: International tax rates	41
Appendix 3: The language of tax	44
Appendix 4: Data and methodology	51

Publishing Information

Published by
The Tax Gap Limited
150 Beresford Road
Ely Cambridgeshire
CB6 3WD

T: 01353 645041
E: info@thetaxgap.com
W: www.thetaxgap.com and www.taxjustice.net

© The Tax Gap Limited 2006.

Any part of this report may be reproduced without the permission of the publishers where doing so is not for commercial purposes or is for the advancement of education. In all other circumstances the permission of the publishers must be sought.

Thanks

A publication of this sort cannot be produced without the help and assistance of a great many people.

Richard Murphy of Tax Research LLP was the primary researcher of this work on behalf of The Tax Gap Limited.

Eddie Bye provided considerable assistance during the research process as did Rachel Purcell in the early stages of this work. Grateful thanks are offered to them both. John Christensen of the Tax Justice Network offered help, support, encouragement and advice during the production of this report. Mike Lewis provided much help in copy editing.

Numerous people within many development and commercial organisations have also offered help and support during the course of this project. They are too numerous to mention individually.

Any errors and omissions that remain within this report are the sole responsibility of The Tax Gap Limited.

Important note

No comment, data or other information in this report suggests that any company to which it refers, or any officer of any such company or any auditor to those companies has in any way acted illegally. The Tax Gaps to which this report refers are all presumed to arise because of the use of legal tax avoidance methods.

Key Findings

What this report does

'Mind the Tax Gap' is the first published, statistically rigorous attempt to measure the size of the UK's 'Corporation Tax Gap': the difference between the expected rates of tax that UK companies should pay and the tax that those companies have actually paid. It does this by examining the published accounts of the UK's 50 largest companies over 5 years from 2000 to 2004.

While HM Revenue and Customs produces published estimates for the 'VAT Gap' a similar assessment has not previously been published for corporation tax. In this sense this report breaks new ground.

An increasing Expectation Gap

The report finds an increasing Expectation Gap amongst the UK's 50 largest companies:

1) These 50 companies have paid an average of 5.7% less corporation tax than expected rates from 2000 to 2004;

2) This 'Expectation Gap' increased from 4.2% in 2000 to 7.6% in 2004;

3) Over 5 years, these companies have thus paid £20 billion less tax on their profits than expected rates would suggest appropriate;

4) In 2004-5 alone this estimated 'Expectation Gap' constituted around £4.6 billion in lost tax revenue from these 50 companies (calculating that 60% of the tax was due in the UK);

5) Extrapolating across all UK companies, the report finds that the likely total UK 'Expectation Gap' may be as much as £9.2 billion a year: about 28% of corporation tax receipts in 2004-05. This lost corporation tax revenue is larger than the equivalent 'VAT Gap' (estimated by HM Revenue & Customs at around 16% in 2002);

6) While the UK's VAT Gap appears to be decreasing, its Corporation Gap is increasing.

How does the Tax Gap happen?

By examining these companies' published accounts, the report suggests several reasons for this Tax Gap. The most significant are:

1) Many companies declared tax liabilities on their profit and loss accounts which suggest that they are paying tax at higher rates than those required by UK law. This is misleading because those provisions include significant charges for deferred tax, much of which is not paid, and because pre-tax profits declared on profit and loss accounts are not the basis used for calculating a company's taxation liabilities.

2) The deferred tax provisions of the UK's largest companies have increased by£3 billion a year since 2002 and there is no indication that this tax will ever be paid;

3) £36 billion of deferred tax is owed in all by the companies surveyed and they provide no indication of when this might be due. This has in effect allowed companies to enjoy the benefits this sum as if it were an interest-free loan from governments with no set date for repayment.

4) The vast majority of deferred taxes relate to excessive corporate tax allowances given to encourage investment in plant and machinery. These tax breaks are wholly unrelated to the underlying economic substance of the transactions taking place.

5) In the UK tax relief for interest paid on borrowing, given even if companies then use that money abroad, allows many companies' UK profits to be taxed well below the headline rate.

6) Too many other explanations for companies not paying the tax that is expected of them are hidden within their accounts in ways that prevent interpretation. This means that there is a significant 'Reporting Gap' between the information that a reasonable user of a set of accounts needs to understand the tax that a company should pay, and the information they get that explains the tax that the company does pay.

The Tax Gap is not necessary

This Tax Gap is not necessary. Nor is the Reporting Gap that is associated with it necessary. As part of the work undertaken the published accounts of the Co-operative Bank were surveyed as a benchmark exercise. They revealed that the Co-operative Bank paid tax at expected rates, generates almost no Tax Gap, and produces near-perfect accounting of its tax liabilities.

The Tax Gap and Inequality

The Tax Justice Network supported the production of this report. It did so because it believes that every person in every country should settle the taxation liabilities expected of them by the government of the country in question. This report questions whether the companies it surveys do that.

The Tax Justice Network holds its belief because it believes that on balance government's raise tax to fulfill useful social objectives. Most particularly many governments use their taxation revenues to reduce poverty, both by re-distribution of income and by providing the mean to those whom the market system has sidelined to enjoy the opportunities available to their more affluent neighbours, whether within their own country or within the world at large.

There has been much debate within this context about how the United Nation's Millennium Development goals are to be financed. These will cost not less than £28 billion a year. This report suggests that if all UK companies paid the tax that was reasonably expected of them they could, by themselves contribute one third of the sum required to change the world forever.

Summary

What this report does

This report is based on a review of the accounts of the 50 largest companies in the UK (the 'FTSE 50'), as valued by the London Stock Exchange in March 2005.

Each company's accounts were reviewed for their reporting periods ending in 2000 to 2004. Because not all companies existed throughout the period 238 sets of accounts (more correctly, financial statements) were subject to review.

The review extracted considerable amounts of information from the accounts, mainly on accounting issues but also on general trading and employment and other related issues so that an overview of the companies' trading could be formed.

Over 30,000 pieces of data underpin this report. Hundreds of thousands of calculations support the analysis. The report is a view of the resulting impressions obtained.

What the report shows

The report shows that the rate of corporation tax paid by these UK companies is falling steadily.

The average declared tax rates of these companies on their profit and loss accounts each year were:

Table 1

Declared tax rates on profit and loss accounts

	2000	2001	2002	2003	2004	Average
Average	31.2%	44.7%	39.7%	36.1%	26.0%	35.5%

These declared tax rates suggest that in most years the companies surveyed were overpaying tax. This report shows that this is a misleading impression. Profits reported on accounts are persistently lower than the profits considered to be taxable by taxation authorities. In addition, the taxation charges that companies provide in their accounts include an item called deferred tax. In most cases there is clear evidence that this is unlikely to be paid. If just these two items are corrected for, and companies featuring exceptional losses or other reporting issues are excluded (which exclusion tends to increase the reported tax rate), a very different impression is obtained:

Table 2

Ratio of tax charge excluding deferred tax to pre tax profit before amortisation charges

	2000	2001	2002	2003	2004	Average
Average	26.6%	27.7%	21.7%	24.9%	22.1%	24.5%

These rates can be compared to the weighted tax rates that might be expected to apply to the profits of UK companies over this period, (specially calculated for the purposes of this report to take into account the likely overseas trading of the companies surveyed), which are as follows:

Table 3

Expected weighted corporation tax rates for UK companies

	2000	2001	2002	2003	2004	Average
Average	30.8%	30.6%	30.2%	29.9%	29.7%	30.2%

The clear discrepancies between actual tax rates and these expected rates constitute an 'Expectation Gap': a significant difference between what UK companies might be expected to pay in tax if prevailing headline rates of tax were charged, and what they actually pay. This Gap is, in percentage terms:

Table 4

The 'Expectation Gap'

	2000	2001	2002	2003	2004	Average
Average	4.2%	2.9%	8.5%	5.0%	7.6%	5.7%

It is also clear that this Expectation Gap is increasing over time.

The value of this Expectation Gap when compared to average declared profits of the companies subject to the survey is:

Table 5

Value of the Expectation Gap

	2000	2001	2002	2003	2004	Average
	£ mil	£ mil	£ mil	£ mil	£ mil	£ mil
Average	3,017	1,629	4,025	3,426	7,733	3,966

In short: because the companies subject to this survey have not paid tax on their profits at the rates which might be expected of them almost £20 billion of tax has not been paid over a five year period.

This report suggests it is likely that the companies surveyed declare at least 60% of their profits in the UK. This therefore suggests that in 2004 the UK Expectation Gap for these 50 companies was approximately £4.6 billion. (£7,733 million x 60%).

The large companies surveyed are likely to have had significantly greater opportunity for tax planning than most companies in the UK. It is, therefore, likely that their Expectation Gap is bigger than that for other companies. In 2004 the 50 companies surveyed paid almost 27% of all UK corporation tax, but it seems very unlikely that their Tax Gap can be extrapolated to other companies on such a simple basis. If instead it is assumed that these 50 companies had an Expectation Gap equivalent to that of all the remaining 2 million companies in the UK this would still leave an Expectation Gap of £9.2 billion in 2004. This report suggests that this is the current best estimate of the Expectation Gap for UK companies in 2004. £9.2 billion represents over 27% of corporation tax receipts in 2004-05.

Other extrapolations reported upon in this report and tested during the course of research also suggest that a figure of about £9 billion is a fair estimate of the UK's corporation tax Expectation Gap. Calculations in support of these figures are to be found on page 24 of this report.

This sum is significantly higher than the rate of the 'VAT Gap' estimated by

HM Revenue and Customs in 2002, then running at almost 16% per annum. While the VAT Gap appears to be declining, the Corporation Tax Gap appears to be increasing.

The reasons for non-payment of tax are widespread. They include incentives given by governments in advance of any economic rationale for their being offered; some income not being assessable to tax; other elements of income being subject to lower than average rates of tax (e.g. capital gains); and a multitude of 'other' differences, many of which companies do not specify. As such, despite companies being required to reconcile their reasons for not paying UK tax at the expected rate, in many cases it is hard to find explanations in their accounts. What is clear is that the two most commonly reasons cited anecdotally - lower overseas tax rates and the offer of research & development tax credits to companies over the last few years - are in fact negligible in the published explanations available.

Deferred Tax

In addition to the differences identified with regard to current tax liabilities, a major component of the corporation tax gap is 'deferred taxation'. At the close of 2004 over £36 billion of deferred tax liabilities were declared upon the balance sheets of the companies subject to this survey. Almost half of this liability had arisen because of the introduction of Financial Reporting Standard 19, which required provision for deferred taxation whether or not there was any possibility of the sum ever being paid. To put this another way: the introduction of FRS 19 showed, by itself, that the companies subject to this survey are in effect enjoying the benefit of at least £17 billion of interest-free loans from governments; loans which have no set date for repayment.

Since 2002 the value of these loans have increased by an average of about £3 billion every year, and there appears to be an ongoing trend of charging deferred tax in company accounts which is unlikely to be paid. In consequence it is quite reasonable to view these deferred tax balances as a £36 billion tax subsidy to business. The introduction of International Financial Reporting Standards in 2005 is unlikely to have changed this pattern.

The substantial weaknesses in deferred tax accounting identified in this report provide a clear indication of a significant 'Reporting Gap' in this area. It is almost impossible to form an objective opinion on when, if ever, the deferred tax liabilities of companies will ever be payable. In addition, it is by no means easy to determine precisely why they have arisen.

The vast majority of deferred tax balances relate to excessive tax allowances given in some countries to companies to encourage investment in plant and machinery, which are wholly unrelated to the underlying economic substance of the transactions taking place. This is clear evidence of a 'Competitive Gap' i.e. differences in the tax rates offered by different countries to attract investment. It is also indicative of a subsidy for capital that may reduce the employment prospects of low-paid labour and which could, therefore, contribute to the Poverty Gap.

Better payment and reporting is possible

It was not possible to undertake an extensive benchmarking exercise as part of the current review to see whether the results obtained from the survey companies were typical of all companies in the UK. One benchmarking exercise was, however, undertaken. The financial reporting of the banks in the survey were compared with that of The Co-operative Bank, notable because it undertakes most of its trade in the UK; is a direct competitor with the banks in the survey for at least some of their business; and declares itself to be run on ethical grounds.

The results of this comparison exercise were surprising. The Co-operative Bank paid tax at almost exactly the expected UK rate; had a wholly

insignificant Tax Gap; enjoyed a standard of financial reporting within its accounts unparalleled within the companies surveyed; and had minimal and immaterial prior year adjustments in its accounts. The Co-operative Bank has not made taxation a part of its ethical policy, but it would appear that it could do so quite easily.

On such a small sample basis it is impossible to conclude whether The Co-operative Bank's performance was the consequence of it being almost entirely UK-based; because it was a smaller company; or whether management policy was the major influence. It may well be all three, but the presence of a very high level of satisfactory reporting suggests that management policy is a major influence. This suggests that other companies could achieve this level if they wished to do so.

Why we think the Tax Gap matters for development

The UK, along with many countries in the world has committed itself to the UN's Millennium Development Goals.

The primary concern of the Tax Justice Network, which has assisted in producing of this report, is the role of taxation in reducing poverty.

Many taxation policies have a negative impact on a widening poverty gap. We believe that the Tax Gap actively contributes to poverty. Regardless of these negative impacts, however, governments need to fund the cost of positive poverty reduction, estimated by the Millennium Development Goals, a set of UN standards which aim to halve poverty by 2015. The projected cost of this is not less than US$50 billion per annum, or about £28 billion per annum.

Funds of this amount can only come from governments, which can only collect such funds by increasing tax rates or by collecting more of the tax that is owed to them.

Increasing tax rates is not popular. It is however reasonable to expect that each person (whether an individual or a company) will pay the tax that is expected of them.

This report makes clear that UK companies are not paying all the tax that might be reasonably expected of them, both by the public and taxation authorities.

The Tax Justice Network believes that those companies have a duty to pay all the tax that might be reasonably expected of them, and that government has a duty to work to close the Expectation Gap.

If these actions were undertaken in combination then:

- the UK could make a strong, world-leading contribution to funding the Millennium Development Goals;
- the Poverty gap would be reduced;
- UK taxpayers would have their Expectation Gap reduced, which would encourage their own compliance with taxation regulation.

The Tax Gap matters for all these reasons. And, as this survey shows, it would seem that shareholders need be no worse off as a result of better tax compliance since dividend payments are remarkably robust in the face of changes in profits, taxation and transfers to reserves.

What is the Tax Gap?

What tax authorities and accountants think

The US Internal Revenue Service define the Tax Gap as:

"the difference between what taxpayers should pay and what they actually pay on a timely basis" [1]

By their reckoning, the US Tax Gap is about US$330 billion a year. [2] Another definition, provided by an accountant, is:

"the difference between what ought to be paid by taxpayers given a certain level of economic activity versus what is collected" [3]

The UK's HM Revenue & Customs (HMRC) has a slightly more complicated definition: "*the tax gap measures the amount of tax we ultimately fail to collect, or, alternatively the amount of uncorrected non-compliance*". [4] In practice they believe that the tax that ought to be paid can be split into two parts:

1. the part that is due if the letter of the law is complied with;
2. the part that is due if the spirit of the law is also complied with.

HMRC regards both parts as being due, in full. They regard tax avoidance as the difference between the tax due in accordance with the letter of the law, and that due in accordance with the spirit of the law. As a result, in their view the Tax Gap is made up of:

1. all tax that is avoided, plus
2. all the tax that is evaded, less
3. whatever tax they can recover through their work from those who have sought to avoid or evade their obligations.

It is clear that the Tax Gap is not a simple subject. We argue that both these definitions of the Tax Gap are inadequate. Our reason is simple. Each of them seeks to describe the consequence of the Tax Gap: uncollected tax. That is important, and measuring the size of this uncollected revenue is a major objective of this report. But in isolation it is insufficient. To really understand the Tax Gap we need to understand what its components are, what motivates it, and what its consequences are.

As a result we argue that the Tax Gap as a broad economic problem consists of many component gaps, described in the next section.

What we think the Tax Gap is

Absolute Gaps

1. The Revenue Gap

The difference between what a tax authority expects to raise in tax given current levels of economic activity, and what it actually raises in taxation revenues.

This Gap can, of course, be broken down between different taxes e.g. income taxes, company taxes, value added taxes

---

1 US Internal Revenue Service Press Release IR-2005-38, March 29, 2005
2 ibid
3 Loughlin Hickey, Global Managing Partner for Tax, KPMG, speaking at the Institute of Chartered Accountants in England and Wales, 17 November 2005
4 http://www.hmrc.gov.uk/lbo/lc_forum_taxgap.htm

2. The Proportionate Gap

The difference between the proportion of income paid in tax by the best off in a society, and the proportion of income paid in tax by the worst off in a society.

This is a measure of how progressive the tax system is.

3. The Poverty Gap

The difference between the after tax incomes of the rich and the poor in a society (to which taxation policy contributes).

This is a measure of social justice within a society.

Corporate Gaps

4. The Reporting Gap

The difference between the information that a reasonable user of the accounts of a corporation needs to appraise the tax it pays and the information they actually get.

This Gap is a measure of how well a company accounts for its activities.

5. The Expectation Gap

The difference between the headline or declared tax rate for companies, and the rate of tax they actually pay.

This Gap is a measure of the difference between the contribution society expects business to make by way of tax paid, and what is actually paid.

Taxpayer Gaps

6. The Responsibility Gap

The difference between the duty of care towards a country that a tax payer is expected to show when declaring their taxation liabilities, and the duty they actually display in their actions.

This is a measure of the attitude taxpayers take towards their duty to pay tax and is likely to indicate the scale of both tax avoidance and evasion in an economy.

7. The Trust Gap

The difference between the actual levels of trust that exist between tax payers and taxation authorities and the level of trust which would benefit both parties in the management of their mutual obligations.

This measure is important because taxation is ultimately always levied with the consent of those who pay it. If that trust breaks down, less tax is paid.

Government Gaps

8. The Transparency Gap

The difference between the information the taxpayers in a country think they need to be able to understand what their government does with the money paid to it and the information they actually receive.

This Gap measures the accountability of governments.

9. The Corruption Gap

The difference between the tax that taxpayers think they pay to a government and the amount that the government actually has paid to it.

This gap measures the corruption present in any tax collection system, whether that corruption is undertaken by politicians, government officials or others e.g. within banks.

10. The Efficiency Gap

The difference between the benefit that could be obtained if all government revenues were spent in pursuit of its policies and the actual sum spent having allowed for waste, inefficiency and corruption.

This is a measure of both the management inefficiency of governments and the corruption that occurs in their spending programmes. The measures overlap because very often it is difficult to differentiate the reasons for the loss.

International Gaps

11. The Competitive Gap

The difference between the tax rates offered by different countries as an incentive to attract inward investment into their economies.

This is a measure of tax competition.

12. The Resource Gap

The difference between the resources countries are able to allocate to ensuring that the international aspects of their taxation affairs are properly managed.

This is a measure of the gap in resources between developed and developing countries. Many developing countries do not have the resources available to them to pursue enquiries about tax liabilities that may be due in their territories if they are not voluntarily declared.

13. The Multinational Gap

The difference between the tax rate paid by companies who operate internationally and the tax rate paid by companies who only operate in one country.

This is a measure of the taxation benefit companies who operate internationally obtain over their domestic rivals.

14. The Haven Gap

The gap between what is considered reasonable behaviour in tax havens and what is considered reasonable behaviour elsewhere.

This is a measure of both the difference in tax rates on offer in tax havens and elsewhere and the difference they offer in defining taxable income, which in many cases is the way in which they avoid charging individuals and companies to tax.

15. The Mobility Gap

The difference between the way those who are internationally mobile are taxed in a country and the way those who live there permanently are taxed.

This is a measure of the advantages the tax system of a country offers to those people who are internationally mobile compared to those who are normally resident in their country.

The National Gaps

16. The Corporate Gap

The difference between the tax rate paid by corporations on a profit and the tax rate an individual might reasonably be expected to pay on the same profit.

This is a measure of the taxation benefit companies are given in a society.

17. The Large / Small Gap

The difference between the tax rate suffered by large companies and the tax rate suffered by small companies.

This is a measure of the benefit large business gets in a society, largely because of its lobbying power, when compared to small business. It is measured by the difference in the average actual tax rate suffered when similar rules are apparently applied to each type of company.

18. The Social Security Gap

The difference between the tax (including social security charges) due on average earnings in a country if earned from employment, and the tax due on the same level of income if earned from other sources.

This is a measure of the total additional tax charges levied upon earnings derived from human endeavour when compared with the tax charges levied on similar income from any other source.

19. The Administration Gap

The difference between the administrative burden suffered by government with regard to tax and that it imposes on business.

This is a measure of the burdens a tax system imposes which are not directly measured as part of the tax charge.

20. The Direct / Indirect Gap

The proportionate difference between the amount of tax a country collects from direct and indirect tax.

This is a measure of the difference between the tax charged on earnings in a country and the tax charged on consumption in a society. It is a good measure of the degree of regressiveness within a tax system since those on lower levels of earnings tend to spend much higher proportions of their income on consumption than do those on higher levels of income, who have a capacity to save.

What this means

Seen in this way, the Tax Gap is very different from the technical issue that is at present usually only referred to in the financial pages of newspapers and the technical taxation and accounting press. The reality is that the Tax Gap is a complex subject covering a wide range of issues that in combination have a significant impact on the way that many people live their lives, not least by significantly influencing their means to secure the resources they need to enjoy an acceptable standard of living. The Tax Gap might focus upon technical issues, but its also about:

1. social justice;
2. corporate responsibility;
3. government accountability, and
4. the stability of the income of the world's nation states.

These are issues of much wider concern than is suggested by the technical nature of the Tax Gap definitions used by taxation authorities.

Through a wide range of agencies, civil society has already taken upon itself to tackle some of the component issues within the Tax Gap, such as:

1. the proportionate gap;
2. the poverty gap;
3. the transparency gap;
4. the corruption gap;
5. the efficiency gap;
6. the social security gap;
7. the direct / indirect gap.

These relate either directly to poverty issues or to management issues that usually contribute to poverty. Management issues have, for example, been tackled by the Publish What You Pay coalition. [5] In this report we extend that concern. Put simply, we think that all these features of taxation can contribute to poverty; and that establishing fair ratios for each of the identifying gaps will make a contribution to that process. In many cases this will mean that the gap has to be closed. On rare occasions it will mean it has to be increased; the example, it would be appropriate that large companies pay tax at higher rates than do smaller ones. This is why we believe it is important to mind the Tax Gap in all its aspects.

That said, no study can tackle all issues. This report is therefore focussed on issues relating to corporations, and concentrates on UK registered companies. It does so for two reasons. First, there is reasonably reliable data available in this area. Second, this subject has been little studied outside the USA, but it has nonetheless been the subject of significant comment.

[5] www.publishwhatyoupay.org

The report provides seeks to measure these companies' Expectation Gap, and provides an accounting opinion on their Reporting Gap.

In doing so, we hope to add to the facts that are known, and to suggest how the Tax Gaps to which corporations contribute could be reduced in the pursuit of reducing poverty.

Is there a Tax Gap?

Defining terms

If there was no Tax Gap, there would be little for this report to comment upon. The existence or otherwise of a Tax Gap is, therefore, the first issue this report considers.

In doing so it is important to be sure about what is being looked at. Unfortunately, accounting for tax and paying tax are far from the same thing. Without an appreciation of this, much of what follows will make little sense. A glossary of many of the terms used in this report has been included as an appendix, which may be useful on occasion whilst reading the commentary in this and other sections.

The Expectation Gap

The Gap that much of this report examines is the *Expectation Gap*. This is the difference between the headline tax rate (the tax which society has signalled it expects a company to pay by setting a tax rate to be charged on its profits), and the tax rate that is actually paid.

First impressions

It has been customary to assess the tax rate a company suffers by looking at its profit and loss account. Conventionally a profit and loss account looks like this:

	£
Turnover	A
Distribution costs	(B)
Administrative expenses	(C)
Operating profit	D
Interest income	E
Interest paid	(F)
Profit or loss on sale of assets	G
Profit before taxation	H
Taxation	(J)
Profit after taxation	K
Dividends paid and proposed	(L)
Profit retained for the year	M

Letters in brackets represent what are usually negative numbers to be subtracted from the total above them.

The profit and loss account tax rate is the ratio of the taxation charge (J) to the profit before taxation (H). For the companies included in the survey the resulting ratios are as follows:

Table 6
Expectation Gap - ratio of tax charge to pre tax profits

		2000	2001	2002	2003	2004	Average
		%	%	%	%	%	%
O2	1	0.0%	0.0%	2.6%	0.5%	-74.7%	-23.9%
Vodafone Group	2	50.8%	-15.9%	-15.8%	-47.6%	-62.5%	-18.2%
British Sky Bcast. Group	3	-3.3%	-4.7%	-8.3%	-48.9%	32.9%	-6.5%
Legal & General	4	36.3%	-28.2%	-69.8%	13.9%	28.2%	-3.9%
Carnival	5	13.0%	5.0%	7.6%	5.0%	5.0%	7.1%
BT	6	30.5%	-63.2%	30.3%	14.5%	27.7%	8.0%
Aviva	7	-18.1%	82.5%	-73.0%	26.4%	23.9%	8.3%
Xstrata	8	0.0%	0.0%	16.8%	13.1%	12.9%	14.3%
Scottish Power	9	18.6%	25.1%	-8.9%	30.0%	31.4%	19.2%
HSBC	10	22.9%	19.7%	26.3%	24.3%	25.6%	23.8%
Prudential	11	30.0%	5.5%	9.1%	41.1%	35.7%	24.3%
Scottish & Southern Energy	12	21.5%	21.9%	26.4%	27.6%	26.3%	24.7%
Allied Domecq	13	22.2%	26.4%	29.1%	26.3%	22.8%	25.3%
Land Securities	14	23.1%	25.9%	27.5%	28.1%	22.7%	25.5%
Reckitt Benckiser	15	29.5%	28.3%	25.1%	25.9%	23.9%	26.6%
Lloyds Tsb Group	16	28.6%	27.4%	29.3%	23.6%	28.7%	27.5%
Anglo American	17	26.1%	24.7%	33.3%	27.5%	27.6%	27.8%
GlaxoSmithKline	18	28.2%	29.4%	26.5%	27.5%	27.8%	27.9%
National Grid Transco	19	0.0%	0.0%	0.0%	36.7%	19.2%	27.9%
Barclays Bank	20	27.0%	28.0%	29.8%	28.0%	28.0%	28.2%
AstraZeneca	21	33.8%	27.0%	29.2%	27.2%	24.7%	28.3%
Reuters Group	22	19.0%	67.7%	-4.7%	44.9%	16.7%	28.7%
HBOS	23	0.0%	29.1%	28.7%	29.0%	28.5%	28.8%
Centrica	24	24.9%	33.1%	34.8%	34.2%	17.9%	29.0%
Tesco	25	27.8%	27.3%	30.9%	30.5%	31.1%	29.5%
Cadbury Schweppes	26	29.6%	29.6%	30.7%	30.7%	29.4%	30.0%
Standard Chartered	27	26.2%	32.9%	30.7%	32.1%	29.5%	30.3%
Associated British Foods	28	44.9%	29.7%	22.6%	28.0%	29.6%	31.0%
GUS	29	27.5%	34.2%	32.1%	34.5%	27.7%	31.2%
Imperial Tobacco	30	28.2%	28.1%	33.1%	35.4%	34.6%	31.9%
Wolseley	31	35.9%	36.4%	29.8%	30.0%	29.0%	32.2%
BAA	32	30.5%	24.3%	47.5%	30.1%	29.9%	32.5%
Royal Bank of Scotland Group	33	34.3%	36.0%	32.7%	31.0%	31.2%	33.0%
BHP Billiton	34	0.0%	39.3%	36.3%	33.6%	23.1%	33.1%
Rio Tinto	35	32.6%	36.2%	54.0%	27.1%	23.4%	34.7%
SABMiller	36	24.3%	28.8%	34.3%	45.3%	41.6%	34.9%
BP	37	29.4%	38.3%	38.5%	34.6%	34.2%	35.0%
WPP	38	30.0%	30.7%	50.3%	34.9%	30.7%	35.3%
Diageo	39	27.6%	24.2%	27.1%	74.5%	24.7%	35.6%

Compass	40	25.1%	36.2%	36.1%	39.9%	41.1%	35.7%
BG	41	31.9%	31.8%	47.1%	38.9%	39.6%	37.9%
Unilever	42	51.5%	42.7%	38.7%	33.6%	27.5%	38.8%
British American Tobacco	43	44.9%	42.9%	38.7%	49.7%	35.1%	42.3%
The Shell Transport & Trading Co.	44	46.9%	43.7%	44.3%	43.2%	46.7%	45.0%
Marks & Spencer	45	37.9%	98.1%	54.3%	29.1%	29.3%	49.8%
Reed Elsevier	46	82.8%	53.8%	37.0%	35.3%	45.7%	50.9%
BAE Systems	47	103.9%	282.9%	-11.4%	96.6%	-100.9%	74.2%
ITV	48	0.0%	0.0%	0.0%	123.3%	29.5%	76.4%
Old Mutual	49	18.0%	343.2%	52.7%	54.4%	32.8%	100.2%
Kingfisher	50	28.1%	25.5%	557.1%	45.2%	40.8%	139.4%
Number in sample		44	46	48	50	50	50
Average		31.0%	40.7%	34.5%	31.6%	22.4%	31.9%

This table superficially suggests that there is no obvious Tax Gap. In each of the years 2000 to 2004 the UK tax rate that applied to all these companies was 30%. In each year but 2004 these companies appear on average to have declared tax liabilities in excess of the rate that might thus be expected. This is also the case, on average, over the period as a whole, and this is also true for 26 of the 50 companies. It should also be noted that these averages are distorted by the fact that some companies declared losses in the period, giving what appear to be negative tax rates. If these companies were eliminated from the sample the average rates are higher still:

Table 7

Declared tax rates on profit and loss accounts

	2000	2001	2002	2003	2004	Average
Average	31.2%	44.7%	39.7%	36.1%	26.0%	35.5%

On this basis the first impression is that companies are being overtaxed in the UK.

First impressions are often wrong

First impressions are often wrong. This study has found that the rates of tax that UK companies are declaring in their accounts do not represent the actual tax that they are paying, or expect to pay. There are several reasons for this.

Deferred tax

Some of the tax charged in the profit and loss account will almost certainly never be paid. This is because that tax charge is usually made up of two components:

1. the current tax charge;
2. the deferred tax charge.

Both can, in turn, be broken down into various further components, some of which will be explored later in this report. At this stage the important difference is that between the tax that is declared to be due for immediate payment in respect of a period (the *current tax charge*), and the tax that might be paid at some time in the future as a result of the transactions undertaken during the current year (the *deferred tax charge*).

Deferred tax is a notoriously difficult concept to grasp; many accountants never succeed in doing so. A definition is included in the glossary, and a

later section of this report is dedicated to the subject. For current purposes, its most important feature is the fact that for many companies it is very unlikely that the deferred tax charges made in their profit and loss accounts will result in real tax liabilities being paid at any time in the foreseeable future. In that case, for all practical purposes deferred tax charges included in the profit and loss account can be, and should be, excluded from any consideration of taxes to be paid when measuring the Tax Gaps.

Accounting and taxable profits are not the same thing

Just as the accounting tax charge is not all it seems for our purposes, nor is accounting profit. There is, of course, nothing wrong with accounting profit. In most developed countries, however (but less so in developing countries), *declared profit* is not the sum on which a company is charged to tax. Instead a *taxable profit* is used. The differences between the two are innumerable, and vary from country to country, but in general terms the following hold true:

1. Charges for the use of fixed assets included in accounts are disallowed for taxation purposes, and different (usually more generous) taxation allowances are given in their place;
2. In the case of most goodwill, no tax relief is given, even though substantial amortisation charges may be included in the profit and loss account of the company;
3. Some expenses a company incurs are not tax allowable. These might include some legal costs; entertaining expenses in the UK; some costs of fundraising; and a wide range of other items;
4. Some income is not taxable (for example, dividends from other UK companies) or may be subject to tax at low effective rates (for example, capital gains);
5. Some income earned overseas is not subject to tax in the UK. For example, if profits are earned in a subsidiary company, and the UK parent company can satisfy the UK's taxation authorities that the subsidiary is really undertaking a trade, then the fact that the profits of the subsidiary company may be taxed at rates lower than those charged in the UK does not prevent the subsidiary being able to enjoy these lower tax rates in the country in which it operates, so long as the profits it earns are not paid back to the UK parent company via dividends.

For all these reasons, accounting profit can be the wrong basis for assessing the Tax Gap.

There is another very good reason why the accounts of a consolidated group of companies (as are all the companies reviewed in this report) do not form a perfect base of assessing the Tax Gap. Put bluntly, consolidated accounts are in many ways a work of fiction. Such accounts are not for any legal entity that actually exists. Consolidated accounts are instead a way of presenting the third party transactions of a group of companies which are either under common control, or under some degree of shared control (since the results of associated companies in which the parent company has a stake of more than 20% are also included in the parent company's accounts, at least in part). This view quite successfully represents the economic resources over which the group parent company has some control and how those resources have been managed with regard to third parties. But groups of companies are not, at least as yet, taxed on the basis of their consolidated accounts. They are instead taxed on the basis of the profits each constituent member of the group of companies makes, and this can provide a very different view of the tax liabilities owing for two reasons:

1. Tax rules vary significantly from country to country, and groups tend to

have an international orientation (there are one or two exceptions amongst the companies covered by this report, most notably BSkyB);

2. Group companies trade with each other. In fact, the OECD has estimated that over half of all world trade is undertaken between companies who are constituent members of the same trading group. None of these inter-group transactions are reflected in consolidated accounts. Indeed, the main purpose of consolidating the accounts is to remove all inter-group transactions from view. But as a result the underlying economic transactions which actually give rise to the group's tax liabilities are much harder to identify and analyse. This issue is a major contributor to the Reporting Gap, for both individual users of accounts, and for governments seeking to obtain an overview of how the transactions that have been presented to them for taxation purposes fit into the overall position of the Group.

Unfortunately, there is currently no more satisfactory basis for assessing the Tax Gap than the data made available in consolidated accounts, whatever their shortcomings.

It is, however, appropriate to make two changes to the reported figures of both profit and the tax charge to obtain a better view of the tax liabilities due by the companies subject to review. Both are accepted as normal practice when undertaking analysis of taxation issues, and both can be done using published accounting data. As such they are not controversial. They are:

- To remove deferred tax from the reported tax charge (for the simple reason that it is unlikely to be paid);
- To add goodwill amortisation charged in the profit and loss account back to profit (since it is almost invariably not tax allowable).

Very different figures for the Expectation Gap emerge if these two adjustments are made:

Table 8
Expectation Gap – Ratio of tax charge excluding deferred tax to pre tax profit before amortisation charges

		2000	2001	2002	2003	2004	Average
		%	%	%	%	%	%
BAE Systems	1	35.6%	50.3%	-1500.0%	22.1%	10.5%	-276.3%
Aviva	2	-24.7%	78.9%	-226.3%	23.7%	17.7%	-26.1%
Legal & General	3	35.8%	-32.3%	-108.3%	8.2%	24.1%	-14.5%
O2	4	0.0%	0.0%	2.3%	-0.7%	4.4%	2.0%
National Grid Transco	5	0.0%	0.0%	0.0%	5.7%	12.1%	8.9%
Reuters Group	6	19.1%	65.7%	-57.3%	24.7%	7.8%	12.0%
Carnival	7	12.6%	36.3%	7.2%	4.4%	2.3%	12.5%
British Sky Bcast. Group	8	-3.5%	0.0%	-1.5%	35.6%	19.9%	12.6%
Xstrata	9	0.0%	0.0%	14.8%	5.5%	19.1%	13.1%
Scottish Power	10	18.3%	16.0%	-1.6%	19.0%	18.9%	14.1%
Compass	11	24.6%	16.0%	3.3%	13.4%	20.9%	15.6%
Reed Elsevier	12	25.0%	29.4%	6.0%	12.8%	19.9%	18.6%
Allied Domecq	13	16.8%	21.9%	29.7%	19.5%	11.4%	19.9%

BT	14	29.7%	26.5%	10.0%	17.6%	18.6%	20.5%
HSBC	15	22.5%	22.7%	18.2%	22.1%	18.6%	20.8%
Scottish & Southern Energy	16	18.5%	19.9%	21.6%	22.5%	23.5%	21.2%
Land Securities	17	22.8%	25.8%	25.1%	12.0%	23.0%	21.8%
GUS	18	19.4%	26.8%	22.6%	19.8%	21.8%	22.1%
AstraZeneca	19	28.0%	19.2%	23.6%	20.6%	21.8%	22.7%
Royal Bank of Scotland Group	20	23.9%	26.0%	22.6%	19.5%	22.0%	22.8%
Cadbury Schweppes	21	27.3%	22.5%	26.1%	25.0%	14.0%	23.0%
Anglo American	22	25.9%	24.4%	26.0%	19.6%	21.3%	23.5%
HBOS	23	0.0%	23.9%	22.6%	25.1%	25.4%	24.3%
Prudential	24	25.3%	8.3%	15.1%	39.1%	34.0%	24.4%
BAA	25	21.9%	23.1%	37.2%	21.5%	18.1%	24.4%
Centrica	26	31.9%	20.9%	23.4%	31.8%	14.4%	24.5%
Reckitt Benckiser	27	28.9%	28.3%	20.8%	23.8%	21.6%	24.7%
Barclays Bank	28	26.4%	25.9%	28.6%	21.5%	24.5%	25.4%
Old Mutual	29	24.1%	26.6%	21.7%	29.4%	25.8%	25.5%
Lloyds Tsb Group	30	25.7%	25.0%	32.6%	20.6%	24.3%	25.6%
Tesco	31	27.3%	26.6%	27.7%	25.5%	25.9%	26.6%
Associated British Foods	32	43.9%	24.7%	24.4%	23.8%	23.3%	28.0%
Imperial Tobacco	33	26.6%	26.5%	33.0%	27.5%	26.8%	28.1%
Standard Chartered	34	27.7%	27.6%	30.3%	29.6%	26.2%	28.3%
BP	35	28.2%	35.2%	24.0%	25.9%	30.0%	28.7%
Wolseley	36	34.4%	33.3%	24.7%	25.9%	25.6%	28.8%
GlaxoSmithKline	37	29.8%	30.6%	26.0%	31.6%	27.8%	29.2%
WPP	38	31.6%	30.9%	27.4%	30.6%	28.2%	29.7%
SABMiller	39	24.4%	28.7%	31.1%	31.8%	33.2%	29.8%
Vodafone Group	40	39.9%	70.1%	-25.3%	37.7%	30.0%	30.5%
Diageo	41	25.5%	21.2%	21.3%	70.4%	18.6%	31.4%
BG	42	28.4%	28.8%	32.8%	31.8%	37.0%	31.8%
BHP Billiton	43	0.0%	41.6%	28.3%	29.7%	30.3%	32.5%
ITV	44	0.0%	0.0%	0.0%	51.3%	15.8%	33.6%
Rio Tinto	45	28.0%	36.3%	51.7%	27.3%	26.0%	33.9%
Unilever	46	52.9%	28.3%	34.9%	23.0%	32.9%	34.4%
British American Tobacco	47	41.9%	36.6%	33.0%	41.9%	25.2%	35.7%
The Shell Transport & Trading Co.	48	44.4%	43.8%	44.6%	43.2%	47.8%	44.8%
Marks & Spencer	49	38.5%	101.5%	28.5%	29.3%	26.3%	44.8%
Kingfisher	50	27.8%	24.6%	314.9%	44.1%	41.1%	90.5%
Number in sample		44	46	48	50	50	
Average		26.4%	29.9%	-12.9%	25.3%	22.8%	18.2%

As with the initial data, there are good reasons for excluding some information from this table to obtain a clearer view of the underlying trends. These exclusions are:

1. To remove the first three companies in the table, since all are showing negative tax rates resulting from losses. Each such loss was however distorted by the fact that they were the result of provisions made in 2002. (Provisions anticipate losses but are not tax allowable, since tax relief is not available on anticipated costs, only those actually incurred). BAE anticipated losses in the aftermath of 9/11. The two insurance companies, Aviva and Legal & General were reflecting the changed states of the financial markets after the dot.com crash. These results are aberrant. As such they do not help understanding and can be excluded.
2. The bottom three results can also be excluded. Kingfisher and Marks & Spencer were also companies that had made substantial provisions for losses, reorganisations and the sale or closure of businesses. Again, these are often not tax allowable (although Marks & Spencer is contesting this in the European Court of Justice). In their cases it did not give rise to losses being reported, but the extent of disallowable costs meant that their tax results were significantly distorted and they should, therefore, be excluded from the sample.
3. Shell did not report its operational results in accordance with UK accounting standards in this period, since it was the Dutch part of the Group that reported actual trading. It included items in its taxation charge within the profit and loss account relating not just to profits but to special taxes on exploration and additional income, and other taxes, although without specifying what they might be or what the impact of doing so was. It thereby included expenses under this heading which no other company included and which BP, for example, appeared to include in its costs of sales (as appears more appropriate). As such its taxation data is unreliable when compared with other companies in the sample and should be excluded.
4. All the companies who reported losses whilst having taxation liabilities give rise to distorted statistical data which reduces the clarity of the overall view given when one year of the sample is compared with another. This is not true however of the overall view for the company, where a loss in one year will give rise to a taxation benefit in a subsequent period. In the following table the 6 sets of data giving rise to negative tax ratios (indicated by blank spaces) have been eliminated from the calculation of annual data, but the average for the company over the period has not been restated, and its relative position in the ordering has not been changed. It is believed that this represents a fair representation on both counts. The following figures are thereby obtained for the Expectation Gap:

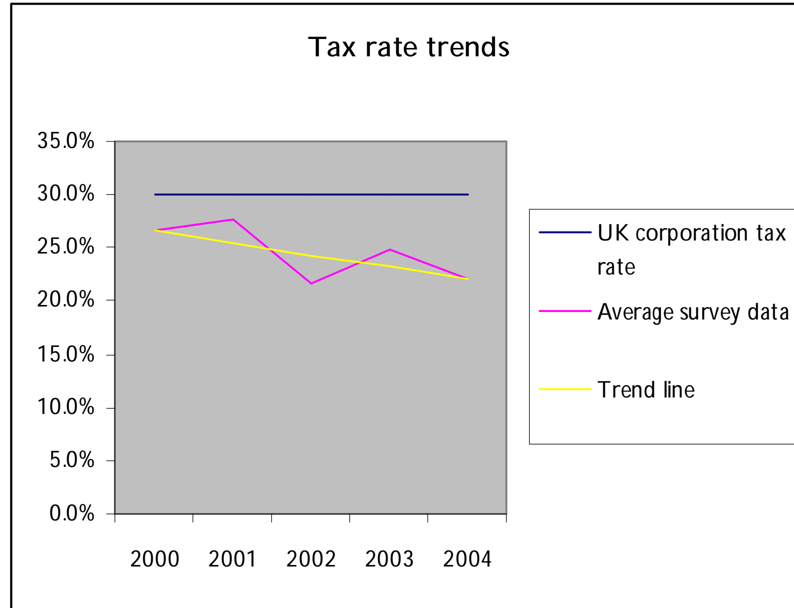
Table 9
Expectation Gap – Ratio of tax charge excluding deferred tax to pre tax profit before amortisation charges – top and bottom three companies and all negative data excluded

		2000	2001	2002	2003	2004	Average
		%	%	%	%	%	%
O2	4	0.0%	0.0%	2.3%		4.4%	2.0%
National Grid Transco	5	0.0%	0.0%	0.0%	5.7%	12.1%	8.9%
Reuters Group	6	19.1%	65.7%		24.7%	7.8%	12.0%
Carnival	7	12.6%	36.3%	7.2%	4.4%	2.3%	12.5%
British Sky Bcast. Group	8		0.0%		35.6%	19.9%	12.6%

Xstrata	9	0.0%	0.0%	14.8%	5.5%	19.1%	13.1%
Scottish Power	10	18.3%	16.0%		19.0%	18.9%	14.1%
Compass	11	24.6%	16.0%	3.3%	13.4%	20.9%	15.6%
Reed Elsevier	12	25.0%	29.4%	6.0%	12.8%	19.9%	18.6%
Allied Domecq	13	16.8%	21.9%	29.7%	19.5%	11.4%	19.9%
BT	14	29.7%	26.5%	10.0%	17.6%	18.6%	20.5%
HSBC	15	22.5%	22.7%	18.2%	22.1%	18.6%	20.8%
Scottish & Southern Energy	16	18.5%	19.9%	21.6%	22.5%	23.5%	21.2%
Land Securities	17	22.8%	25.8%	25.1%	12.0%	23.0%	21.8%
GUS	18	19.4%	26.8%	22.6%	19.8%	21.8%	22.1%
AstraZeneca	19	28.0%	19.2%	23.6%	20.6%	21.8%	22.7%
Royal Bank of Scotland Group	20	23.9%	26.0%	22.6%	19.5%	22.0%	22.8%
Cadbury Schweppes	21	27.3%	22.5%	26.1%	25.0%	14.0%	23.0%
Anglo American	22	25.9%	24.4%	26.0%	19.6%	21.3%	23.5%
HBOS	23	0.0%	23.9%	22.6%	25.1%	25.4%	24.3%
Prudential	24	25.3%	8.3%	15.1%	39.1%	34.0%	24.4%
BAA	25	21.9%	23.1%	37.2%	21.5%	18.1%	24.4%
Centrica	26	31.9%	20.9%	23.4%	31.8%	14.4%	24.5%
Reckitt Benckiser	27	28.9%	28.3%	20.8%	23.8%	21.6%	24.7%
Barclays Bank	28	26.4%	25.9%	28.6%	21.5%	24.5%	25.4%
Old Mutual	29	24.1%	26.6%	21.7%	29.4%	25.8%	25.5%
Lloyds Tsb Group	30	25.7%	25.0%	32.6%	20.6%	24.3%	25.6%
Tesco	31	27.3%	26.6%	27.7%	25.5%	25.9%	26.6%
Associated British Foods	32	43.9%	24.7%	24.4%	23.8%	23.3%	28.0%
Imperial Tobacco	33	26.6%	26.5%	33.0%	27.5%	26.8%	28.1%
Standard Chartered	34	27.7%	27.6%	30.3%	29.6%	26.2%	28.3%
BP	35	28.2%	35.2%	24.0%	25.9%	30.0%	28.7%
Wolseley	36	34.4%	33.3%	24.7%	25.9%	25.6%	28.8%
GlaxoSmithKline	37	29.8%	30.6%	26.0%	31.6%	27.8%	29.2%
WPP	38	31.6%	30.9%	27.4%	30.6%	28.2%	29.7%
SABMiller	39	24.4%	28.7%	31.1%	31.8%	33.2%	29.8%
Vodafone Group	40	39.9%	70.1%		37.7%	30.0%	30.5%
Diageo	41	25.5%	21.2%	21.3%	70.4%	18.6%	31.4%
BG	42	28.4%	28.8%	32.8%	31.8%	37.0%	31.8%
BHP Billiton	43	0.0%	41.6%	28.3%	29.7%	30.3%	32.5%
ITV	44	0.0%	0.0%	0.0%	51.3%	15.8%	33.6%
Rio Tinto	45	28.0%	36.3%	51.7%	27.3%	26.0%	33.9%
Unilever	46	52.9%	28.3%	34.9%	23.0%	32.9%	34.4%
British American Tobacco	47	41.9%	36.6%	33.0%	41.9%	25.2%	35.7%
Number count		38	40	42	44	44	
Average		26.6%	27.7%	21.7%	24.9%	22.1%	24.5%
UK corporation tax rate		30.0%	30.0%	30.0%	30.0%	30.0%	30.0%

The Expectation Gap

It is the average data in this table which provides the clearest indication of the Expectation Gap. As can be seen, the trend is steadily downward over time. In every year there is a gap, the UK corporation tax rate being fixed at 30%:



Checking that the Gap is not just a reflection on international tax rates

Almost without exception, the companies covered by this survey are international entities. In almost all cases, then, the tax rates to which they are subject are not only those of the UK. World tax rates will also affect them. To ensure that this factor has been taken into account, analysis of world tax rates was undertaken especially for this report. The findings are detailed in Appendix 1.

This work suggests that weighted average international tax rates for multinational companies in the period under review should have been:

Table 10
Expected corporation tax rates for UK companies

	2000	2001	2002	2003	2004	Average
Average	32.0%	31.4%	30.4%	29.8%	29.2%	30.5%

It will be noted that the data hovers at around the UK rate.

Calculating an expected rate for the UK

What is clear is that neither the UK rate of tax, nor the average overall rates of tax, will by themselves be adequate indicators of the expected tax rate applying to UK companies. This is because a significant part of the profits of a UK group company will be taxed in the UK, since the group parent company must have declared UK profits available to it to pay dividends. These profits must therefore have come into its possession, and they will therefore be subject to UK tax.

As this survey shows, 42% of average pre-tax profits were distributed as dividends over the five year period surveyed. Dividends are paid net of tax i.e. out of taxed income. Taxed UK profits were, therefore, needed to ensure they could be paid. The expected UK tax rate is 30%. Therefore pre-

tax profits in the UK of at least 60% of total pre-tax profits would be required to have made settlement of this sum by way of dividend.

It therefore seems appropriate to weight the expected tax rate in this proportion. The result is that expected UK multinational company tax rates are:

Table 11	2000	2001	2002	2003	2004	Average
Expected rate	30.8%	30.6%	30.2%	29.9%	29.7%	30.2%

When compared with the actual rates found to be declared as payable, above, the comparison is as follows:

Table 12	2000	2001	2002	2003	2004	Average
Expected rate	30.8%	30.6%	30.2%	29.9%	29.7%	30.2%
Actual average rates	26.6%	27.7%	21.7%	24.9%	22.1%	24.5%
Difference	4.2%	2.9%	8.5%	5.0%	7.6%	5.7%

On average, UK companies paid 5.7% less tax than was expected of them during this five-year period.

If these actual rates of difference are applied to the aggregate profits of the companies in question for each of the years covered by the survey, the value of the Tax Gap can be ascertained:

Table 13

Valuing the Tax Gap of the Sample

	2000	2001	2002	2003	2004	Average
	£mil	£mil	£mil	£mil	£mil	£mil
Aggregate pre-tax profits	71,835	56,172	47,350	68,523	101,747	69,125
Tax Gap %	4.2	2.9	8.5	5.0	7.6	5.7
Value of the Expectation Gap	3,017	1,629	4,025	3,426	7,733	3,966
Cumulative average	3,017	2,323	2,890	3,024	3,966	
Proportion of Expectation Gap expected to arise in the UK	60%	60%	60%	60%	60%	60%
Value of UK Expectation Gap	1,810	977	2,415	2,056	4,640	2,380

Over 5 years the total Expectation Gap for these companies amounted to £19.8 billion, of which almost £12 billion might have arisen in the UK.

This UK data can be extrapolated to estimate the total size of the UK's corporation tax Expectation Gap:

Table 14
Valuing the UK Corporation Tax Expectation Gap

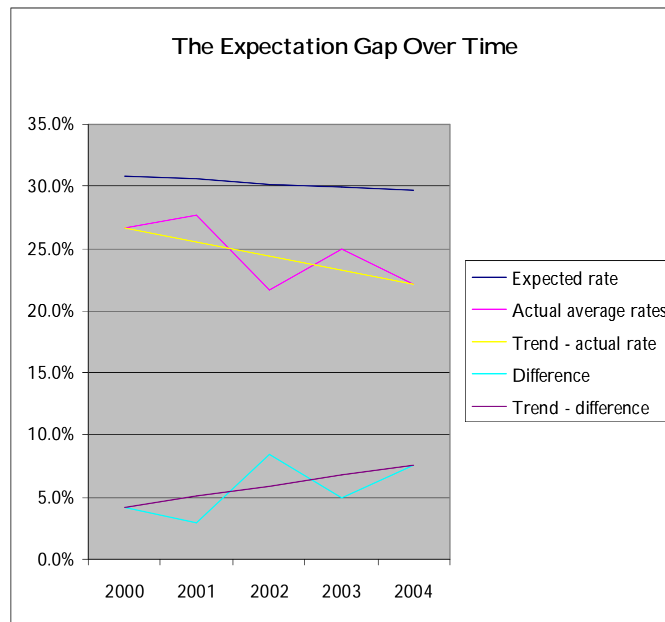
	2000	2001	2002	2003	2004	Average
	£mil	£mil	£mil	£mil	£mil	£mil
Total UK Corporation Tax paid in year	32,421	32,048	29,320	28,115	33,641	31,109
UK corporation tax charge of sample in year	7,130	7,216	6,711	7,986	9,049	7,618
Percentage of UK corporation tax covered by sample	22.0%	22.5%	22.9%	28.4%	26.9%	24.5%
Total extrapolated UK Expectation Gap	8,231	4,341	10,550	7,237	17,249	9,522
Cumulative Expectation Gap	8,231	12,572	23,122	30,359	47,608	

On this basis, the average UK Expectation Gap for corporation tax may be over £9.5 billion a year, with the trend growing over time.

In practice the Gap is likely to of this order, but not quite as high as the extrapolated figure for 2004 might suggest. There are several reasons for this. First, large companies have more opportunity for tax planning by operating multinationally. Second, they have more resources to dedicate to the task. Third, they might actually think it more important than do smaller companies.

But even if the Expectation Gap of the remaining 2 million companies in the UK [6] contributed just as much to the Expectation Gap as the 50 companies surveyed, that Gap would be about £9.2 billion a year and rising. This would amount to 28% of actual corporation tax receipts: a similar value to the 26.3% gap between the 22.1% actual aggregate average tax rate of the companies surveyed in 2004, and the UK expected corporation tax rate of 30% in that year.

This is a substantial gap. In addition, it is clear from the data noted above (graphed below) and in Table 15 that the trend of the corporation tax Expectation Gap is markedly upwards:



6 Source: Companies House website, average data.

Why is tax not paid?

Finding reasons

It is clear from the findings of this survey that the companies subject to the survey are not paying tax at the rate expected of them. Since 2002 UK companies have been required to publish a reconciliation between the tax that they declare that they owe for a period (the current tax charge on the profit and loss account) and the tax that they might be expected to pay at the UK's 30% standard rate of corporation tax (which as we saw above happens to coincide closely with the overall anticipated rate of tax that might apply to them throughout this five year period). Some companies provided such reconciliations in the years 2000 and 2001 as well, but the basis on which they were prepared was inconsistent and so they have not been used in this report.

Unfortunately, UK accounting standards allow this reconciliation to be done in one of two different ways. The first is to reconcile the actual sums involved. This method has a fairly high degree of numeric reliability. The second is to reconcile the overall tax rates, stated in percentage terms. This method seems to be particularly attractive to the larger companies covered by this survey, and due to roundings in the percentage calculations appears unreliable when restated in value terms to provide comparability with the first method. This second method therefore appears misleading, and explains why some data used in this section appear not to reconcile with other data used in this report. Use of this method of reconciliation should be strongly discouraged.

The reconciliations for the years in question, using aggregate data, are:

Table 15
Why tax is not paid

	2002	2003	2004	Total
	£ mil	£ mil	£ mil	£ mil
Tax at 30% in UK	14,066	21,492	32,368	67,926
Amortisation	6,880	9,357	7,669	23,907
Tax due after amortisation disallowed	20,946	30,849	40,037	91,833
Expenses not deductible	2,599	1,672	757	5,028
Non assessable income	-2,444	-1,129	-950	-4,523
Excess capital allowances	-1,084	-1,717	-1,684	-4,484
Prior year adjustment	-749	-700	-1,319	-2,768
Enterprise Zone Allowance & Equivalent	-300	-519	-346	-1,165
Other items	2,018	-2,121	-3,506	-3,609
Total	20,986	26,336	32,990	80,312

The “other items” are largely explained by “short term timing differences”, a frequently used catch-all phrase which provides no real explanation as to why a difference has occurred. It does, however, also include the following items in aggregate over the three-year period reviewed:

	£ mil
Differences in overseas tax rates	249
State and local taxes	434
Losses	606
Gaines covered by losses	-249
R & D	-261
Pensions	-601

It is interesting to note that many UK companies have often anecdotally explained their falling tax rates by suggesting they have enjoyed the benefit of research & development tax credits. This survey suggests these have had a small and relatively insignificant influence on their tax rates, but have provided a useful cover for declining rates by suggesting they are the consequence of official taxation policy.

It is as interesting to note that differences in overseas tax rate only have a small effect, which is consistent with the research on tax rates included in this report. It has to be accepted as a result that whilst it is known that many of the companies covered by this survey use tax havens this does not seem to have given rise to substantial taxation benefit for the companies involved. However, it must also be accepted that some of the companies who obtained substantial benefit in this way might have hidden the benefit by simply describing it as an 'other' difference. The fact that the effect of aggregate difference in overseas tax rates was to increase liabilities strongly supports this possibility.

What is clear is that some companies do seek to use manufacturing incentives to their advantage. Over half of the 'enterprise zone and equivalent allowances' benefit was claimed by Glaxo, with Barclays (surprisingly) and Unilever being the other main contributors. Of course, other companies may have described such benefits as 'excess capital allowances'. The ambiguities in reporting allowed by current accounting standards increase the Reporting Gap in this area.

For example, whilst accounting standards dictate that a reconciliation of tax charges has to take place, they do not specify in what detail that reconciliation has to be undertaken. BHP Billiton and SABMller provide considerable depth. Shell and Carnival provide just two reconciling items, which in the case of Shell seem inexplicable. Five or six items are normal for most of the companies. This leaves open the possibility that items which might draw attention to uncomfortable issues for companies, including the benefit of using tax havens, are hidden in the 'other' category.

Where is tax paid?

A limited geographical analysis

The information published by UK companies allows a very limited analysis of where tax is paid by the companies. The tax charge is simply split between the UK and 'overseas'.

Even this analysis is not meaningful in many cases, because either turnover or operating profit are not reported in a fashion that allows any judgement to be made on whether the tax split bears any relationship with the underlying trading of the company.

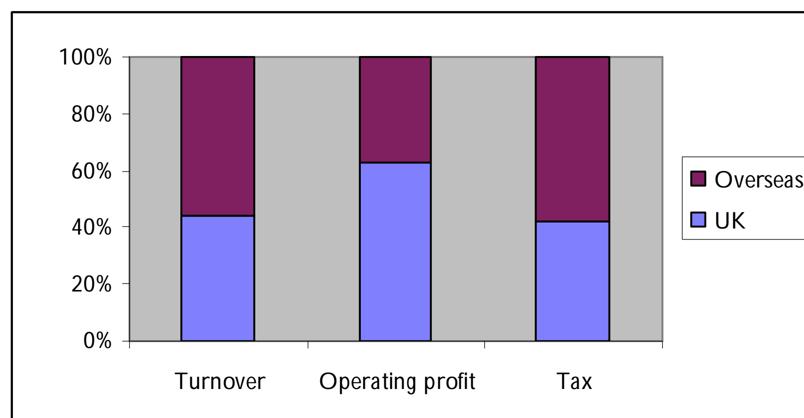
Given these limitations in the available data, an analysis has been undertaken on those companies where a split between UK and non-UK turnover, operating profits and taxation is available. This calculation has been undertaken in aggregate over the five year period.

49.8% of the aggregate turnover of the companies surveyed can be split in this way over the five year period. For the companies involved 43.8% of their turnover arose in the UK.

Of the reported operating profits of these companies (i.e. their profits before interest and other finance charges, including goodwill amortisation - although there is some inconsistency in this respect) 62.9% arose in the UK. Perhaps unsurprisingly, it appears that UK companies make more operating profit on their UK operations than they do from their overseas activities.

However, when it comes to current tax charges (as declared on the profit and loss account), current UK tax charges after double tax relief (which basically eliminates any UK charge on profits earned overseas and remitted to the UK, meaning that the basis of tax charge used for this calculation should be similar to the basis of declaration of group operating profits) represent 42.2% of total current tax charges.

Put graphically, the pattern looks like this:



It appears that UK companies are paying the tax in the UK that their turnover suggests appropriate, but not the tax that the ratio of their operating profits suggests appropriate.

There is an obvious reason. The UK has a generous system of tax relief for interest paid on borrowings, so that tax relief is given on that cost whatever the reason for the borrowing. In other words, a UK company can borrow in the UK and obtain tax relief on the interest it pays even though the cash

borrowed is used solely in its overseas operations. It appears likely that companies are exploiting this opportunity to reduce their UK tax liabilities. If the UK's generosity on many international tax issues is abused by an increasing number of companies then opportunities those companies have enjoyed, such as the unquestioning relief for interest paid, may be subject to review in the future. They should not be surprised if the rules are changed.

Deferred tax

A subject that can't be ignored

There are few accountants who do not wish that they could ignore deferred taxation. It is notoriously difficult to calculate, and just as hard to understand. A definition is included in the glossary. A short definition, provided in the UK's Financial Reporting Statement 19 (which applied to the accounts covered by this report from 2002 onwards in most cases), is that deferred tax balances are *'The estimated future tax consequences of transactions and events recognised in the financial statements of the current and previous periods'*. Perhaps the most important word in this definition is 'estimated'. It is impossible to calculate deferred tax liabilities with absolute accuracy. To appraise the significance of deferred tax estimates in accounts, however, some numbers must be used.

How much?

At the start of 2000 the total net deferred tax liabilities of the companies covered by this report were £9,296 billion. The closing net liabilities at each subsequent year end were as follows:

Table 16					
Deferred tax carried forward	2000	2001	2002	2003	2004
	£ mil	£ mil	£ mil	£ mil	£ mil
Total	8,715	13,408	28,506	34,763	36,285
Number of companies	44	46	48	50	50
Average	198	291	594	695	726

£9.3 billion is not an insignificant number in taxation terms. In 2000 this represented about 27% of the annual UK payment of corporation tax by all companies. By 2004 however this reported liability had risen approximately fourfold to over £36 billion, a sum about 109% of the annual total corporation tax paid in the UK.

£17 billion – just from changing accounting rules

This increase came about for several reasons. The first was that Financial Reporting Standard 19 on 'Deferred Tax' was issued on 7 December 2000, and was first used in the 2002 accounts of most companies covered by this review. The Standard changed previous accounting rules so that accounting on a 'full provision' basis was required on most types of timing difference. Previously a 'partial provision' basis had been allowed. A partial provision basis meant that deferred tax had only to be provided in a company's accounts if the company thought it likely that the deferred tax would be paid in the reasonably foreseeable future. A full provision basis requires it to be included in the accounts whether or not it is likely to be paid. The technical possibility of payment is enough to require its inclusion.

The impact of the change was that many companies that had previously believed that their deferred tax liabilities would never be paid, and as such had not charged them in their accounts, now had to do so.

The impact of this change can be assessed by the restatements made in the deferred taxation liabilities of companies between (in most cases) 2001 and 2002 and in some cases (where companies adopted the new rule early) between 2000 and 2001. Almost £17 billion of additional liabilities were recognised because of the restatements, or almost half of the total deferred tax liability now reported to be owing by the companies covered by this report. There seems to be almost no prospect of this liability being paid. As such this liability can fairly be considered part of the Expectation Gap, and, because it does ultimately represent cash not paid, a part of the Revenue

Gap as well.

The biggest single additional liability recognised as a result of the introduction of FRS 19 was the additional charge made by BP, amounting to US$10,047 million (£5,485 million as translated for the purposes of this report). BT recognised an additional liability of £2,015 million, whilst Prudential created an additional provision of £2,445 million in 2001. Some companies, however, saw almost no impact from the change in rules.

Over £9 billion of deferred tax charges

In addition to the additional liabilities recognised under FRS 19, the pattern of deferred tax charges over the period changed significantly. Until FRS 19 the deferred tax component of the tax charge in the profit and loss account was as likely to be negative (i.e. a reduction in tax charge) as positive (i.e. an additional charge). That is because only those liabilities likely to be paid were included. This pattern changed after FRS 19 was introduced, as this aggregate data shows:

Table 17 Deferred tax charges	2000	2001	2002	2003	2004
	£ mil	£ mil	£ mil	£ mil	£ mil
Total	-15	495	3491	2871	2741
Number of companies	44	46	48	50	50
Average	0	11	73	57	55

Over the period as a whole £9,584 billion of deferred tax charges have arisen. Once FRS 19 was introduced the trend was for much larger deferred tax charges, with many fewer reversals in the charges made. Over the three year period 2002 to 2004, 37 of the sample companies made net deferred tax charges totaling £10,775 million. 13 released net deferred tax provisions to their profit and loss accounts amounting to a total sum of £1,671 million. In short: not only did FRS 19 introduce a massive deferred tax balance that is unlikely to ever be paid, but that since 2002 that sum has grown by about £9 billion.

The unseen charge

There is one other element to the change in deferred tax liabilities. This is their restatement. Accounting is a logical subject in which, one hopes, logical rules apply. If it did then the following logic would work:

Deferred tax reconciliation	£
Balance at start of year	W
Add or subtract opening balance adjustment	X
Charge in the profit and loss account for the year	Y
Balance at the end of the year	Z

One hopes that W + X + Y = Z

Unfortunately this is rarely the case in the accounts subject to this survey. In no less than 215 of the 238 sets of accounts reviewed there was some further adjustment. These occurred for reasons such as:

1. an addition or subtraction to the balance because of the purchase or sale of a business;
2. a restatement of the deferred tax balance because of the re-translation of the balance owing, where this was not expected to be paid in the currency in which the accounts were reported.

These are legitimate, and if disclosed it is possible to work out where the other side of the double entry resulting from restatement of this tax liability might arise in the balance sheet or profit and loss account respectively. But too often the adjustment occurs without explanation being given. For example, in Shell's 2003 accounts the deferred tax charge reported to have been charged to the profit and loss account was a credit of US$196 million (i.e. a reduction in the overall charge). However, the overall deferred tax liability rose by $659 million instead of falling by US$196 million. Therefore a deferred tax adjustment of US$855 million (£467 million) occurred for which no explanation appears available in the accounts.

Overall across the whole sample these unexplained adjustments net out to less than £1 billion over the whole period. But when, as in the case of Shell, such an adjustment can in one year be substantial and yet be unexplained, this aspect of deferred tax accounting leaves much to be desired, and leaves substantial uncertainty as to the true impact of taxes on the profit and loss accounts of the companies involved. In Shell's case, for example, the charge might have been against profit, although without explanation offered.

What makes up the balance?

Throughout the period under review, companies have been required to disclose the major components of their deferred tax liabilities. Some do this in considerable detail. Others rely far too much on the 'other differences' or 'short-term timing differences' categories. The major components of the deferred tax liabilities of the companies covered by the survey are:

Table 18
The composition of deferred tax balances

	2000	2001	2002	2003	2004
	£ mil	£ mil	£ mil	£ mil	£ mil
Excess capital allowances	13,616	17,219	36,278	41,232	42,984
Bad debts	-16	-17	-983	-2,083	-1,792
Pension payments	-613	-602	-319	1,432	750
Short term timing differences	-1,614	-1,774	-1,245	-1,011	-1,244
Untaxed transactions	384	596	827	325	428
Losses	-2,178	-1,887	-2,514	-4,166	-4,428
Unrealised gains	696	2,284	990	1,803	2,437
Other differences	-1,559	-2,411	-4,528	-2,769	-2,850
Total	8,715	13,408	28,506	34,763	36,285

It can be seen that taxation allowances for capital expenditure in excess of the equivalent depreciation charges completely dominate the provisions, with the next biggest item being provisions for tax on capital gains recognised in the accounts but where sale of the asset has yet to take place. Pension payments have uniquely changed their overall balance. Until 2002 companies had deferred tax assets for pensions. The situation has now changed. Companies are now seeking to make good shortfalls in their pension funds, and are creating deferred tax liabilities in the process.

The future of deferred tax

The one certainty about deferred tax accounting is that it will change. In 2005 all the companies covered by this survey will adopt International Financial Reporting Standards. These differ from the UK standards they replace, and it is likely that deferred tax liabilities will increase again as a result, with another round of adjustments to reflect this fact. The increase will not reflect any increased probability that the tax will actually be paid.

The deferred tax problem

The problem with deferred tax as it is presently accounted for is that it amounts to significant sums on the balance sheets of many of the companies within this survey, and yet almost no indication is given as to when, or if ever, it might become due. As the evidence of this report shows, in many cases the chance that a real cash payment will arise from many of the declared liabilities appears to be quite low.

This means that the resulting liabilities seriously distort the accounts of many companies. The deferred tax reserves are, in effect, long term loans from governments with no repayment date and no interest being charged. The shareholders, however, have no way of determining the impact of these loans on future cash flow when appraising the performance or worth of a company. This is misleading accounting at best. It can only be resolved if an indication of the likely timing of the liability is provided, and there is no reason why this should not be done.

Conclusions on deferred tax

Several things can be concluded about deferred taxation in accounts:

- It seems very unlikely that most of the £36 billion of deferred tax shown on the balance sheets of the companies subject to this review will be paid;
- The annual average charges for deferred tax of around £3 billion per annum that have become normal under FRS 19 accounting rules will rarely result in tax being paid;
- The accounting for deferred tax that is taking place does not always provide all the information that a reasonable user of the accounts might wish for. In particular, many companies fail to reconcile their opening and closing deferred tax liabilities, creating a Reporting Gap as a result. Even those that do provide such a reconciliation do not always explain where their deferred tax adjustments are charged in their accounts;
- The composition of deferred tax balances suggests that governments are offering tax incentives for investment in fixed assets such as plant and machinery which are wholly unrelated to the underlying economic substance of the transactions taking place. This is clear evidence of a Competitive Gap.
- If these increasing deferred tax balances are to be prevented from seriously distorting the balance sheet perspective of many companies, accounts need to report when or if the deferred tax liabilities can reasonably be expected to be paid in the opinion of the directors.

The standard of reporting

Inconsistent reporting

For those involved in this research, one of the most marked findings was the sheer inconsistency and the variability in the quality of the reporting in the accounts of the companies surveyed.

One would have hoped that one auditor might at least have applied a common standard to the companies they audited. This was not the case.

The perfunctory approach many companies take to tax accounting was exemplified by the attitude to deferred tax assets. When deferred tax accounting first became an issue it was anticipated that most (if not all) balances would be deferred tax liabilities. As such, accounting standards required that movements in deferred tax liabilities be disclosed and that an analysis of the break down of these liabilities be provided in company accounts. It is now increasingly commonplace for a company to have deferred tax assets instead of, or as well as deferred tax liabilities (17 did in 2000, 30 by 2004). Despite this change it has remained commonplace to ignore movements in the value of the deferred tax asset when preparing the note on deferred tax charges to the profit and loss account. This note thus frequently disagrees with the tax note itself. WPP is an example of a company where deferred tax assets are not analysed as to their cause, and the deferred tax movement in the tax note does not explain the movement in the asset during the periods under review. It is far from alone. Reckitt Benckiser were another company whose deferred tax notes ignore the fact that it has deferred tax assets, and as such the note supplies little useful information.

Indeed, so unusual was it for a deferred tax charge in the tax note and the declared profit and loss account movement in the deferred tax note to agree with each other, that notes were made of the occasions when this unusual event occurred. HSBC and BT, for example, managed this apparently simple accounting feat. It was very worrying that so few companies or their auditors appeared to undertake this most rudimentary of checks, and to ensure that they complied with such a basic quality measure in their tax reporting. Scottish Power clearly put effort into this issue, but restatements meant its accounts were hard to follow. Lloyds TSB also suffered a problem with restatements, restating its accounts 4 times over the survey period.

In the opinion of the research team, Shell's tax reporting was the worst in the survey. This was not helped by the fact that under dual listing rules, the accounts of the operating company were published under Dutch accounting rules. To use a basis for tax reporting entirely different from that used in the UK, when those accounts were published alongside those of the UK quoted company, was at least potentially misleading. Its approach to such issues as tax reconciliations was not encouraging either.

It was impossible to identify a company whose overall accounting performance could be considered first rate, although Marks & Spencer, RBS, Imperial Tobacco, and Wolseley stood out as being above average. Associated British Foods accounts could also be reconciled consistently with some effort.

In general too many companies are using 'other' reporting categories to reduce disclosure.

The fact that many companies spread their tax disclosure far and wide throughout their accounts must also hinder any understanding of tax in their accounts for most users. Wolseley were amongst the few companies who brought all their tax notes together under one heading. This seems to be the most basic requirement for a company serious about conveying useful

information about tax.

Data on segmental reporting is inconsistent in its availability and its content. There appears to be inconsistency in deciding what is operating profit, for example. None of this helps interpretation of accounts.

Nor is tax disclosure helped by the inclusion of a parent company's share of the charges due by its associates when the resulting liabilities are accounted for through its interest in that associated company. Full disclosure of the share of associated company and joint venture tax charges should be matched by disclosure of how these impact upon the cash flow and balance sheet. For companies like BAE Systems, which has substantial joint venture activity, the taxation notes are almost impossible to use because of this problem.

So important is this issue of the quality of reporting that a further report on the subject will be issued later in 2006.

Enhanced reporting

Within the constraints of existing reporting requirements many companies could do a great deal to improve the quality of their tax reporting. We recommend urgently that:

1. All tax reporting, whether with regard to current or deferred tax and whether with regard to profit and loss, cash flow or balance sheet issues should be included in one note to the accounts, to which others can refer if necessary.

2. All notes should be checked for internal consistency e.g. with regard to deferred tax, the profit and loss account charge in the deferred tax note should be the same as the deferred tax charge on the proper loss account. This would seem so obvious as to not require comment, but is a feat rarely achieved.

3. Corporation tax liabilities should be published separately from other taxation liabilities. This was not done by at least seven companies in the survey.

4. Tax reconciliations should contain as few 'other' items as possible, and these should never account for more than 10% of the reconciliation.

5. No company should use percentage rate tax reconciliations. They are misleading and tend to be inaccurate.

6. The tax rate calculation to which a tax reconciliation takes place should not be that for the UK alone, but should reflect the expected tax rate applicable to the declared net profits of the company. The basis for this calculation should be disclosed if this reconciliation is to be meaningful.

7. Deferred tax movement reconciliations covering both deferred tax assets and liabilities should always be published.

8. The likely timing of settlement of any deferred tax liabilities should be disclosed.

9. The tax accounting for associated company and joint venture activities must be improved so that the cash flow and balance sheet consequences of these measures are understood.

10. Segmental reporting should be improved so that tax charges by

business segment are disclosed.

None of these changes require alteration to accounting standards to legislation. They would simply represent the use of best practice and would be indicative of a willingness to assist the user to understand the taxation charges included in a set of accounts.

Quantum leaps required if the Tax Reporting Gap is to be closed

The voluntary improvements in reporting referred to in the previous section would be of significant benefit to all users of accounts. Such changes would not, however, make multinational companies fully accountable for their taxation liabilities. Much more detailed reporting is required if global companies (like most of those in this study) are to be held accountable for their actions as global citizens. As a basic step in this direction, it is vital that every company disclose the following information, without exception being made:

1. A list of the countries in which they have operations;
2. The names of their subsidiaries that operate in each of the countries in question;

The following should then be published for each and every country:

3. Turnover in total;
4. Third party turnover;
5. Third party costs excluding those of employment;
6. Interest paid;
7. Profit before tax;
8. Tax charge on profits split between current and deferred tax;
9. Other taxes or equivalent charges due to the government of the territory in respect of local operations;
10. The actual payments made to the government of the country and its agencies for tax and equivalent charges in the period;
11. The liabilities owing locally for tax and equivalent charges at the beginning and end of each period, as shown on the balance sheet at each such date;
12. Deferred taxation liabilities for the country at the start and close of the period;
13. Gross and net assets employed;
14. The number of employees engaged, their gross remuneration and related costs;
15. Comparative data.

Only if this information is disclosed will it be clear whether a company is fulfilling its taxation obligations, which is the least that is now expected of it by governments and civil society around the world. If required by an International Financial Reporting Standard such disclosure could (and should) become a normal part of financial reporting. It would probably take less space to disclose than the considerable acreage of reporting currently given to director's remuneration.

A benchmark for comparison – The Co-operative Bank

Reasons for benchmark testing

Various reviewers of this report suggested that it would be desirable to compare the results from the survey companies with those that might be obtained from other sample groups such as:

1. UK small and medium-sized enterprises;
2. privately owned large companies within the UK:
3. smaller quoted companies such as those on AIM;
4. quoted companies located in other territories.

In practice limited resources have made this impossible for now, although it is hoped that surveys to be undertaken in future may provide some of these comparison checks.

The test undertaken

One comparison test was, however, undertaken because the data necessary to undertake it was easily available. This test, briefly commented upon here, was undertaken to see whether a company that has declared itself to be managed on an ethical basis might produce a significantly different tax result when compared with other companies undertaking a similar trade. The company chosen for this purpose was the Co-operative Bank, whose results for the five-year period from 2000 to 2004 were compared to those of the other banks included in this survey:

- HSBC
- Royal Bank of Scotland
- Barclays
- HBOS
- Lloyds Tsb
- Standard Chartered.

The results

The results of the comparison test were surprising and encouraging. In summary:

- The Co-operative Bank's Tax Gap is virtually non-existent. According to its profit and loss account it declared tax due at 30.1% over the five year period, compared to an average for the sample of 28.8%. It actually paid tax at 29.4% against an average for the sample of 25.2%. In effect this meant that the Co-operative Bank paid the tax expected of it. This is in contrast to all the other banks within the sample, one of whom paid tax at just 20.8% on average (see next page):

Table 19
Current tax charge to pre-amortisation profit rate – Co-operative Bank compared to other and other banks in the survey

	2000	2001	2002	2003	2004	Average
	%	%	%	%	%	%
Co-operative Bank	29.6%	30.5%	30.0%	29.2%	27.5%	29.4%
HSBC	22.5%	22.7%	18.2%	22.1%	18.6%	20.8%
Royal Bank of Scotland	23.9%	26.0%	22.6%	19.5%	22.0%	22.8%
Barclays Bank	26.4%	25.9%	28.6%	21.5%	24.5%	25.4%
HBOS		23.9%	22.6%	25.1%	25.4%	24.3%
Lloyds Tsb	25.7%	25.0%	32.6%	20.6%	24.3%	25.6%
Standard Chartered	27.7%	27.6%	30.3%	29.6%	26.2%	28.3%
Number count	6	7	7	7	7	
Average	26.0%	25.9%	26.4%	23.9%	24.1%	25.2%

- The average difference between the Co-operative Bank's declared and actual rates of tax was 0.7%. The largest Gap in the sample was for RBS, who had a Gap of 10.2%.

Table 20

The Banks' Tax Gaps expressed in percentage terms

	2000	2001	2002	2003	2004	Average
	%	%	%	%	%	%
Co-operative Bank	1.4%	-1.0%	-0.2%	0.8%	2.5%	0.7%
HSBC	0.4%	-3.0%	8.1%	2.2%	7.0%	2.9%
Royal Bank of Scotland	10.4%	9.9%	10.1%	11.6%	9.2%	10.2%
Barclays Bank	0.6%	2.1%	1.2%	6.5%	3.5%	2.8%
HBOS	0.0%	5.2%	6.1%	3.9%	3.1%	4.6%
Lloyds Tsb	2.9%	2.3%	-3.3%	3.0%	4.5%	1.9%
Standard Chartered	-1.5%	5.3%	0.4%	2.5%	3.4%	2.0%
Number count	6	7	7	7	7	
Average	2.4%	3.0%	3.2%	4.4%	4.7%	3.6%

- The Co-operative Bank had the simplest tax reconciliation of any bank in the sample. That tax reconciliation gave no indication of aggressive tax planning taking place e.g. the use of enterprise zones or employee trusts, use of which are evidenced in some other banks' tax reconciliations. Nor is there indication of an over-dependence upon the sale of tax driven products such as lease finance.

- The Co-operative Bank does not appear to seek to benefit from low overseas rates of tax, despite the fact that it trades in the Channel Islands. This is in contrast to HSBC and Barclays in particular.

- The quality of the Co-operative Bank's reporting appears to be the highest of all the banks in the sample. All its disclosures balanced bar immaterial rounding differences, for example.

- The Co-operative Bank's deferred tax accounting is good in most respects. Unusually (and exceptionally), the entire movement in its

reserves are explained by the notes to the profit and loss account throughout this period. It does not provide sufficient breakdown of its deferred taxation balances. This is a minor blemish in an otherwise almost perfect record.

Appendix 1 - The companies included in this report

The data used

Unless noted otherwise, the data used to prepare this report relate solely to the fifty companies with the largest market values listed on the London Stock Exchange on Easter Sunday (March 27) 2005.

The data collection process is described in fuller detail in Appendix 4.

The companies

The companies in question, their market values on the day in question and their reported turnovers (sales), pre-tax profits and shareholder's funds or capital employed as declared in their 2004 financial statements are as follows:

Table 21

Background information on the companies reviewed

		Market Capitalisation	Turnover 2004	Pre-tax Profit 2004	Shareholder funds 2004
		£ million	£ million	£ million	£ million
BP	1	117,740	155,617	13,235	41,847
HSBC	2	94,470	27,616	9,612	47,288
Vodafone Group	3	92,550	33,559	-5,047	111,924
GlaxoSmithKline	4	71,920	20,359	6,119	5,925
Royal Bank of Scotland Group	5	52,940	22,754	6,917	31,865
The Shell Transport & Trading Co.	6	45,950	144,770	17,679	46,171
Barclays Bank	7	35,560	13,945	4,603	17,417
AstraZeneca	8	34,820	11,697	2,776	7,871
HBOS	9	31,930	10,227	4,592	20,535
Lloyds Tsb Group	10	26,610	9,567	3,493	9,977
Tesco	11	24,430	30,814	1,600	7,945
Diageo	12	22,670	8,891	1,969	3,692
British American Tobacco	13	19,950	10,764	1,886	5,416
Anglo American	14	18,750	13,610	2,534	13,647
Rio Tinto	15	18,270	6,193	1,963	6,870
BT	16	17,510	18,519	1,948	3,094
BHP Billiton	17	17,500	12,494	2,466	7,664
National Grid Transco	18	15,310	9,033	1,362	1,213
Unilever	19	15,020	27,252	1,926	3,754
Aviva	20	14,460	29,798	1,488	9,244
BG	21	14,410	4,082	1,544	4,590
Standard Chartered	22	12,280	2,930	1,178	4,605
Reckitt Benckiser	23	12,190	3,871	770	1,676
Prudential	24	11,900	16,355	650	4,281
Cadbury Schweppes	25	10,900	6,738	642	3,088
British Sky Bcast. Group	26	10,770	3,656	480	90
Imperial Tobacco	27	10,220	3,032	688	136
O2	28	10,100	5,694	95	10,091

GUS	29	9,140	7,548	692	3,007
SABMiller	30	9,140	6,205	759	3,813
BAE Systems	31	9,400	9,095	-232	4,738
Centrica	32	8,350	18,303	1,708	2,571
Scottish Power	33	7,760	5,797	792	4,752
Scottish & Southern Energy	34	7,660	5,124	607	1,728
Legal & General	35	7,660	10,911	646	3,376
WPP	36	7,640	19,598	457	3,966
Reed Elsevier	37	6,970	4,906	562	2,267
Kingfisher	38	6,900	8,799	427	4,407
Wolseley	39	6,500	10,128	559	1,902
BAA	40	6,340	1,970	539	5,018
Carnival	41	6,210	2,130	300	2,466
Xstrata	42	6,180	3,325	747	4,378
Land Securities	43	6,130	1,481	373	6,039
Associated British Foods	44	5,980	5,165	494	3,496
Allied Domecq	45	5,930	3,229	479	590
Reuters Group	46	5,890	2,885	437	612
Marks & Spencer	47	5,680	8,302	782	2,454
Compass	48	5,420	11,772	370	2,482
ITV	49	5,300	2,053	207	3,418
Old Mutual	50	5,230	3,629	873	4,772
Total		1,032,540	816,191	101,747	504,167
Average		**20,651**	**16,324**	**2,035**	**10,083**

Appendix 2 - International tax rates

Reason for undertaking the review

International companies based in the UK are not subject solely to UK tax rates. It is normal for such companies to operate as groups, and for the group to have separate operating companies in each country in which it works. Some, such as BP, work in more than 100 countries. In many cases if the company is undertaking a trade in a country and it does not transfer its profit back to the UK by way of a dividend, it can retain any tax benefit that it obtains overseas through lower tax rates. For that reason it is important to make sure that any Tax Gap is valid in comparison with international as well as UK tax rates.

Data used for this survey of tax rates

KPMG has published an annual survey of tax rates in a wide range of countries over several years. Given that KPMG operate in all the countries on which they report, it has been presumed that their data is reliable. The data is published at the start of each year, but since tax rates are published in advance of a year in most cases it is presumed that they relate to the year that follows i.e. the survey of rates in January 2004 will cover rates applying to profits during the following year.

By itself, however, tax rate data is of limited value. It must be weighted so that a country of very small size with an unusual tax rate (like tax havens) does not distort the survey. To weight the data information published in the CIA Fact Book in July 2005 was used. Data was collected on:

1. Population (indicating size);
2. GDP (indicating economic significance);
3. The budget for state spending (indicating fiscal need).

Data was then sorted to produce the following table. Where data was split into groups by size an arbitrary split of half the population by number was made between the upper and lower groupings (see next page):

Table 22
Corporation tax rate data

	2000	2001	2002	2003	2004	Change
Average tax rate (%)	31.7	31.1	30.3	29.8	29.1	4.3
Weighted average based on GDP of country	32.0	31.4	30.4	29.8	29.2	4.8
Average rate of tax in the EU (%)	34.8	33.5	32.0	31.3	30.8	6.4
Average rate of tax in the OECD (%)	33.8	32.7	31.1	30.6	29.7	6.7
Average rate of tax in non OECD (%)	30.1	29.8	29.6	29.1	28.6	0.9
Average rate of tax in large countries (%)	34.2	33.1	32.6	32.1	31.4	4.1
Average rate of tax in small countries (%)	29.2	28.9	27.8	27.4	26.7	4.6
Average rate of tax in countries with high GDP per head (%)	33.1	32.2	30.7	29.8	29.5	6.3
Average rate of tax in countries with low GDP per head (%)	30.5	30.2	29.9	29.7	28.8	2.6
Average rate of tax in country with high state spending (%)	33.5	32.0	30.4	30.0	29.5	6.4
Average rate of tax in country with low state spending (%)	30.6	30.6	30.1	29.6	28.8	2.9
Maximum rate (%)	47.2	42.1	42.0	42.0	42.0	11.2
Minimum rate (%)	15.0	15.0	16.0	12.5	12.5	2.5
Number of companies in survey	65	68	69	69	69	
Maximum rate cut in year (%)	9.0	15.0	15.0	13.0	10.0	
Maximum rate rise in year (%)	10.0	11.3	7.0	6.0	3.0	
Number of cuts in year	12	17	17	13	15	
Number of rises in year	5	5	4	7	3	
Net number of cuts per annum	7	12	13	6	12	

This survey demonstrates that:

1. the trend in tax rates is downward;
2. that trend is more marked in more affluent countries, which did however tend to start with higher rates;
3. the trend is not universal; some countries have increased rates but in general the cuts are bigger than the increases.

A choice of rates

Of the rates available to choose from above, that used in this report is the weighted average based on the GDP of the country. The weighting used was the relative proportion of total GDP in the countries covered by the survey attributable to each group.

This rate is lower than that which would be used based on an EU or OECD basis, even if these countries might, in fact, dominate the trade of many UK corporations.

It is worth noting that for the years 2002 to 2004 it is possible to compare these rates with those produced from data published on Forbes.com. That data suggests rates of 29.9% in 2002, 28.8% in 2003, and 28.1% in 2004. The

data above cannot reproduce rates as low as these. As the dataset is larger and has been more consistent over time the KPMG based data is considered more reliable.

Appendix 3 - The Language of Tax

It is almost impossible to comprehend tax without some understanding of the technical language that it uses. This section seeks to explain that language.

This glossary is based upon that included in "Tax Us If You Can" published by the Tax Justice Network, to which this author was a major contributor. "Tax Us If You Can" is available as a free download at http://www.taxjustice.net/cms/front_content.php?idcat=30. Commercial and accounting terms necessary to understand particular issues raised in this report have been added to ensure comprehensiveness.

Term	Description
Affiliate	A related company or subsidiary
Aggressive tax avoidance	the use of complex schemes of uncertain legality to exploit taxation loopholes for the benefit of taxpayers who can afford the fees charged by professional advisers who create such arrangements .
Amortisation	See goodwill
Arising basis	Treating income earned outside the country of residence as liable to tax in the year in which the income is earned, even if it is not remitted to the country where the tax is payable. Compare with the remittance basis.
Banking secrecy	Banking secrecy laws strengthen the normal contractual obligation of confidentiality between a bank and its customer by providing criminal penalties to prohibit banks from revealing the existence of an account or disclosing account information without the owner's consent. Can be used to block requests for information from foreign tax authorities.
Capital expenditure	Cash expended to acquire fixed assets.
Capital gains tax	A tax on the profits from the sale of capital assets such as stocks and shares, land and buildings, businesses and valuable assets such as works of art.
Company or corporation	An entity treated as a separate legal person from those who set it up, established under the rules of the country in which it is registered.
Controlled foreign corporation (CFC)	A tax definition to describe a situation in which a company which charges tax on the profits of corporations has a subsidiary registered in a tax haven or other territory where little or no tax is charged on the profit the subsidiary makes. The subsidiary is then called a CFC and its profits can in some cases be subject to tax in the country of residence of the parent company.
Coordination centres	A special form of company with taxation advantages, often used to attract corporate headquarters to a country. Most notably found in Belgium, the Netherlands and Ireland.
Corporation tax	A tax on the profits made by limited liability companies and other similar entities in some countries, but otherwise usually being similar in application to income tax.
Deferred tax	A fictional tax which only exists in company accounts and is never paid. Deferred tax does not, as such, exist. But the rules of accountancy generally require that income be matched with expenses. If an expense is recognised for tax purposes more quickly than it is for accounting purposes (which is common with much plant and equipment, for example) this means that the tax cost for the years when this happens is understated. Conversely, when all the tax allowances have been used on these assets there might still be accounting charges to make and the tax cost would then be overstated. To balance this equation a notional tax charge called deferred tax is charged to the profit and loss account in the earlier years and put on the company's balance sheet as a liability. The liability is released as a credit to profit and loss account in the later years and supposedly over the life of the asset all should balance out. Other transactions that can give rise to deferred tax liabilities (and assets) include: 1. pension liabilities that are accrued in the financial statements but are allowed for tax only when the contributions are made to the pension fund at a later date;

2. inter-group profits in stock that are not recognised in the consolidated accounts of a group but are taxable nonetheless in the group company that made the profit;
3. losses reported in the financial statements where the tax relief is only available to carry forward against future taxable profits.

Double tax relief	Tax relief given by the country in which the tax payer resides for tax paid in another country on a source of income arising in that other country.
Double tax treaty	An agreement between two sovereign states or territories to ensure, as far as possible, that income arising in one and received in the other is taxed only once. Includes rules to define Residence and Source, and limits on Withholding Taxes. Also usually includes provisions for cooperation to prevent avoidance, especially information exchange.
Effective tax rate	The percentage of tax actually paid in relation to the total income of the person paying the tax.
Export processing zones	Artificial enclaves within states where the usual rules relating to taxation and regulation are suspended to create what are, in effect, tax havens within larger countries.
Fixed assets	The plant and machinery, vehicles, IT equipment, land and buildings and other tangible items that a company acquires to enable it to undertake its trade, the benefit of which is expected to endure for more than one year, and often for a lot longer.
Flat tax	A tax system in which as income rises the amount of tax paid remains constant in proportion to total income. Compare with progressive taxes.
General anti-avoidance principle	A law that seeks to prevent a tax payer from obtaining the taxation benefit arising from any transaction if they undertook it solely or mainly to obtain a tax benefit. It does so by looking at the motivation of the taxpayer at the time of entering into the transaction, for which reason the concept of tax compliance is important. If the person was seeking to be tax compliant then they should probably keep the benefit they obtained from the transaction. If they were taxation non-compliant then they should not. Compare with a general anti-avoidance rule.
General anti-avoidance rule	A general anti-avoidance rule seeks to tackle those who try to break the rules of taxation through the use of further rules. Rather than considering intention, it lays downs ways of interpreting series of events to determine whether the benefit of tax legislation can be given to the tax payer. However, because rules are invariably open to interpretation a general anti-avoidance rule runs the risk of increasing the opportunity for abuse.
Goodwill	The excess of the value paid for a business over the value of the tangible assets, whether real or financial (e.g. trade debtors) which it owned at the time of acquisition. This difference is a measure of the intangible ability the business had created to make profit out of those tangible assets and is referred to as an intangible asset. The writing off of goodwill over time in the profit and loss account is called amortisation.
Holding companies	A company that either wholly owns or owns more than 50 percent of another company, the latter being called a subsidiary. An intermediate holding company is a holding company which has one or more subsidiaries but is itself owned by another company. The term 'ultimate holding company' refers to the one that is finally not controlled by another company.
Income tax	A tax charged upon the income of individuals. It can also be extended to companies. The tax is usually charged upon both earned income from employment and self employment and unearned income e.g. from investments and property.
Intangible assets	See goodwill. May also include patents, copyrights and other assets from which income is derived but which have no obvious physical existence. All are deemed to have a limited life and as such their cost is amortised over their expected useful lives.
International Business Corporations (IBC)	A type of company offered by many offshore finance centres and tax havens, usually one which receives all or most of its income from abroad. IBCs usually pay an annual registration fee but are subject to minimal or zero tax

	rates.
Inversion	The act of a parent company whose headquarters are located within one jurisdiction switching registration with an offshore subsidiary they own to secure location within that offshore jurisdiction in order to secure a tax advantage. Mainly occurring in the USA.
Licence. (Licensing)	A contract for the use or property, often intellectual property such as a patent, copyright or trademark. If ownership of the property is transferred to a holding company located in a tax haven, the licence fee income paid to the licensor may be exempt from tax, as well as reducing the taxable profits of the operating company (often a subsidiary) which is the licensee.
Limited liability partnerships (LLP)	A partnership that provides its non-corporate members with limited liability. LLPs are frequently based offshore for tax avoidance purposes.
Loophole	A technicality that allows a person or business to avoid the scope of a law without directly violating that law.
Money-laundering	The process of 'cleaning' money from criminal or illicit activities to give it the appearance of originating from a legitimate source.
National insurance contributions	See social security contributions. Often called NIC.
Offshore	Offshore relates to any jurisdiction (regardless of whether they are islands) which provides tax and regulatory privileges or advantages, generally to companies, trusts and bank account holders on condition that they do not conduct active business affairs within that jurisdiction. The term "offshore is very broad and normally includes "onshore" tax havens such as Andorra, Lichtenstein, etc.
Offshore financial centre	Although most tax havens are Offshore Finance Centres (OFCs) the terms are not synonymous. Tax havens are defined by their offering low or minimal rates of tax to non-residents but may or may not host a range of financial services providers. An OFC actually hosts a functional financial services centre, including branches or subsidiaries of major international banks. States and microstates that host tax havens and OFCs dislike both terms, preferring to use the term International Finance Centres.
Operating profit	The profit earned from a company's trading activities before charges are made for financing the business, such as interest expenses, and exceptional or one off costs of the business such as the costs or profits from selling subsidiaries or closing activities.
Partnerships	Any arrangement where two or more people agree to work together and share the resulting profits or losses.
Payroll taxes	See social security contributions.
Permanent Establishment	An office, factory, or branch of a company or other non-resident. Under Double tax treaties business profits are taxable at source if attributable to a Permanent Establishment. May include construction sites or oil platforms in place for over 6 months.
Preferential tax treatment	A situation in which individuals or companies can negotiate their tax treatment in the state in which they have a tax liability. Pioneered by Switzerland in the 1920s, the arrangement is commonplace in the offshore world.
Pre-tax profits	The profit of a company after deducting all expenses but before tax charges and the payment of dividends.
Private company	A company not quoted on a stock exchange. Shares cannot usually be sold without the consent of the company or its owners; in many countries little or no information need be disclosed on the activities of such companies even though their members enjoy the benefit of limited liability.
Profit laundering	The process of transferring profits from a territory in which they would be taxed to another in which there is either no tax or a lower tax rate. Mechanisms for achieving this include transfer-pricing, re-invoicing, licensing, thin capitalisation, corporate restructurings and inversions.
Progressive taxes	A tax system in which as income rises the amount of tax paid increases in proportion to the income as well as in absolute amount i.e. the percentage tax rate increases as the income rises. Also referred to as Graduation. Compare with flat and regressive taxes.

Public company	A company whose shares are quoted on a recognised stock exchange and are available to be bought and sold by anyone who wishes without consent being required from the company itself. Generally required to be more transparent than private companies.
Quoted company	See public company.
Race to the bottom	The downwards trend of tax rates and regulatory requirements on capital arising from competition between sovereign states to attract and retain investment.
Regressive taxes	A tax system in which as a person's income from all sources rises the amount of tax they pay reduces in proportion to their income even if it increases in absolute amount i.e. their percentage tax rate falls as their income goes up. Compare with progressive taxes and flat taxes.
Reinsurance	Some large companies decide not to insure their risks with the conventional insurance markets but instead set up their own insurance companies. When insurance companies do this it is called reinsurance. By setting up a captive or reinsurance company offshore, a tax deduction for the premiums paid is available in the country where the risk is and the premium is received offshore where there is little or no tax. This can, therefore, be viewed as another form of transfer-pricing.
Re-invoicing	Re-invoicing involves invoicing a sale to an agent, typically based in a tax haven or OFC, who subsequently sells on to the final purchaser. In practice the agent pays part of their mark up to the original vendor or to the purchaser, usually to an offshore account. This is a widely used process for laundering profits to a tax haven. The process is dependent upon secrecy for its success.
Remittance basis	Concerns income earned outside the country of residence. The remittance basis says that tax is only due in the year when income is remitted to the country in which the tax payer is resident and not when it arises. Enables a person to avoid tax indefinitely in their country of residence provided it is kept and spent abroad. Compare with the arising basis. Both have relevance within the context of the residence basis of taxation.
Residence	For an individual, the person's settled or usual home; for simplicity a presumption may be applied based on a rule-of-thumb, such as presence within the country for six months or 183 days in any tax year. It may be possible to be resident in more than one country at one time (though double tax treaties aim to prevent this). Some individuals may also try to avoid being resident anywhere. For companies, residence is usually based on the place of incorporation but can also be where the central management and control of the company is located, if they are different. Tax haven companies formed for non resident owners are usually defined not to be resident in their country of incorporation.
Residence basis	Taxation of residents of a territory on all their worldwide income wherever it arises, usually with a credit for tax already paid overseas. The aim is to discourage residents from investing abroad in lower tax countries, by ensuring that income is taxed at the residence country rate if it is higher. Compare with source and unitary basis.
Ring-fencing	Different and preferential tax and regulatory treatment given by tax havens to companies and trusts owned by non-residents as contrasted to companies and trusts owned by residents.
Sales tax	Taxes on sales can be levied in two ways. Firstly, as a general sales tax (GST) added to the value of all sales with no allowance for claiming a rebate on tax paid. Secondly, as a value added tax (VAT) charged by businesses on sales and services but which allows businesses to claim credit from the government for any tax they are charged by other businesses. The burden of VAT therefore falls almost entirely on the ultimate consumers. GST and VAT are both regressive taxes since lower income households always spend a higher proportion of their income on consumption and therefore invariably spend a greater proportion of their income on this tax than do the better off. VAT is the most widely used form of sales tax.
Social security	Payments made towards a fund maintained by government usually used to

contributions	pay pension and unemployment benefits. Health benefits are sometimes covered as well. Social security contributions are generally considered to be taxes.
Source basis	Taxation of income in the territory where it is earned. Compare with residence and unitary bases. Under double tax treaty rules, income attributable to a Permanent Establishment is taxable at source. Some countries tax only on a source basis, and consider income earned outside the country exempt; but some tax on the basis of both source and residence (subject to a foreign tax credit).Compare with residence and unitary bases.
Special purpose vehicles	Any company, trust, LLP, partnership or other legal entity set up to achieve a particular purpose in the course of completing a transaction, or series of transactions, typically with the principal or sole intent of obtaining a tax advantage.
Stamp duty	A tax on the value of contracts. Usually charged on contractual dealings on shares and other stocks and securities and on dealings in land and property.
Subsidiary company	A company 50% or more owned by another company which is its parent company.
Tax arbitrage	The process by which a sophisticated tax payer plays off the tax systems of two different countries to obtain a tax benefit as a result.
Tax avoidance	The term given to the practice of seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud). The term is sometimes used to describe the practice of claiming allowances and reliefs clearly provided for in national tax law. It is, however, now generally agreed that this is not tax avoidance. If the law provides that no tax is due on a transaction then no tax can have been avoided by undertaking it. This practice is now generally seen as being tax compliance. So what the term tax avoidance now usually refers to is the practice of seeking to not pay tax contrary to the spirit of the law. This is also called aggressive tax avoidance. Aggressive tax avoidance is the practice of seeking to minimise a tax bill whilst attempting to comply with the letter of the law while avoiding its purpose or spirit. It usually entails setting up artificial transactions or entities to recharacterise the nature, recipient or timing of payments. Where the entity is located or the transaction routed through another country, it is international avoidance. Special, complex schemes are often created purely for this purpose. Since avoidance often entails concealment of information and it is hard to prove intention or deliberate deception, the dividing line between avoidance and evasion is often unclear, and depends on the standards of responsibility of the professionals and specialist tax advisers. An avoidance scheme which is found to be invalid entails repayment of the taxes due plus penalties for lateness.
Tax base	The range of transactions that a country chooses to tax. A broad base includes a wide range of transactions. A narrow base includes relatively few transactions.
Tax competition	This is the pressure on governments to reduce taxes usually to attract investment, either by way of reduction in declared tax rates, or through the granting of special allowances and reliefs such as tax holidays or the use of export processing zones. Applies mainly to mobile activities or business, but the competition to attract investment may result in an overall decline of corporation tax rates and in the amounts of corporation tax paid, often resulting in an increased burden on individuals.
Tax compliance	A term that is acquiring a new use. It can mean payment of tax due without engaging in tax avoidance or evasion. It is also now being used in contrast to the terms tax avoidance and tax evasion. Tax compliance in this context is used as a test of a person's intention before they undertake a transaction. It asks whether the person is seeking to comply with the spirit of the legislation concerning the transaction into which they are entering. If they are, then it should be presumed their intent was to be legal. If they are seeking to

	comply with the letter but not the spirit of the law (and it is usually possible to determine this from the form the transaction takes) then it should be presumed their intent was to break that law, the onus of proof otherwise falling upon them. This test is then used in connection with a general anti avoidance principle to determine whether that principle should be applied to a transaction, or not. A person who has used an appropriate motive is "tax compliant".
Tax efficiency	A term used by tax professionals to suggest getting away with paying as little tax as possible.
Tax evasion	The illegal non payment or under-payment of taxes, usually by making a false declaration or no declaration to tax authorities; it entails criminal or civil legal penalties.
Tax haven	Any country or territory whose laws may be used to avoid or evade taxes which may be due in another country under that country's laws. The Organisation for Economic Cooperation and Development defines tax havens as jurisdictions where: 1. Non-residents undertaking activities pay little or no tax; 2. There is no effective exchange of taxation information with other countries; 3. A lack of transparency is legally guaranteed to the organisations based there; 4. There is no requirement that local corporations owned by non-residents carry out any substantial domestic (local) activity. Indeed, such corporations may be prohibited from doing business in the jurisdiction in which they are incorporated. . Not all of these criteria need to apply for a territory to be a haven, but a majority must.
Tax holidays	A period during which a company investing in a country does not have to pay tax under an agreement with its government.
Tax mitigation	A phrase used by tax professionals when describing the desire to pay as little tax as possible.
Tax non-compliant	A person who is not seeking to be tax compliant.
Tax planning	A term used in two ways. It can be used as another term for tax mitigation. When, however, tax legislation allows more than one possible treatment of a proposed transaction the term might legitimately be used for comparing various means of complying with taxation law.
Tax shelter	An arrangement protecting part or all of a person's income from taxation. May result from pressures on government or a desire to encourage some types of behaviour or activity, or may be a commercial or legal ruse, often artificial in nature, used to assist tax planning.
Thin capitalisation	Financing a company with a high proportion of loans rather than shares. Used by Transnational Corporations to reduce the business profits of a subsidiary, since the interest on loans is usually allowed as a deduction, but dividends on shares are paid out of after-tax income. The interest is usually paid to another subsidiary of the transnational corporation located in a tax haven where no tax is paid upon its receipt, resulting in an overall reduction in the tax charge of the group of companies.
Transfer-pricing	A transfer pricing arrangement occurs whenever two or more businesses (whether corporations or not) which are owned or controlled directly or indirectly by the same people trade with each other. The term transfer pricing is used because if the entities are owned in common they might not fix prices at a market rate but might instead fix them at a rate which achieves another purpose, such as tax saving. If a transfer price can be shown to be the same as the market price then it is always acceptable for tax. What are not acceptable for tax purposes are transfer prices which increase the cost or reduce the sales value in states which charge higher tax rates and increase the sales value or reduce the costs in states with lower tax rates. The difficulty for many corporations at a time when over 50% of world trade is within rather than between corporations is that there is no market price for many of the goods or services that they trade across national boundaries

	because they are never sold to third parties in the state in which they are transferred across national boundaries within the corporation. This gives rise to complex models in which attempts are made to allocate value to various stages within the supply chain within a company, which process is open to potential abuse. For this reason it is argued that such firms should be taxed on a unitary basis.
Transnational corporations (TNCs)	A corporation with subsidiaries or divisions in two or more nations. Also known as multinational corporation (MNC).
Unitary basis	Treating the income of related entities within a single firm or corporate group on a combined or consolidated basis, and applying a formula to apportion it for taxation by the different countries or territories from which it derives. Each may apply the rate of tax it wishes. An alternative to the residence and source bases of taxation. It has been used in federal countries such as the USA, applying an allocation formula based on a ratio of sales, employment costs and assets employed within each state. It has been opposed by tax authorities (and TNCs) because they consider that it would be too difficult to reach international agreement especially on the formula. However, taxation of highly integrated TNCs may in practice entail a formula-based allocation of profits, due to the difficulty of finding appropriate arm's length transfer prices.
Value Added Tax	Known as VAT. See sales tax
Withholding tax	Tax deducted from a payment made to a person outside the country. Generally applied to investment income, such as interest, dividends, royalties and licence fees.

Appendix 4 – Data and methodology

The data collection process

Key financial data was collected for each of the companies over five years ending with the financial reports published in 2004 i.e. from accounts ending in 2000 to 2004 inclusive. In some cases data was not available for the whole period, either because the company did not exist in its current form (e.g. O2 and Xstrata), or because a merger made it difficult to ensure continuity of relevant, comparable data (e.g. HBOS). In those cases shorter data periods have been used. All calculations for the companies in question allow for this fact.

In every case the result published in a year is assumed to be that for the year. So, for example, the accounts of Tesco to 28 February 2004 are considered to be their result for 2004 just as much as the results of the many companies whose accounts were prepared for the year to 31 December 2004. It is not believed that this assumption causes any significant distortion in the conclusions drawn in this report.

In every case the information was collected from the published consolidated accounts of the company in question, made available on their websites. With the exception of some information on turnover in the case of several insurance companies, all the data used came from audited financial statements. Unless explicitly noted, no data has been collected from any other source.

If the accounts for any year were restated subsequently, the originally declared figures are used in this report, since they were those considered accurate at the time of publication.

All data used has been checked as follows:

1. The data was extracted in reverse order i.e. the 2004 accounts were used first, and the comparative figures for 2003 were extracted at the same time as the data for 2004;
2. The 2003 accounts were then used, and the figures already extracted for the year from the 2004 comparative data was double-checked. Corrections were made if the 2003 figures had been restated in 2004. Data for 2002 from the comparative figures published in 2003 was then extracted.
3. The process was then repeated for 2002, 2001 and 2000.
4. The whole process was then repeated to check the validity of the data.

In some cases judgements have had to be made because of inconsistent presentation of data between years, and in some (limited) cases due to what appear to be simple errors in the accounts themselves. In no case are these considered likely to be material to the conclusions drawn in this report.

Where data has been made available inconsistently, or the basis of presentation has changed materially, data has only been collected for the later periods e.g. with regard to reconciling the taxation charge reported in accounts when the requirements for 2000 and 2001 were significantly different from the standards used from 2002 onwards.

Where the accounts of the companies were reported in US dollars (11 cases) or in Euros (in the case of Unilever), the data for all years has been translated into sterling at the average exchange rates for the currencies in question in the year to 31 December 2004 published by HM Revenue & Customs. To use any other basis would have created problems with

inconsistencies of translation in balances between periods; this was considered more problematic for the purposes of this report than any distortion use of a consistent exchange rate could produce. Since most data used within annual periods has been compared on proportionate, percentage bases the basis of translation has no impact at all for much of the data included in this report, as long as it has been consistently applied (as it has been).

Using the data

The data collected amounts to more than 30,000 pieces of individual information. Despite that, and quite deliberately, much of the data referred to in this report relates to average results for the sample as a whole. This is because, as will be noted at various stages in this report, all companies are capable of producing aberrant data which are difficult to interpret on the basis of the information available within their audited financial reports. This might be because of exceptional losses (such as those BAE made in 2002), or because of the vagaries of accounting standards e.g. the substantial losses reported by Vodafone during this period due to the requirement that it amortise its substantial investment in goodwill, contrary to what will be required of it in 2005 onwards when International Financial Reporting Standards will change this rule. In consequence aggregate data frequently offers a more balanced view of what might be happening.

Where individual company data is used the opportunity has been taken on occasion to omit the top and bottom companies in any sample. Again, this is because the companies in question have frequently reported aberrant performance at some time during the period 2000 – 2004 which has distorted their results. Opportunity might be taken to comment upon these aberrations, but where clearer indication of general trends is desired it has, on occasion, been considered wise to exclude these exceptional results from consideration.