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The taxing question of avoidance

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Justin Pugsley reports on the steps government is taking to crack down on corporate tax avoidance and the ramifications for British plcs

A flurry of reports suggests that Britain is rapidly becoming a high tax country making its companies increasingly uncompetitive as the Chancellor's fiscal grabs swallow a growing proportion of the economy.

In a struggle to remain competitive UK companies are apparently resorting to more aggressive tax avoidance schemes. Tax avoidance is legal, as opposed to tax evasion, which is a criminal offence.

Indeed, the tax authorities seem to be locked into a perpetual cat and mouse game with highly creative tax consultants. In each budget, the Chancellor tries to curb some of the excesses in the system and the recent one was no different.

Emphasising the point of the UK tax burden, accountants Ernst & Young, recently presented a report showing that it is steadily increasing.

According to the report it will hit 37.6 per cent of GDP this year, rising to 38 per cent in 2010-11. This compares with the previous peak of 37.7 per cent reached in the early 1980s. Much of that has been achieved by so called stealth taxes rather than raising the more visible levels of corporate and personal tax rates. Various industry bodies have also been particularly vocal about the high level of UK taxes, particularly relative to the past and to other countries. They say that the tax burden is even higher than notoriously high tax countries such as Germany.

"The tax burden is too much on the heavy side. The Confederation of British Industry has been very clear about this," said Bill Dodwell, a tax expert with accountants Deloitte. He also points to the Institute of Fiscal Studies' green budget, which says that the UK corporation tax burden is higher as a percentage of GDP than any other EU state.

However, not everyone is convinced by these arguments and some in fact argue that Britain's biggest companies are actually paying less tax. For instance the Tax Justice Network says tax avoidance costs the UK £10 billion a year. Meanwhile, tax research group, Tax Gap Ltd has even gone as far as producing an index tracking the levels of taxation paid by the top 50 FTSE companies. The report states that between 2000 and 2004, these companies on average paid 5.7 per cent less corporation tax than expected. The expectation gap actually increased from 4.2 per cent to 7.6 per cent over the same period and they have paid £20 billion less than tax rates would suggest is appropriate.

Tax Gap says that its calculations are based on information contained within company reports. It goes on to say that £36 billion of unpaid deferred tax now sits on the balance sheets of the top 50 FTSE companies. And the sum is increasing steadily and much of it may never be paid. "Only improved accounting disclosure can overcome this deficiency in the accounts of these companies and this has to be a key issue that all the companies covered by this survey need to address," Tax Gap concluded.

A year ago, Prem Sikka, professor of accounting at the University of Essex wrote in The Evening Standard that the level of corporation tax as a share of GDP has dropped dramatically, in fact to its lowest ever. In 1997-98, he says it stood at 11.5 per cent as a share of the total tax intake, by 2003-04 it had fallen to 7.7 per cent and now accounts for only 2.5 per cent of GDP. He says that companies get much of their 'tax money' back through sweeteners, subsidies, loans, export guarantees and so on.

According to John Christensen, co-ordinator for the Tax Justice Network, most tax avoidance schemes by large multinationals involve some sort of price transfer mechanism. Crudely, this involves using pricing to shift profits from high tax jurisdictions to low tax ones. "There are transfer pricing laws in existence around the world to make sure you cannot artificially move profits from a high tax jurisdiction to a low tax one," explained Mark Schofield, tax expert with accountants PricewaterhouseCoopers (PWC). "Those rules are rigorously enforced by tax authorities." Indeed, a large company can't simply set up a subsidiary on a low tax Caribbean island and transfer all its profits there. It has to show that it has material operations in that low tax country otherwise the opportunity for any tax efficiency is greatly reduced.

For example, pharmaceutical companies often set up manufacturing operations in lower tax countries. Rather than the Cayman Islands, those activities would have to be in a country with some sort of industrial infrastructure such as Singapore with a corporate tax rate of 20 per cent or Eire with a 12.5 per cent rate. This compares with the UK corporate tax rate of 30 per cent. Meanwhile, that pharmaceutical company may do its research and development in the UK to take advantage of special tax credits aimed at promoting that type of activity. "The UK is very keen to promote itself as an R&D centre for science and technology," said Dodwell. The UK also has fairly generous tax relief on capital expenditure. It's very much a case of multinationals trying to take advantage of the favourable tax structures offered in the various countries they operate in.

But companies have other avenues of lowering their overall tax bills. According to Dodwell most companies look to reduce their overseas taxes where possible. "The most obvious way to do that is to put as much debt into the overseas group as they can. However, there are restrictions as to what can be done," said Dodwell. He said one of the items noted in the budget is that some groups are structuring their transactions in such way that they don't recognise taxable income. In other words they're pushing the envelop too hard. "They don't record the taxable income and the revenue. The Treasury is going to be looking into those sorts of areas with a view to clamping down on them," explained Dodwell. He added that they can only generate taxable losses where there is an economic cost.

However, some do stretch the rules as far as they can. Christensen says one way is to hold intellectual property rights offshore and charge them back to the company at very high levels. Others will simply deliberately misprice intra-company transactions. "The tax authorities try hard to clamp down on this type of thing, but in practice it is very hard to curb," said Christensen. He goes on to explain, quoting Tax Gap Ltd, that although the UK's corporate tax rate is 30 per cent, on average companies are getting it down to 22 per cent, "and the level is falling quite rapidly," he said.

However, it should be noted that corporate decisions about locating operations are not decided just on tax issues. Establishing operations in Eire or Estonia, for instance, may not be practical. The company may need to be closer to its customer base or require skills, which simply aren't available in those type of countries. Also, there are services such as export credit guarantees for very large projects and generally these needs are better met by large countries, which also tend to be relatively high tax locations.

Often large companies find it useful to have the support of a relatively powerful government such as the UK one. This would apply particularly to the defence industry and to an extent to construction firms pursuing contracts in the Middle East, for example.

However, one issue that all agree upon is the sheer complexity of the UK tax system. The system has been performing contortions to satisfy changing accounting practices such as IFRS,

globalisation and of course to curb tax avoidance. Some economists argue that the complexity of the UK's tax system is itself damaging UK competitiveness. It tends to create uncertainty and unintended consequences. Christensen argues that part of the solution would be to incorporate into tax legislation a general anti-avoidance principle.

"Then the courts would shift away from the current confused position which is to accept that avoidance is legal while evasion is illegal," he explained. "That acceptance provides an incentive for people to find as many loop holes as possible."

Meanwhile, the activities of tax havens such as the Cayman Islands are increasingly coming under scrutiny. The US Government has challenged the secrecy of these havens on occasions in connection with crime, with Switzerland being a high profile case.

Indeed, could the day come when companies seen aggressively pursuing tax avoidance are named and shamed as socially irresponsible? As Christensen observes, all countries need certain levels of taxation to pay for the various types of infrastructure which sustain the functioning of the market. Some multinationals recognise and support this argument, but many still don't.

It is also quite possible that financial pressures resulting from growing welfare budgets will trigger some sort of backlash against the worst forms of tax avoidance. So far the burden of taxation has been steadily shifting from companies and the super-rich to ordinary individuals. It may go so far that society begins to see this as unacceptable and expect it to be reined in and even reversed.

Indeed, environmental issues are now at the top of socio-economic agendas and companies are expected to comply. Twenty years ago the environment was a relatively low profile issue. Fair trade is also making greater headway as rich consumers vote with their conscience to purchase products in a way that better rewards developing world farmers. There are even fast growing sectors channelling investment towards ethical and green companies. There may be a time when aggressive tax avoidance carries a heavy social stigma. This could impact on those companies' abilities to market their products and also hit the cost of raising finance.