Tax and British business

Making the case

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Foreword

In a period of austerity, when some areas of public spending are being significantly reduced, it's important for those who still can to contribute to the public finances by paying their taxes. CBI members recognise and honour this obligation. But to listen to the way the story is sometimes told, British business contributes next to nothing to government tax revenue. That simply is not true: British business pays its way. In 2010-11 business paid around £163bn in taxes to HM Revenue & Customs (HMRC). This constitutes more than a quarter of total tax revenues (£551bn).

Tax and British business: Making the case is about bringing an informed voice to the UK business tax debate. It is about highlighting the significant contribution business makes to our economy and society, and aims to combat the misunderstanding (and, sometimes, misinformation) that has been clouding this debate. It also shows why a balanced and proportionate tax regime is needed to allow business to continue to grow the UK economy and contribute to society. In the end, with cuts in public spending, the only way out of our current situation is through private sector growth. The private sector seeks to create genuine, sustainable jobs. But to do that – while recognising the need to pay taxes out of profits – the tax system must also enable businesses to compete effectively.

The structure of this report is simple. First, it places the tax contribution of business operating in the UK into a wider economic context, arguing that business underpins the majority of tax revenue collected by the government. Second, it shows how over the last 10-20 years the scope and appetite for abusive tax avoidance has already been severely circumscribed for large companies such that many previous abuses have been reduced or eliminated. Third, it explains why the responsible management of tax issues is a necessary part of business activity, made more important by the complexities of the UK and international tax systems. Fourth, it seeks to address misunderstandings by explaining some of the basics of tax and accounting rules (particularly when they clash). Finally, it explains why a competitive tax system is vital to the future growth of the UK economy, in the face of growing global competition for mobile business activity.

I believe that business should not engage in abusive tax arrangements. However, in running their normal day-to-day activities, as well as in commercial transactions large and small, businesses need to manage their tax affairs as a key part in operating their business. But most businesses in the UK would never contemplate evading taxes or defrauding the government. They manage their taxes within the law and fully engage with HMRC.

Business has been slow to enter the public debate on tax policy to defend its record and advocate pro-growth tax policies. With *Tax and British business: Making the case* business now enters that debate.

John Cridland
Director-general, CBI

1 The tax contribution of business

Businesses pay their way in tax

The UK business community makes a very large contribution to the Treasury's coffers every year. In the latest financial year, businesses operating in the UK paid around £163bn in taxes, which is more than a quarter of the total UK tax take of £551bn for 2010-11. To put this into context, it is roughly the equivalent of the combined 2010 budgets for the Department of Health, the Department of Education and the police force.[1] At a time of public austerity, with public net borrowing figures of £142bn for 2010-11,[2] the significance of business' tax contribution is even more evident. But in a globalised world, if this contribution is to be safeguarded, the UK will need to maintain a pro-growth tax environment.

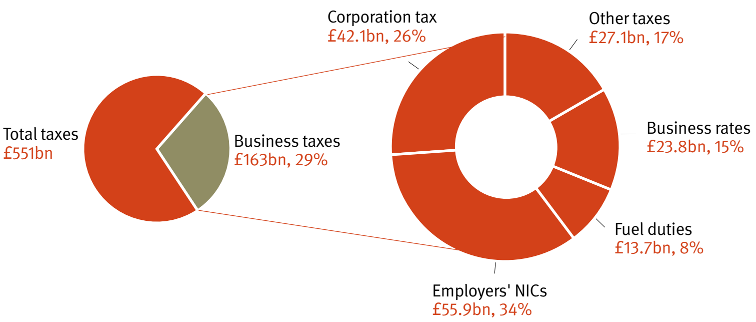
Although the principal tax contribution by businesses comes through corporation tax, it is far from the whole story, as **Exhibit 1** shows. Out of business' total contribution in 2010/11, 26% (£42bn) was from corporation tax, the rest being paid through a number of other taxes such as: Employers National Insurance (£56bn), business rates (£24bn), and fuel duties (around £14bn).

Breaking the business contribution down further shows that as well as paying tax on their profits, they also make a contribution based on their roles as property owners, employers, consumers of goods and services, and for the environmental impact of their business. While there is a great deal of focus on the share of their profits that businesses pay, **Exhibit 2** shows that companies contribute to tax in many other ways.

It is also worth noting that businesses contribute to the efficient running of the tax system and of the economy, on top of their direct tax contribution. While these do not count as direct contributions to tax revenue, they show that business activity underpins the existence of tax flows and economic growth beyond those it pays and collects. There are three main areas:

- **Economic prosperity**. Virtually all taxes, such as income tax, employees' national insurance contributions and VAT depend on the successful operation of British business, including creating jobs, paying wages, supplying goods and services and processing transactions. So while businesses in the UK may pay around a quarter of all tax revenues, they underwrite the vast majority of the government's annual tax take, which is used to fund public services and to invest in the UK's future.
- **Tax collection**. Business also makes a significant contribution through its role in collecting taxes for the government, such as income tax through PAYE and VAT on sales. Data collected by The Hundred Group showed that large companies in the UK, as well as paying £16.3bn, collected a further £37.2bn in taxes for the government in 2010.[3] This is a significant cost that businesses meet as part of their contribution to the UK government.

Exhibit 1 **Business' share of total taxes, 2010/11 (£bn/%)**



Source: HMRC, CBI Analysis

Exhibit 2 **Total estimated business tax contribution, 2010/11**

	£bn
Profits	**46.8**
Corporation tax	42.1
PRT	1.5
Capital gains tax	1.7
Betting and gaming duty	1.5
Property	**27.2**
Business rates	23.8
Stamp duty land tax (property)	1.9
Stamp duty & SD reserve tax (shares)	1.5
Employment	**59.5**
Employer NICs	55.9
PAYE agreements	0.1
Bank payroll tax	3.5
Consumption (product)	**11.0**
Irrecoverable VAT	10.0
Customs duties	1.0
Environmental	17.1
Vehicle excise duty	0.9
Fuel duties	13.7
Landfill Tax	1.0
Aggregates Levy	0.3
Climate Change Levy (CCL)	0.7
Renewables obligation	0.5
Other	1.0
Total taxes borne by business	**162.6**
Total taxes	**551.4**
Taxes borne % total taxes	**29%**

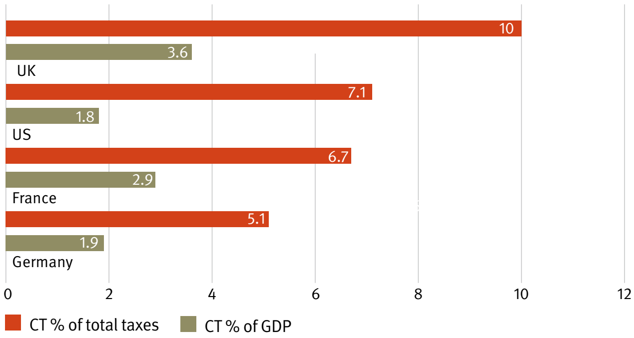
Source: HMRC, ONS, PwC Total Tax Contribution, CBI analysis

- **Funding retirement**. The vast majority of UK pension funds (84%) hold shares or bonds tied to businesses. Pensioners, through their pension funds, rely on these companies continuing to make profits in order to provide them with a reliable and secure retirement income. As the UK faces up to the problems of providing adequate social care and retirement income for a rapidly ageing population, the contribution that business makes to pension incomes will become ever more important.

Global context: UK firms pay more corporation tax than those in similar countries

UK business pays more corporation tax than businesses in many of our competitor countries, even those with a much higher rate, international comparisons show. In 2008, UK corporation tax made up 10% of total UK tax receipts and 3.6% of GDP, in line with the OECD member averages of 10.1% and 3.5% respectively. UK businesses pay more corporation tax than their counterparts in the US, France and Germany, both as a proportion of total taxes collected and as a proportion of GDP (**Exhibit 3**).[4]

Exhibit 3 **Corporation tax receipts as a proportion of total tax receipts and GDP, 2008**



Source: OECD

Corporation tax contribution varies by sector

While businesses pay a large share of the overall tax take, the business tax burden does not fall uniformly across all businesses. Many business taxes are targeted towards a certain sector or type of business. For example, two similarly sized companies may pay very different amounts in business rates because one – such as a retailer – occupies more commercial building space than another – such as a creative agency. Corporation tax bills also differ between businesses and sectors, despite there being a common headline rate of corporation tax (currently 26%). The three reasons for this range in tax contributions are:

- The profitability of a sector
- The size and type of companies within each sector
- The availability of deductions or reliefs.

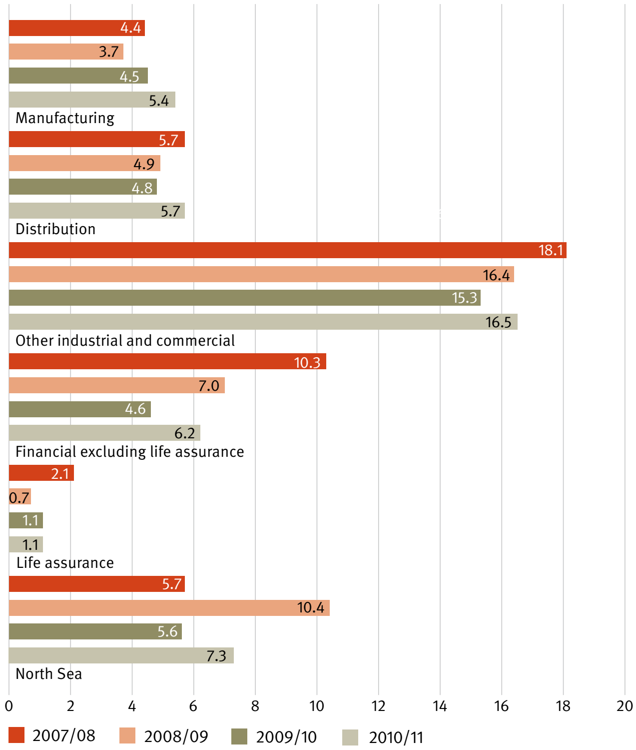
Sector profitability

The corporation tax contribution of companies within different business sectors varies significantly and can change markedly on an annual basis. For example, when oil prices spiked in 2008/09, corporation tax receipts from North Sea oil and gas producers also spiked. Conversely, the recession affected the profits of financial services firms most significantly, seen in the sharp drop in corporation tax receipts from this sector from 2007/08 to 2009/10. The fact that profitability differs between sectors, and that changes in the business environment affect sector profitability in different ways, means that the corporation tax contribution of sectors is not uniform across the economy or through time.

Size and type of company

Corporation tax revenues are dominated by big businesses: the largest 1% of companies pay 81% of all UK corporation tax and 60% of small firms pay no corporation tax at all. The amount of tax paid by business also differs widely by type of company. By far the largest share was paid by companies that are part of multinational groups, whether UK or foreign-owned (42% and 45% respectively).[5]

Exhibit 4 Corporation tax receipts by sector, 2010/11, £bn



Source: HMRC

Three key facts about corporation tax

- The top 1% of companies pay 81% of all corporation tax
- Sixty percent of small companies pay no corporation tax
- Over half (55%) of all companies claim capital allowances, while 10% claim group relief and only 1.8% claim double tax relief

Source: Oxford University Centre for Business Taxation

One reason for the difference in corporation tax paid by different types of firms is that profitability varies by type: we would expect a large multinational group, with large profits in the UK, to pay more corporation tax than a SME. But this is also due to the existence of a lower rate of tax for companies with profits under £300,000 a year (the Small Profits Rate, currently 20%) and marginal relief for firms with profits between £300,000 and £1,500,000.

Deductions and reliefs

As noted in the previous section, there are many factors which, taken together, have a significant impact on the corporation tax liability of a company – these include the deductions or reliefs that companies can claim against their corporation tax bill. Their availability and size differ by sector, depending on factors such as the capital intensity of a business. This means that businesses from across the economy end up facing different 'effective' rates of corporation tax, even though the headline rate (currently 26%) applies to all firms with profits above £1.5m.

A more detailed examination of how the system of deductions and reliefs operates in the UK can be found in chapter 3, Understanding how the business tax system works.

Conclusion

British business makes a major contribution to the country's tax revenues. It contributes more than a quarter of the total tax take and plays a key role both in collecting taxes paid by other taxpayers and also in delivering the economic growth and wealth that indirectly leads to higher tax revenues from consumers and larger incomes for pensioners. The business community in this country also pays more corporation tax than businesses in many of our competitor countries. But not every business pays an identical share of its revenues in tax, as the final contribution will depend on the sector of the economy the company operates in, the size of the firm and the deductions and reliefs available to it.

Against that background it is vital that the government and organisations that operate and use the tax system understand that a pro-growth business tax environment underpins economic prosperity. A tax environment which does not encourage British business to grow would translate into fewer jobs, less opportunity, and lower tax receipts. That would not be good for the British economy or British workers.

2 Why tax management is neither abuse nor evasion

There is a very loud and vigorous debate underway over whether businesses pay their ‘fair share’ of the total tax burden. In the current era of austerity there is also a great deal of concern that businesses either abuse the system or even evade paying their proper contribution. While it is important to have a debate about business tax it is vital that that discussion is based on facts and on an understanding of the whole purpose of the tax system, rather than on misinformation, misunderstanding or prejudice.

There is insufficient public recognition that, barring a few extreme examples, business is trying to comply with a massive number of tax and other regulatory rules. The tax system is very complicated – in fact, the UK has one of the largest tax rulebooks in the world. Businesses therefore need to employ experts to ensure that they follow all the rules and take advantage of any tax reliefs available to them. This is known as tax management and is an important function of the business world alongside other areas such as human resources, financial management and overall corporate decision making. For the health of the tax system, and for public confidence in it, it is essential to distinguish straightforward tax management from illegal tax evasion or abusive schemes to avoid tax.

It is a dangerous – if sometimes convenient – myth that all tax management is abusive, and that tax management is the same as evasion. That is simply untrue and not fair to British business .

Settlements, ‘lost’ revenue, and the tax gap

One example of this debate over how the tax system operates has been the recent discussion, most notably in the Commons Public Accounts Committee, about whether Her Majesty’s Revenue & Customs (HMRC) has entered into ‘sweetheart’ deals with very large businesses that have led to tax revenue being foregone. There have also been questions as to whether this is contributing towards what is perceived to be an ever-growing ‘tax gap’ – the difference between the amount of taxes the government should arguably collect and the amount of taxes it actually collects.[6]

In fact, the tax gap estimated by HMRC has been shrinking over recent years (for example, from £39bn in 2008-09 to £35bn in 2009-10). Furthermore, the total corporation tax gap attributable to the 800 very largest companies/groups handled by HMRC’s Large Business Service constitutes approximately 3.5% (£1.2bn) of the total tax gap of £35bn.[7] Despite reports to the contrary, very large business is only a relatively small element in the tax gap.

Beyond the part of the tax gap that measures abusive tax arrangements, there are many honest disagreements over interpretation that relate to tax management. The determination of taxable profits is not a precise science and there will often be a difference in good faith between HMRC’s view of the tax due and a company’s view.

Such differences of interpretation are an expected part of the tax system, and the final result is usually determined by detailed discussions on the application of the relevant law. It should also be noted that HMRC contains some of the most experienced tax specialists in the UK (supplemented, in specific cases, by private sector expertise), so there is not the imbalance in resources sometimes claimed. If agreement cannot be reached, the courts will ultimately decide, but both parties are usually keen to avoid the costs and uncertainty of litigation and so a ‘settlement’ is reached. There is often a distinct advantage to the government in getting payment today, rather than a notional sum, totally dependent on risks of litigation, at some undetermined point in the future. The yield from inquiries by HMRC’s Large Business Service and the resulting settlements have nearly doubled in five years, from £2.2bn in 2005-06 to £4.06bn in 2010-11, due to the adoption of more sophisticated risk profiling.

Furthermore, HMRC has been keen to point out that, from its perspective, such a settlement is always based on interpretation of the law and not, for example, purely on a ‘split the difference’ basis. Thus, there is never any liability which HMRC ‘waives’. Some commentators arrive at a higher potential liability by multiplying an ‘income’ number by the statutory tax rate (26%). But that ignores credits, deductions, deferred tax and a host of other items which mean that cash tax will almost always be lower (see chapters 3 and 4 for more detail).

Evasion, abusive arrangements and tax management

In order to understand what tax management is and how it is a positive part of the way that the government operates and uses the tax system, it is vital to distinguish it from abusive arrangements and evasion. Quite simply, anyone who evades tax by not declaring taxable income is involved in criminal behaviour. Similarly, where companies and their advisers devise or implement abusive arrangements that are legal, the CBI believes these should be tested by HMRC to the full. But all of this is very different to responsible tax management.

It is therefore wrong to brand all tax management as 'abusive'. Tax management is necessary and indeed often encouraged by the government. The majority of businesses seek only to reach a clear and certain outcome in the taxes they pay, while satisfying stakeholders that they have been thorough in applying all reliefs and allowances made available by law, so that they do not pay more than they are legally obliged to. This is no different from the attitude of most taxpayers – pay the tax due.

Tax management is a well-established principle of British law

There is a core legal principle in the UK that governs tax liability whether it is for a private individual, a small business or a multinational corporation. The principle that dates back to a judgement by the House of Lords almost 80 years ago states that taxpayers individual and corporate should pay tax, but no more than specified by law.[8] In that case one of the Law Lords said that everyone is "*entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be*." He added: "*If he succeeds in ordering them so as to secure that result, then ... he cannot be compelled to pay an increased tax*." A stricter approach to abusive, highly artificial arrangements is now taken, but this general principle remains at the core of business tax management.

Rooting out abusive arrangement and evasion

- Tax evasion – not declaring taxable income that is due – is rightly illegal
- Abusive arrangements are those which are highly artificial, with no commercial purpose
- These abusive arrangements are unacceptable

Corporations are aware of their responsibilities to the society in which they operate to pay the tax they owe – but their principal role is not to generate revenue for the government. The principal economic contribution that any company makes to the UK is to provide goods and services that people want, thereby enabling that business to employ workers, support a supply chain and generate profits, from which taxes are paid, dividends are paid to shareholders (often pension funds) and investment is made to grow the business.

Declining trend in abusive arrangements

The scope and corporate appetite for abusive arrangements has diminished significantly in recent years. This is partly due to the development of a much more open, effective and less adversarial relationship between taxpayers and HMRC, along with the introduction of new reporting requirements and anti-abuse initiatives. The evolution of tax case law has reduced the scope for abusive arrangements, while adding to the complexity faced by business. But, very importantly, it is also due to changing corporate attitudes towards tax management, with businesses becoming more aware of the reputational risks posed by tax and becoming more engaged in tax governance.

HMRC has new tools and techniques to tackle abusive arrangements

The past ten years or so have seen a noticeably less aggressive approach to their tax affairs by the majority of companies and less adversarial, more open relationships between taxpayers and HMRC. Apart from the consequences of developments in the case law approach described above, some of this has stemmed from greater legislative reporting requirements, and various HMRC initiatives. The main changes in practice that have contributed to the decline in abusive arrangements are:

- **Enhanced relationship**. HMRC has changed the way that many businesses are dealt with, encouraging them to discuss both compliance and tax management issues more readily. Areas of potential dispute have been identified more speedily, and avoided in a number of cases or resolved more quickly in others. This has led to a significant reduction in both the number and value of open issues for large companies between 2007 and 2011. The number of open issues fell from 7,624 to 2,721 and the cumulative value from £35.1bn to £25.5bn over the period.[9]

- **Senior Accounting Officer**. Since 2009, a Senior Accounting Officer takes reasonable steps to establish, maintain and monitor the adequacy of the business's tax accounting systems and processes and certifies to HMRC annually that those systems allow for the submission of materially accurate tax returns.

- **Disclosure of Tax Avoidance Schemes**. DOTAS requires promoters of tax arrangements that satisfy certain characteristics to report details to HMRC ahead of implementation. In 2009, HMRC said DOTAS had led to the introduction of 49 anti-abuse measures, cutting off more than £12bn in scheme-based abuse opportunities.

- **Transactions with affiliates**. Significant resources are devoted by companies to compiling documentation about how terms are agreed for transactions with affiliates in order to prevent an adjustment for tax purposes under 'transfer pricing' rules.

- **Risk profiling**. HMRC has used the shrinking resources at its disposal to achieve a greater return on its investigative efforts by risk-profiling industries, businesses, and activity. In many instances, HMRC may well have come out of a settlement with more tax than it would otherwise have done because companies have been prepared to settle in return for speed and certainty.

- **General anti-avoidance rule**. A study group set up by the government suggests a GAAR should focus on abusive arrangements with no commercial purpose. If this proposal can successfully be targeted at preventing abusive arrangements without creating uncertainty in relation to the tax treatment of normal commercial arrangements, the CBI believes it should be supported.

Corporate attitudes towards tax have changed

The scope for abusive arrangements has also diminished due to changing corporate attitudes. Tax has become a more important issue for most companies and is often now on the agenda of the board of directors. There are greater reputational issues at stake than ever before and companies are talking about their tax affairs in a different way and through different media. Additionally, tax is a topic increasingly seen by many stakeholders as an important area of corporate social responsibility (CSR). A number of companies are using CSR reports as well as financial statements to provide information on tax.

Many companies are starting to form a tax strategy and policies that express their views on timely compliance and cooperation and, indeed, their positions on the scale of how they balance tax management and risk. They generally reflect the need to remain competitive on tax as against others in the same industry or market. Only a minority of companies discuss their tax strategies or policies in financial statements, but the number is growing. More companies, however, are showing interest in how taxes are part of the economic value they create and distribute to stakeholders, whether as taxpayers or tax collectors on behalf of government.

> *"Tax has become a more important issue for most companies and is often now on the agenda of the board of directors."*

Internal governance on tax is much tighter than it was previously. This is partly because of the greater profile it has within the business, but also a result of external factors involving HMRC (greater reporting requirements and closer cooperation on a real-time basis), the OECD (development of transfer pricing guidelines) and the EU Commission (VAT as a community tax).

Finally, HM Treasury and HMRC have made efforts to make business feel more engaged in the policymaking process, through consultation. This allows businesses to better understand the legislation which reaches the statute book, as well as how HMRC will apply it. This in turn makes abusive arrangements less likely.

The courts have reduced the scope for abusive arrangements

Statutory interpretation of tax law has changed over the years, since the Duke of Westminster case (page 9). This has added to the complexity of the tax system, increasing the importance of proactive tax management to ensure compliance. It has also significantly reduced the scope for abusive arrangements, and taxpayers (and their advisers) are aware of this – and often welcome it.

The general liberty of a corporate taxpayer to order its affairs to reduce its tax bill remains true, but the overly literal interpretation of statute which was applied in that case has been much criticised since. In the years that have followed, there has been a shift away from a literal reading of the judgement to interpretations that put greater weight on contextual approaches designed to identify the purpose of a statute and to give effect to it (for further details, see annex 1).

Conclusion

People are concerned that taxpayers – and especially businesses – pay their fair share of tax and do not manage to pay less than they should. However this important debate is coloured by a focus on tax evasion and abusive arrangements. These should not be confused with tax management, which is simply how businesses use the tax system to make use of incentives and ensure they pay what they are required to pay. Action by lawmakers, HMRC and companies themselves has helped to reduce the number of abusive arrangements seen as contributing to a tax gap.

3 Understanding how the business tax system works

Taxpayers have to work out how much tax they are legally obliged to pay according to the combination of some long-established principles in the statute and other measures including incentives or penalties which change more regularly. Not only is the management of tax costs permitted by law, it is often directly encouraged by government incentives.

This trend provides three reasons why businesses will need to use tax management. Firstly, it is important to remember that governments often alter the incentives within the tax system to encourage a specific behaviour on the part of businesses and individuals. In the same ways as individuals use the tax incentives aimed at them, such as individual savings accounts (ISAs), businesses also use the incentives provided which are, in the government's opinion, to the benefit of the UK economy.

Second, the sheer complexity of the tax system means companies have to make decisions even where laws are unclear. This very often makes it difficult to establish the one, scientifically ascertainable 'right' amount of tax owed by a company. Third, many British companies have been successful on the world stage, but that often involves dealing with multiple jurisdictions, all with slightly (or very) different rules, and all wanting a slice of the tax pie. Proactive management is required to avoid double taxation (which almost always would mean less taxation for the UK). It is worth examining each of these arguments in turn.

The government uses deductions and relief to encourage business behaviour

One of the features of the last 30 years has been the increasing use of the tax system by governments of every colour as a delivery mechanism for social and economic policy objectives. As intended, taxpayers respond to these incentives. There is a range of factors which, taken together, have a significant impact on the corporation tax liability of a company – these are the deductions or reliefs that companies can claim against their corporation tax bill.

Their availability and size differ by sector, depending on factors such as the capital intensity of a business. This means that businesses from across the economy end up facing different 'effective' rates of corporation tax, even though the headline rate (currently 26%) applies to all firms with profits of above £1.5m.

Examples of the main reliefs available to business are:

- **Group relief**. This allows the transfer of losses between companies and is the most significant relief available to businesses. It is substantially more important, relative to income and trading profit, for financial companies than it is for industrial and commercial companies.
- **Capital allowances**. These allow a reduction in the amount of corporation tax payable, offered as an incentive for investment in certain fixed assets. Industrial and commercial companies benefit proportionately more from these, reflecting the more capital-intensive nature of this part of the economy.
- **Losses carried forward**. These can be used to offset against trading profits and are of greater benefit to financial companies for whom profits and losses can be volatile.
- **R&D tax credit**. This incentivises research and development activity by providing relief against a company's corporation tax bill relative to its R&D expenditure. Pharmaceutical and advanced manufacturing firms benefit most. Additional tax credits are available to encourage innovation in the UK.

Exhibit 5 shows the effect of deductions and reliefs on the corporation tax bill of two aggregated business sectors, to illustrate the extent of the impact they have on a company's taxable profit.

Other allowances or reliefs target more specific matters. The important point is that tax management is needed to ensure expenditure qualifies. For example, a number of Enterprise Zones are being identified where tax 'breaks', including reduced business rates and, in some cases, more attractive capital allowances, will be available by reference to investment in particular geographical areas. Again, management is needed to ensure investment is in the right place, and the tax reduction can be secured.

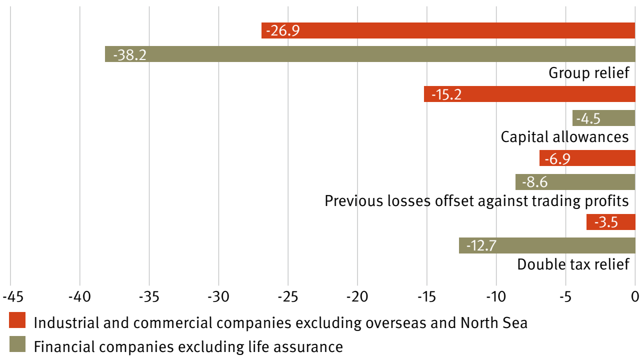
An increasingly complex tax system makes tax management a necessity

The complexity of the tax system adds to the importance of carrying out responsible tax management. Businesses are faced with a constant stream of decisions about their financial affairs each day, many of which have tax implications. As mentioned in the previous section, this complexity arises in part from the decision of governments over the years to use the tax system to incentivise businesses to act in a particular way.

The Office of Tax Simplification identified more than 1,000 tax reliefs in the tax system and took action in the 2011 budget to begin removing them.[10] But complexity breeds complexity, and the increased volume of tax legislation has been accompanied by a rapidly increasing number of complex anti-abuse provisions. A large amount of tax legislation, estimated to be as high as 40-50%, is taken up with what are often termed anti-avoidance measures, trying to clarify the precise nature of what a government intended to offer by way of an incentive or where a subsequent government wishes to narrow its scope.

Many UK-headquartered companies earn the majority (and in some cases almost all) of their profits from overseas operations, which also adds to tax complexity for business. These companies which operate in multiple jurisdictions can also themselves face different foreign tax regimes which will thereby affect their UK tax liability. For example, despite the move to a dividend exemption regime[11] the receipt of certain payments such as royalties will still bear UK tax subject to a credit for foreign taxes paid. In such circumstances the UK tax liability can differ significantly by sector, such as for pharmaceuticals and other intellectual property-dominated companies. Proactive management is required to avoid double taxation (which almost always would mean less taxation for the UK). This tax management is not abusive but is absolutely necessary if the business is to remain viable.

Exhibit 5 **Main determinants of taxable profit (Percentage of profit and other income)**



Source: HMRC; CBI Analysis

There is no such thing as the 'right' amount of tax

The myriad of incentives shows it is not possible to identify a single, scientifically ascertainable 'right' amount of tax. Corporate tax law is too complex, too uncertain and with too many interactions for that to be the case. This means one cannot simply say that if the proportion of a company's profits paid in tax is lower than the statutory tax rate (currently 26% for most companies) this must result from abusive arrangements. The availability of capital allowances, deductions provided by statute, the mix of UK and overseas profits and tax losses can all legitimately lower the effective tax rate.

Conclusion

There is a great deal of misunderstanding over the use of tax management by businesses, which leads it to be confused with tax evasion or abusive arrangements. It is important to highlight that tax management is not only legal, but is an essential feature of a wider legal principle that taxpayers, both individual and corporate, should pay tax but no more than is specified by law. For businesses the need for tax management is driven by two factors: the use by governments of the tax system to encourage behaviour and the growing complexity of the system, domestically and internationally.

4 Nine tax rules that can lead to confusion

The complexity of the tax system allows plenty of room for genuine misunderstanding about how much tax a company should pay. Complicated tax and accounting rules and the lengthy series of steps to move from gross turnover to taxable income leads to confusion as to what various numbers mean. Without some specialist tax and accounting knowledge, these misunderstandings and misconceptions can lead to the conclusion that abusive arrangements have been used, when they have not.

This section runs through nine rules that lead to common misunderstandings and inaccurate assessments of the tax positions of companies operating in the UK. The first three relate to different rules on what must be taken into account for determining the proper amount of 'income' on which tax will be charged, and the time at which income is held to be taxable. The others look at misunderstandings surrounding some tax concepts.

Cash tax and book tax

'Cash tax' is what companies ultimately have to pay in relation to their tax liabilities. Cash taxes are determined by the tax return. But a large number of adjustments to the statutory financial accounts are required by the Taxes Acts to get to the taxable income figure. These adjustments mean that the 'tax' figure shown in the financial statements will almost never be the same as the 'tax' figure on the tax return. 'Book tax' is the amount of tax charged against profit and is shown on the company's financial statements. All of these differences between taxable and accounting profit will combine to ensure that there is almost always a difference between cash tax and book tax in any one year (see annex 2 for a more detailed explanation and a worked example).

Deferred tax accounting

This seeks to deal with the mismatch due to timing differences. It is based on the temporary differences between the tax base of an asset or liability and its carrying amount in the financial statements. Where tax relief is obtained in advance of the charge against accounting profit, the tax base will be lower than the book value and so there will be a deferred tax liability. Where tax relief comes later – for example where a loss is to be carried forward to use in a later tax period –there will be a deferred tax asset.

Groups' relief of losses

There are special rules that apply to losses arising to companies in the same tax group, as mentioned earlier. They typically apply where companies satisfy 75% beneficial ownership tests. If the profit and loss account (P&L) of a company after all these adjustments shows a loss, that 'tax loss' can be used against taxable profits of another company in the group, in the same period, that would otherwise attract corporation tax. As a result, while one company in a group may show a 'profit', the consolidated group may pay less tax than the application of the statutory tax rate to that amount might indicate.

Provision for uncertain transactions

Where the tax treatment of a particular transaction is uncertain, such as in complex transfer pricing disputes, this can result in a provision being charged against profits for the additional tax liability that might arise should the self-assessed basis filed in the tax return be shown by future events to have been incorrect. The company must convince independent auditors that such provisioning is required. All such amounts will go into a 'reserve' which will then have to be reviewed on an annual basis and 'released' – put back into the income of the company – when the size of the liability is finalised.

Transfer pricing

The fact that a company engages in 'transfer pricing' indicates nothing about tax avoidance. All companies that transfer goods or provide services to affiliates across borders are required by law to establish the price at which the goods or service is transferred – ie, transfer pricing. It is sometimes suggested that companies manipulate profits by the prices at which they transfer goods and services within a group. By contrast, companies have an obligation under statute and accounting rules to ensure that their intra-group – and especially cross-border – transactions are made and recorded on an arm's length basis. If HMRC believes the 'transfer pricing' is not accurate, it may require adjustments to be made to reflect the amounts that would be shown if the transactions had been on an arm's length basis. Similar 'transfer pricing' rules apply in other countries too to effectively establish the price acceptable for tax purposes at which related parties sell goods and services to each other.

Moving tax residence

Some UK companies have chosen to move their tax residence – central management and control functions – to another territory. It is a misperception that it is easy for a UK company simply to move to a jurisdiction with a more favourable tax system or that such decisions are taken lightly. While tax is one factor, there is a significant number of other legal and commercial factors and consequences which need to be taken into consideration. Moving residence does not result in all of the group profits being taken out of the UK tax base. The controlled foreign company (CFC) rules also prevent the headquarters of a company transferring its profit-making 'apparatus' into an offshore subsidiary rather than moving there.

Where is income earned?

The place where profits accrue for tax purposes is determined by a number of factors. Merely because a company's or group's headquarters is in the UK that does not mean that the revenue-earning potential is in the UK. But it is not straightforward to move a company's profits out of the UK to another location merely because you might wish to do so, and the CFC rules are there to prevent artificial diversion of profits.

Settlements

The determination of taxable profits is not a precise science and there will often be a difference in good faith between HMRC's view of the tax due and a company's view. If agreement cannot be reached, the courts will ultimately decide but both parties are usually keen to avoid the costs and uncertainty of litigation and so a settlement is reached. HMRC has been keen to point out that, from its perspective, such a settlement is always based on interpretation of the law and not, for example, purely on a 'split the difference' basis. Thus, there is never any liability which HMRC 'waives'.

Worldwide and territorial taxation

A UK company is generally taxable on its income wherever it arises in the world. That does not apply to the income of a foreign subsidiary of a UK company. That income is only taxable when it is sent back to the UK and since 2009 dividends received from a foreign subsidiary are generally not taxed when received by the UK parent. The rationale underlying the UK position is that this is a better – and less complex – way of relieving foreign taxation on foreign income. It is also less open to foreign tax credit abuse.

Conclusion

Complicated tax and accounting rules and the number of steps to move from gross turnover to taxable income lead to confusion as to what various figures mean. It is simply not possible to look at turnover or gross income and say that the tax must, therefore, be 'X'. Without some specialist tax and accounting knowledge these misunderstandings and misconceptions can lead to the conclusion that abusive tax schemes have been used when they have not.

5 A competitive global tax landscape

Businesses now place a much larger value on operating within simple and predictable tax environments. A key characteristic of any competitive tax regime is that it is simple to understand and efficient to comply with. It must also work together with other tax systems to avoid the double taxation of profits, for example through double tax treaties. The concern is that the growing complexity of the UK tax system means that the UK has become a less attractive place for business to invest. Against that background, it is vital that policymakers, businesses and outside commentators have an intelligent debate about the business tax system.

The UK must compete for increasingly mobile business activity – or risk losing out

In an era of globalisation and competition, an attractive tax environment is vital to the UK. The cost of an uncompetitive regime is lost business activity, lost revenue and a tax environment which does not encourage British business to grow. And this translates into fewer jobs, less opportunity, and lower tax receipts. That is not good for the British economy or British workers.

Increased mobility of goods, services, labour, capital and ideas have combined to require companies to structure their operations in an increasingly global manner, with diminishing regard for national boundaries and jurisdictions. These factors, added to the growing strength of developing economies and the reduction in trade barriers, have led many businesses to globalise activities. In conjunction with this, the internationalisation of shareholder bases and the geographical diversification of company ownerships have loosened the historical ties between companies and specific jurisdictions.

The globalisation of business means that not only are differences in the competitiveness of national tax systems becoming more important, but multinational companies are also becoming ever more responsive to these differentials. In this global context the UK competes with other locations for mobile business activity. The UK economy is significantly boosted by the presence of many of the largest multinational companies in the world. As the government noted in its Corporate Tax Roadmap, "*the UK is an open economy and many of the best known businesses in the world are located in the UK, generating growth, creating jobs and making a significant contribution to the public finances.*"[12]

If the UK is to retain and attract the business and talent it needs to stimulate economic growth, a competitive and stable tax environment is a necessity. Thus, the government's stated ambition on headline corporation tax rates and its reforms on the taxation of foreign profits and intellectual property have been steps in the right direction, as they would make the UK a more attractive destination for investment by multinational companies, both those based in the UK and inward investors. The proposals for reform of the Controlled Foreign Companies regime are intended to protect the UK tax base from artificial diversion of profits, including those attributable to intra-group financing arrangements, without undermining the UK's attractiveness as a location for multinationals through excessive compliance burdens.

Not only does an uncompetitive tax system risk driving business offshore and erode the competitiveness of UK businesses, it also threatens government tax revenues. High capital mobility, leading to increased business responsiveness to tax differentials, threatens the stability of corporate tax revenues. This is particularly important given the strategic significance of the UK's highly mobile financial services and knowledge-intensive businesses. Those who argue that the business tax burden should be raised to meet the UK's fiscal needs must recognise the risk that this would jeopardise current levels of tax paid by business to government. Business wants to contribute to Britain, but it simply cannot do that if Britain is not competitive with its foreign peers. Lost business costs the UK not just the corporation tax paid each year by these businesses, but the other business taxes which together account for more than three times the value of corporation tax.

Reductions in the UK corporation tax rate are needed to maintain competitiveness

Recent reductions in the corporation tax rate and the government's aim to reduce the rate to 23% have attracted criticism from some commentators. Critics have claimed that in a time of public austerity, business should be paying more taxes and that this tax cut is 'unfair'. But that misses an important point: business understands that it must shoulder its share of the burden, but unlike an individual for whom there is a welfare safety net, there is no safety net for business. If businesses become uncompetitive, and can no longer compete, they cease to exist, and the jobs, tax revenue and agglomeration benefits they provide will all disappear. So, such cuts are an important factor for the competitiveness of the British economy.

Additionally, corporate tax rates are falling throughout the world – according to KPMG, the average global corporation tax rate fell by 3% between 2005 and 2010. This means that rate reductions in the UK are necessary just to keep pace with this global trend.[13] **Exhibit 6** shows how the headline statutory rate of corporation tax has been falling in major economies over the last 15 years – and how the UK's rate has had to fall in recent years to remain competitive.

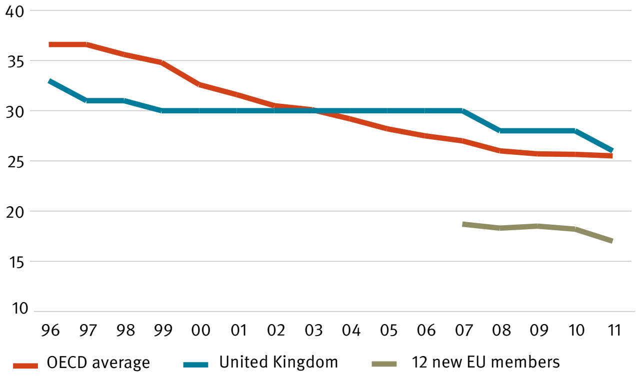
Two further measures of a country's corporation tax rate – the effective average and effective marginal tax rates – also show that the UK regime is far from being the most competitive in the G20. These measures show the size of the disincentive presented by the corporate tax system to locate activity in a particular country and the size of the disincentive to undertake a greater quantity of investment once the location decision has been made. The effective average tax rate (EATR) is the most comprehensive comparator between countries and the effective marginal tax rate (EMTR) in effect measures the proportionate increase in the cost of capital for a specific investment project as a result of corporate taxation. The UK has the 9th and 15th lowest rates of EATR and EMTR of the G20 countries, respectively.[14]

Conclusion

The UK government has announced its intention to construct the most competitive regime in the G20 to encourage companies to invest and stay in the UK. This does not just mean a competitive headline rate of corporation tax, but includes the use of other incentives to ensure the UK tax environment is attractive to business. However, tax competitiveness is important to governments, and to the national economy. If certain tax incentives give the UK a competitive edge, then the UK benefits.

The competitiveness of companies operating in the UK with respect to their foreign equivalents is also an important tax issue. If many other countries allow their companies to use a certain method for accounting for the tax implications of intellectual property, for example, but the UK does not, UK companies will be at a disadvantage.

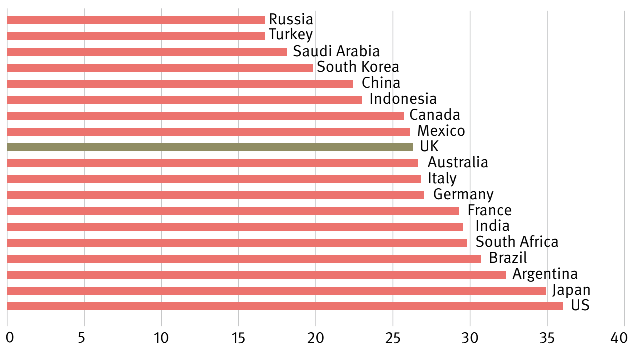
Exhibit 6 Statutory headline corporation tax rates 1996-2011 (%)



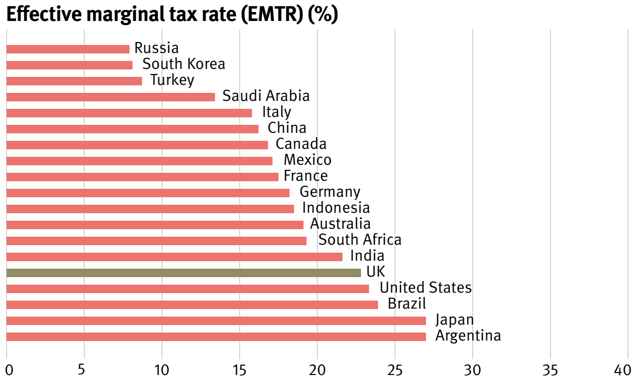
Source: OECD

Exhibit 7 Effective average and marginal tax rates G20 countries, 2011

Effective average tax rate (EATR) (%)



Effective marginal tax rate (EMTR) (%)



Source: Oxford University Centre Business Taxation

6 Summary

There is a very vigorous debate underway over the amount of money that businesses pay in tax. Unfortunately much of that discussion is shrouded in misunderstanding. It is vital that there is an intelligent debate over the UK's tax regime, since a competitive system that is seen as fair is an essential ingredient for the competitiveness of the UK economy.

The reality is that businesses pay their way in terms of total tax revenue, contributing more than a quarter of total receipts. On top of that, businesses play a key role both in collecting taxes paid by other taxpayers and also in delivering the economic growth and wealth that indirectly leads to higher tax revenues from consumers and larger incomes for pensioners.

The business community in this country also pays more corporation tax than businesses in many of our competitor countries. But not every business pays an identical share of its revenues in tax, as the final contribution will depend on the sector of the economy the company operates in, the size of the sector and the firm and the deductions and reliefs available to it.

People are concerned that taxpayers – and especially businesses – pay their fair share of tax and do not evade their liability or use abusive arrangements to pay less tax. Action by lawmakers, HMRC and companies themselves has helped to substantially reduce the number of abusive arrangements that have been seen as contributing to a tax gap. It is important that the debate is not distorted by a focus on tax evasion and abusive arrangements. These should not be confused with tax management, which is simply how businesses use the tax system to make use of incentives and ensure they pay what they are required to pay.

Tax management must be understood as simply describing what is open to all taxpayers, whether individuals or businesses: they should pay tax, but no more than specified by law. One reason for misunderstanding is that the range of tax incentives used by government, the increasing complexity of the system and the need for multinationals to navigate different tax jurisdictions makes tax management even more important to ensure business pay the tax for which they are liable. The tax system is by its nature very complicated and there are some rules that, while in place for a specific purpose, can add to misunderstandings.

Tax competitiveness is important to governments, and to the national economy. If certain tax incentives give the UK a competitive edge, then the UK benefits. This competitiveness will, of course, benefit entrepreneurs and other owners of capital. The UK must continue to look to lower the business tax burden, even in these times of austerity, as long-term competitiveness of the UK economy will lead to long-term tax revenues. But it will also benefit workers, their families, the supply chain and the exchequer. A competitive tax system that encourages growth benefits everyone – *that* would be good for Britain.

"A competitive tax system that is seen as fair is an essential ingredient for the competitiveness of the UK economy."

Annex 1 Tax management in the courts

Judicial interpretation of tax law has changed over the years since the Duke of Westminster case, to the complexity of the tax system and significantly reducing the scope for abusive arrangements

In 1981 in the Ramsay case, the House of Lords held that if a group created a matching capital gain and loss (on loan notes) at no economic risk to itself (the gain not being taxable due to a statutory tax exemption), the loss was not allowable as a tax loss. In Lord Wilberforce's judgement he said "*There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded*."

This ended arrangements where the same transaction, effectively, went in a circle, within a group of individuals or companies. But taxpayers were still uncertain how far the principle extended. In *Furniss v Dawson*, a third party had agreed to buy a family's shares. The family, however, first sold them to another company for shares, which itself sold on to the third party. The House of Lords said that the inevitability of the onward sale meant that the family's sale should in effect be regarded as made directly to the third party.

Difficulties remained, however, in determining what constituted a connected series of transactions with pre-ordained steps with no commercial purpose, and a string of cases followed. But the 1997 McGuckian case was marked the high-water mark of looking at Ramsay and Furniss as a free-standing principle in this way. In this case, the sale proceeds of the rights to certain dividends expected to be declared shortly by a company controlled by the taxpayer were treated as income (although the basis of the judgment was not entirely clear).

Mawson v BMBF in 2004 was the last major case to reach the House of Lords in this specific area and it effectively set the standard for current interpretation by the courts. The test is that the court has to go back to basics and try to find out which transactions a given tax provision was intended to cover. 'What was the objective intention of Parliament in enacting this provision?' Yet in answering this question, one must look at the words actually used not the words which arguably ought to have been used. More recent cases in the lower courts have made clear the need, in applying this case law, that the facts must be viewed realistically, leaving taxpayers facing a rather strict assessment of the tax status of their transactions.

Annex 2 Simplified example tax calculation

Differences between 'cash tax' and 'book tax' result from a combination of permanent and timing differences:

- **Permanent differences** can either increase or decrease the cash tax due. Items that increase tax include legitimate business expenditures that are not allowable for tax purposes such as business entertaining or depreciation on buildings where no tax relief is available. On the other hand there may be profits that are not fully taxable. Examples in the UK are items that fall within the capital gains tax regime which has its own computational rules and in many cases provides full exemption from tax.
- **Temporary timing differences** arise where the point in time when revenues or expenses can or must be recognised is different in the tax return to what it is in the accounts. Depreciation of assets that qualify for capital allowances is a good example of a temporary timing difference. Depreciation is not deductible for tax but relief is provided through the capital allowances regime. For many assets tax relief is provided at a faster rate than the accounting depreciation charge and this means that taxable income in a year is lower than the accounting profit. As a result the cash tax payable is lower than the accounting profit multiplied by the tax rate.

Simplified tax calculation showing effect of permanent and timing differences

Opposite is a simple illustration of a tax calculation for a UK group with operations both in the UK and outside. It is designed to show how the factors described in chapter 3 operate to give an accounting tax rate – the Effective Tax Rate in this case of 22.3% – and a cash tax rate of 19.5% that both differ from the UK corporation tax rate of 26%.

ACCOUNTING PROFIT	**UK**	**Overseas**	**Total**
Turnover	1,000	1,000	2,000
Cost of goods sold	-650	-650	-1,300
Depreciation	-120	-120	-240
Profit on sale of subsidiary	50		50
Profit before tax (book profit)	280	230	510
TAXABLE PROFIT			
Profit before tax	280	230	510
Add depreciation	120		120
Add non-deductible items	10	10	20
Deduct non taxable gain (1)	-50		-50
Deduct capital allowances (2)	-150		-150
Taxable profit	210	240	450
Tax rate	26%	20%	22.8%
Current tax (3)	55	48	103
Deferred tax (2)	8	0	8
Tax charged in accounts (4)	62	48	110
	22.3%	20.9%	21.6%
Cash tax due	55	48	103
	19.5%	20.9%	20.1%

Notes

(1) UK tax law provides a specific exemption from tax (the substantial shareholdings exemption) for the sale of qualifying shares in a subsidiary.

(2) The accounting charge for depreciation is replaced in the calculation of taxable profits by capital allowances. These are assumed to be higher than the accounting charge by £30 and deferred tax is provided at 26% on this excess.

(3) Current tax is the tax payable based on the tax return but will also include any tax provisions in respect of uncertain items.

(4) Figures may not sum exactly due to rounding.

Annex 3 Deferred tax accounting

As explained in chapter 3 there are many reasons why the taxable profit in any one year may be different from the accounting profit. Where this is due to a permanent difference then it is appropriate for the tax charge in the accounts to follow the tax return. But where the difference is due to timing then the accounts should reflect the fact that the difference is expected to reverse in a later period. For example if the capital allowances for an asset exceed the depreciation charge in a year this will reduce the tax payable but as the total cost of the asset qualifying for tax relief is the same as the cost in the accounts, the position will reverse in later years when tax relief will be lower than the accounting depreciation. To reflect this position an amount of deferred tax is charged based on the difference between the tax relief and the accounting cost. In practice this calculation is performed on the pool of all assets and on a cumulative basis with the deferred tax being calculated by reference to the difference between the tax written down value (cost less capital allowances to date) and the book value (cost less depreciation to date).

Another example where it is appropriate to provide deferred tax is if an asset is revalued upwards but not sold. If the amount of the increase would be subject to tax, if and when that asset were sold at that revalued amount, then again this is a 'temporary difference' and provision is made for that tax as a deferred tax liability. Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability settled, based on tax rates and laws that have been enacted at the date the accounts are signed. Generally, measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences at the balance sheet date based on the way that the entity expects to recover/settle those deferred tax assets or liabilities.

A **deferred tax asset** (DTA) may arise, for example, where:

- Retirement benefit costs are deducted in determining accounting profit (because service is provided by the employee), but are not deducted in determining taxable profit until the entity pays retirement benefits (or contributes to a pension fund)
- The net realisable value of an item of trading stock is less than the previous carrying amount. On its financial books therefore, the entity reduces the carrying amount of the asset, but that reduction is ignored for tax purposes until the asset is sold.

A **deferred tax liability** (DTL) may result, for example, where:

- Capital allowances are available that are greater than book depreciation
- The carrying amount of an asset is increased to fair value in a business combination for book purposes, but no equivalent adjustment is made for tax purposes
- Revenue is received in arrears and is included in accounting profit on a time apportionment basis but is included in taxable profits on a cash basis

Changes in deferred tax are generally recognised in profit or loss for the period (unless the tax arises from a business combination or a transaction or event that is recognised outside profit or loss, such as foreign exchange differences on the translation of the financial statements of a foreign operation). The tax consequences that accompany, for example, a change in tax rates or tax laws, a reassessment of the recoverability of deferred tax assets, or a change in the expected manner of recovery of an asset are generally recognised in profit or loss.

References

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2 *Commentary on the public sector finance*, OBR, June 2011

3 *Total Tax Contribution: Understanding the economic contribution that large companies make to UK public finances*, PwC 2010 survey for The Hundred Group

4 *Revenue Statistics 2010*, OECD

5 *Corporation Tax in the UK,* Devereux M, Loretz S, Oxford University Centre for Business Taxation, 2011

6 The tax gap represents the amount of tax that the government believes may be owing. This number needs refining in two important ways. Firstly reasonable people might disagree on some of the assumptions behind some of the numbers. Second, government statistics tell us that the tax gap is actually made up of a 'hard' tax gap and a 'soft' one

7 This includes both 'avoidance' (£1bn down from £2.1bn in 2004-05) and 'technical issues' (£0.2bn)

8 *Inland Revenue Commissioners v Duke of Westminster* [1936] A.C. 1

9 Report by the Comptroller and Auditor General on HM Revenue and Customs 2010-11 Accounts

10 UK's tax system has over 1000 reliefs. HM Treasury press release, 8 November 2010

11 Prior to 1 July 2009, all foreign dividends were subject to UK corporation tax, and credit was then given for foreign tax suffered to prevent double taxation. From 1 July 2009, most such dividends are exempt from corporation tax as part of the move to a more territorial tax system

12 *The Corporate Tax Roadmap*, HM Treasury, 2011

13 *Corporate and Indirect Tax Survey 2010,* KPMG

14 *Corporation Tax in the UK,* Devereux M, Loretz S, Oxford University Centre for Business Taxation, 2011

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