Date: October 2010

The Corporate Tax Gap

Summary

The Corporate Tax Gap

In 2008 the TUC published ‘The Missing Billions’, which is now seen as having made a major contribution to the UK debate on the Tax Gap – the difference between the tax that HM Revenue & Customs might theoretically expect to collect and that tax which is actually paid to them.

‘The Missing Billions’ dealt with just one part of the Tax Gap – that relating to tax avoidance, which is the legal minimisation of tax liabilities contrary to the spirit of the law. This review reconsiders just one part of that work – the part relating to companies and how this issue has developed since ‘The Missing Billions’ was published.

In ‘The Missing Billions’ tax avoidance by UK companies was estimated at £12 billion. That estimate is not updated here, largely because, as this report notes, many of the companies whose accounts underpinned that earlier work have ceased to publish any data on their UK trading, profits or tax liabilities since 2006, which was last year of accounts covered by ‘The Missing Billions’. We call in this report for a remedy to this retrograde step in corporate reporting by requesting adoption of what is called ‘country-by-country reporting’ which ensures that all companies report their activities separately for each and every country in which they operate – including the UK. Only by adopting this practice do we believe that multinational corporations can evidence their commitment to corporate responsibility – including their responsibility to pay tax at the right time, in the right place and in the right amount.

However, it is still possible to draw conclusions by revisiting the sample of fifty of the largest companies in the UK whose accounts underpinned the estimates made in ‘The Missing Billions’ and in this report. In particular, this report confirms a number of worrying trends, which only add to the concerns we had in 2008.

Firstly, the downward trend in the effective tax rates of the UK’s largest companies appears to be continuing. Whilst effective rates of corporation tax reported in the accounts of these companies oscillated a little between 2007 and 2009 the trend rate fell to 21% at the close of the period, indicating that the annual trend of a fall of approximately 0.5% in the effective corporation tax rate of these companies noted in ‘The Missing Billions’ continued in the period 2007 to 2009.That effective tax rate fell by more than 5% in a decade when the UK headline rate of tax was fixed at 30% for most of that period.

This has serious implications for the UK economy and for the fairness of the UK tax system. This differential of 7% between the headline and effective tax rate for the UK's largest companies was calculated for a period when the headline tax rate was falling from 30% to 28%. The Coalition government has now announced that the UK's mainstream corporation tax rate, which applies to the profits of large companies, will fall from 28% to 24% over the next four years. If the 7% differential between the headline and effective tax rate is maintained during that period (and there is little reason to think it will change despite the small reduction to capital allowance rates that have been announced) then the effective tax rates paid by the UK's largest companies might fall over the next few years to an average of about 17%. This is 3% less than the small company's corporation tax rate in the UK, and also less than the basic rate of income tax at which many UK small businesses are taxed. We will as a consequence have, for the first time, a regressive corporation tax system in the UK where the largest companies in the UK will be paying lower rates of tax than almost all of their employees and almost all small businesses in this country.

The result will be the creation of an uneven playing field where large business will be favoured over small at a time when the reverse is needed, firstly to ensure big business pays it fair contributions for the benefits it receives from the UK government and economy and secondly to ensure that small business is competitive as it creates significantly more employment in the UK than do larger enterprises.

Second, we note that the losses many companies incurred as a result of the financial crisis have, of course, impacted on tax paid. Most especially though, by paying particular attention to tax data in the accounts of the UK's High Street banks we show that those banks appear to have since 2008 accumulated tax losses having a total cash value to them of approximately £19 billion. These they can now offset against the tax payments they might owe in 2010 and onwards on the profits they are now making solely as a result of their banking operations being saved at considerable cost by the UK taxpayer.

This is of great significance. At a time when everyone is supposed to be contributing to the resolution of the UK financial crisis in equal measure it would seem that the banks who created it, and whose losses were supported by the government with taxpayer funds, will be offsetting the resulting tax losses against their future profits for some time into the future. As a result, they alone will not be making any significant contribution to the economy as we struggle to come to terms with the problems they created. And since it seems that, overall, the rest of the UK's businesses do not have similar losses to offset against future profits, and so they will be making tax payment in the future, this situation is peculiar to these banks.

There is no logic to this extraordinary situation. To give banks a second tax subsidy on losses which have already, effectively, been borne by the taxpayer and government is quite unnecessary, and economically inappropriate.

There are a number options available to tackle this issue. For example, the banks in question might continue to pay bank bonus taxes, or pay a Robin Hood Tax, or have their right to carry tax losses forward limited so that they expire after a limited period if not utilised by that date, or a combination of all these factors, and maybe others.

What is clear is that the proposed bank levy now being **considered will make little difference to the overall contribution these banks will make to the cost of** remedying the mess they caused, not least if their tax payments in the UK are reduced to anything like the extent their deferred tax assets might suggest likely.

As a result urgent action is now needed to ensure that banks contribute through their tax payments to government to the extent most in the UK would expect so that as cuts begin to impact on the UK economy as a whole they are seen to be bearing their fair share of the burden for the consequences of their past profligacy and recklessness. Without such action this will not happen, and that is unacceptable.

The impact of this work in combination is therefore as follows.

First it makes clear that for reasons that change over the economic cycle there is a corporate tax gap, and that it continues to need to be monitored.

Second it is vital that the companies trading in and from the UK be required to disclose the geographic nature of their activities and tax payments if anyone in civil society (and maybe also in our tax authorities and those of other states) are to have adequate opportunity to readily asses the relationship between these multinational corporations and the states that grant them their licence to operate and which hosts their activities. The current situation where multinational corporations can appear to float above such geographically based obligation is unacceptable to all organisations in civil society and government and should be subject to urgent reform. Without this information, the contributions companies make to society cannot be assessed and that is clearly inappropriate, both for them and those who wish to understand their activities.

Third the contribution of the UK's High Street banks to future tax gaps is likely to be significant, and at substantial cost to everyone in the UK unless urgent action is taken soon to ensure that they make effective contribution to the UK Exchequer out of the profits they are now making against which they will, unless action is taken, offset tax allowable losses when those losses have already been subsidised by the UK taxpayer.

Finally, and as was said in the 'Missing Billions' it is beholden on the UK government to continue to tackle the tax gap – whatever the differences in the bases of estimation used – and that this can only be done effectively if the proposed cuts in expenditure at HM Revenue & Customs, on top of those that have already taken place over the last four years, are reversed. Recent announcements by the Coalition government do not alter the fact that they are planning enormous cuts in resources at HM Revenue & Customs over the next four years. The announcement of new resources to tackle the tax gap simply reduces those cuts from an estimated £3 billion in all over four years – resulting in the loss of up to one quarter of all current staff by the end of this period – to cuts of £2.1 billion. When reasonable estimates of productivity by tax officers suggests each can collect up to thirty times their salary when engaged in tax investigation work[1] the yield from investment in such personnel is very obvious. At a time when the alternative to raising revenue in this way are massive cuts in public services, employment and loss of well being for many in the UK the case is not just obvious – it becomes an imperative.

And that is why the TUC believes that the Tax Gap is now one of the biggest issues on the UK policy agenda.

[1] Source: ARC, the union for senior tax officials in HM Revenue & Customs and part of the First Division Association.

Section one

What is the Tax Gap?

In February 2008 the TUC published 'The Missing Billions'[2]. The report suggested that some £25 billion a year was lost to the UK Exchequer from this activity each year.

The tax gap that 'The Missing Billions' identified related to tax avoidance. Tax avoidance is seeking to minimise a tax bill without deliberate deception (which would be tax evasion) but contrary to the spirit of the law. It therefore involves the exploitation of loopholes and gaps in tax and other legislation in ways not anticipated by the law. Those loopholes may be in domestic tax law alone, but they may also be between domestic tax law and company law or between domestic tax law and accounting regulations. The process can also seek to exploit gaps that exist between domestic tax law and the law of other countries when undertaking international transactions[3].

'The Missing Billions' estimate of £25 billion of tax avoidance a year was split into two parts. Tax avoidance by individuals was estimated to be £13 billion a year and that by companies was estimated at £12 billion a year.

These losses are different to those from tax evasion, which is the illegal non payment or under-payment of taxes, usually resulting from the making of a false declaration or no declaration at all of taxes due to the relevant tax authorities, resulting in legal penalties (which may be civil or criminal) if the perpetrator of tax evasion is caught[4].

The extent of UK tax evasion has been most recently independently estimated in a report for TUC affiliated union PCS, in which the sum was estimated to be £70 billion a year[5].

Tax avoidance and tax evasion are two components in what is called the tax gap – the third part of which is unpaid tax, estimated by H M Revenue & Customs in March 2010 to be £26 billion[6].

It should be noted that HM Revenue & Customs do not agree these figures for the tax gap: their official estimate is currently £42 billion a year[7]. This is not

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[2] http://www.tuc.org.uk/touchstone/Missingbillions/1missingbillions.pdf
[3] http://www.taxresearch.org.uk/Documents/TaxLanguage.pdf
[4] ibid
[5] http://www.pcs.org.uk/download.cfm?docid=71E391EF-AA15-4032-966A39152975661D
[6] http://www.hmrc.gov.uk/about/hmrc-accs-0910.pdf
[7] http://www.hmrc.gov.uk/stats/measuring-tax-gaps-2010.htm.pdf

the place to discuss the reasoning behind these estimates: that discussion has taken place elsewhere[8].

The purpose of this report is to look again at the issue of the corporate tax gap – the tax not paid by companies in the UK and to explore some aspects of that gap which have arisen since 'The Missing Billions' was published.

8 http://www.taxresearch.org.uk/Blog/2010/08/05/the-uk-shadow-economy-proving-the-tax-gap-is-as-big-as-i-claimed/ and http://www.taxresearch.org.uk/Blog/2010/09/12/the-tax-gap-why-hmrc-have-to-be-wrong/

Section two

Calculating the corporate tax gap

In 'The Missing Billions' the corporate tax gap was defined as the 'expectation gap', which is the difference between the rate of tax set by the government of the country in which the company operates and the actual rate of tax they pay. This gap is a measure of the difference between the contribution societies might reasonably expect businesses to make by way of tax paid, and what is actually paid.

This comparison of the headline rate of tax with tax actually paid might seem a crude measure but in fact numerous academic studies have found that the headline rate appears to be a major influence on business decision making albeit that the effective rate is also of significance[9]. If, therefore, business takes account of the difference between these two rates in making their decisions it is entirely appropriate to do so for other purposes.

In preparing 'The Missing Billions' report, accounting data published by the fifty largest companies in the FTSE 100 in July 2007[10] was reviewed in depth. That review involved collecting extensive information on their financial reporting for each of their financial years ending in 2000 to 2006 inclusive (or a shorter period if they were formed after 2000 with no obvious predecessor, as was true in several cases). This involved a review of three hundred and forty four sets of accounts in all spread over a seven-year period.

To undertake the current research it was decided to use the same sample set of companies as was used in 'The Missing Billions' to provide continuity and consistency (as far as possible) in data used for reporting trends. The only problem that arose in doing so was that some companies did not survive from 2006 (when the original survey ended) to the close of 2009 (for which the updated data was prepared[11]).

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[9] For example, see *Do Countries Compete over Corporate Tax Rates?*, Michael P. Devereux, Ben Lockwood, Michela Redoano, 2005
www.sbs.ox.ac.uk/NR/rdonlyres/ACE5A5B5-1508-4F65-8F11-136CDB5C84C7/0/DevereuxLockwoodRedoano.pdf

[10] There was one exception: Standard Life should have appeared at 49 in the list but had been a quoted company for less than a year at the time the data was collected. Prior to 2006 it has a completely non-comparable reporting basis to all other companies in the survey as it was a mutual company. As a result it was excluded from the survey and the 51st company, Shire plc was substituted in its place.

[11] The companies that ceased to have independent existence during that period were Cadbury Schweppes, HBOS, Reuters, Hanson and ICI. The data that follows has been

The methodology for calculating the current tax rate of the companies surveyed was identical to that used when preparing the calculations in 'The Missing Billions'. For a number of reasons, the data reported on the face of the company's profit and loss accounts is not suitable for the purpose of analysis. For the purposes of this survey, more reliable and useful data had to be extracted to form the basis of interpretation of underlying tax trends.

The first such change is required because some of the tax charged in the profit and loss account of all the companies surveyed will almost certainly never be paid. This is because the tax charge published in a company's profit and loss account is usually made up of two components. The first is the current tax charge and the second is the deferred tax charge. It is only the current tax charge that is likely to be paid by the company in the near future, which for these purposes usually means within twelve months of the end of the period for which the accounts have been prepared. Deferred tax might be defined as tax that might be payable at some time in the future as a consequence of transactions that have already occurred, but with there being no certainty as to when or if that tax might be paid.

The second modification is to add back to the reported profits of the companies surveyed the charge included in their accounts for the write-off of goodwill. Goodwill is the difference between the price paid when buying a company and the actual value of the assets that are acquired. This sum has to be written off over time under most accounting rules and substantial goodwill write-off charges are included in the profit and loss accounts of many of the companies in this survey. These charges are, however, usually not tax allowable. As a result, to add this number back gives a better and more reliable indication of the taxable profit of the company than is available by using the unadjusted profit before tax figure included in the accounts. It is stressed that the resulting figure for profit can only be an approximation to actual taxable profit. However, there is currently no more satisfactory basis for assessing the tax gap than the data made available in companies' consolidated accounts as adjusted for this figure, and hence it is used here.

These two adjustments were applied to all the data for all the companies surveyed for the years 2000 to 2009 covered by this report.

In addition in 'The Missing Billions', when calculating overall population averages some further adjustments were made to eliminate 'rogue' or 'outlying' data which distorted the presentation of results. This is a normal statistical methodology. In the 'Missing Billions' the three companies with the highest and lowest tax rates were excluded from the samples when calculating averages, and in addition the results of any company declaring a loss were excluded from consideration as it is (for technical reasons) possible for a

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adjusted to allow for this fact in calculating averages for the appropriate years when data is missing for these companies.

company to declare an accounting loss and yet still have a tax bill, which can severely distort data.

This filter has also been included in the current survey, but with another added as well, which is to exclude all data where the reported tax rate exceeded 50%. This happened in a number of cases where profits were very low and the reported tax bill was utterly disproportionate to it as a result. This issue apart, the basis of calculation is similar in the current survey to that used in 'The Missing Billions'. Finally, data from Shell has been excluded for all calculations for 2007 – 2009 (as it also was, effectively, in 2000 – 2006) as it is not at all clear that the figure for tax that Shell declares only relates to taxes on profits: it seems likely that some oil based taxes are also declared in their taxation liabilities as declared on the face of their accounts. This makes the data they publish potentially unreliable as a basis for comparison.

The resulting data is as follows:

Current tax to pre goodwill profit %
Shell, losses and all tax rates over 50% eliminated

	2000 %	2001 %	2002 %	2003 %	2004 %	2005 %	2006 %	2007 %	2008 %	2009 %	Ave. %
Shell											
BG	28.4%	28.8%	32.8%	31.8%	37.0%		30.5%		37.8%	35.9%	32.9%
BHP Billiton	0.0%	41.6%	28.3%	29.7%	30.3%	27.1%	27.4%	27.3%	27.1%	47.8%	31.8%
BAT	41.9%	36.6%	33.0%	41.9%	25.2%	28.0%	24.8%	24.5%	25.0%	27.7%	30.9%
Sainsburys	31.3%	38.4%	30.9%	28.6%	27.9%	21.7%	28.8%		33.0%	30.4%	30.1%
SABMiller	24.4%	28.7%	31.1%	31.8%	33.2%	34.7%	30.5%	30.3%	28.7%	23.3%	29.6%
Glaxo SK	29.8%	30.6%	26.0%	31.6%	27.8%	29.2%	33.8%	31.2%	26.5%	28.4%	29.5%
Imperial Tobacco	26.6%	26.5%	33.0%	27.5%	26.8%	28.7%	26.5%	23.1%	39.4%	28.8%	28.7%
Morrisons	34.6%	33.1%		35.2%				31.0%	17.0%	20.6%	28.6%
Vodafone	39.9%			37.7%	30.0%	31.5%	31.8%	28.8%	19.1%	5.7%	28.1%
BP	28.2%	35.2%	24.0%	25.9%	30.0%	20.4%	26.0%	30.5%	38.2%	22.0%	28.0%
Wolseley	34.4%	33.3%	24.7%	25.9%	25.6%	20.5%	27.3%	22.7%	35.8%		27.8%
Standard Chartered	27.7%	27.6%	30.3%	29.6%	26.2%	24.4%	20.9%	30.1%	21.3%	38.0%	27.6%
Rio Tinto	28.0%	36.3%		27.3%	26.0%	23.4%	23.6%	23.0%		33.3%	27.6%
WPP	31.6%	30.9%	27.4%	30.6%	28.2%	29.5%	26.1%	22.9%	24.1%	23.5%	27.5%
Old Mutual	24.1%	26.6%	21.7%	29.4%	25.8%	18.2%	19.6%	26.1%	27.9%	42.3%	26.2%
Prudential	25.3%	8.3%	15.1%	39.1%	34.0%			33.1%			25.8%
Barclays	26.4%	25.9%	28.6%	21.5%	24.5%	34.9%	26.6%	32.6%	26.1%	9.3%	25.6%
AstraZeneca	28.0%	19.2%	23.6%	20.6%	21.8%	26.8%	30.5%	25.2%	32.4%	26.9%	25.5%
BAE Systems	35.6%	50.3%		22.1%	10.5%	16.0%	22.5%	18.8%	20.5%	24.5%	24.5%
Scot & Southern En	18.5%	19.9%	21.6%	22.5%	23.5%	35.6%	28.0%	23.2%	27.8%		24.5%
Unilever		28.3%	34.9%	23.0%	32.9%	21.4%	19.3%	16.5%	21.5%	21.9%	24.4%
Tesco	27.3%	26.6%	27.7%	25.5%	25.9%	21.8%	28.7%	19.2%	20.5%	19.2%	24.3%

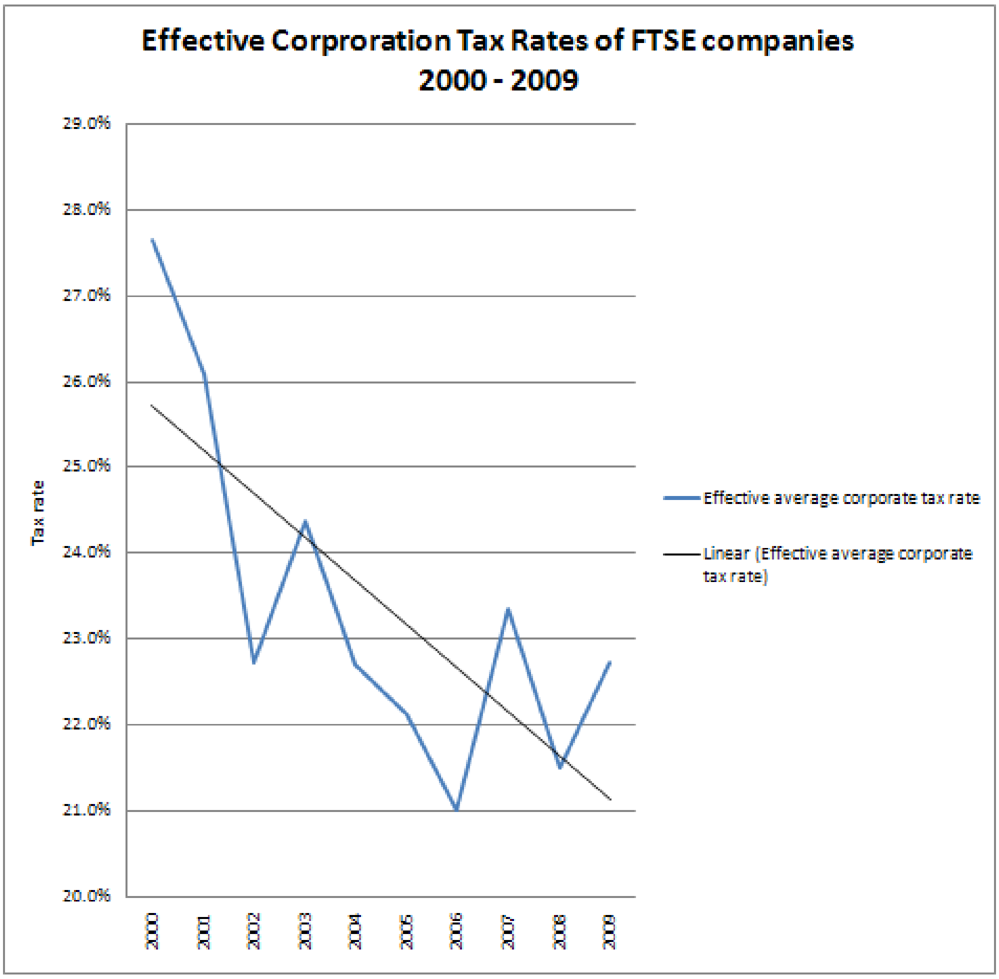
Reckitt Benckiser	28.9%	28.3%	20.8%	23.8%	21.6%	24.1%	22.4%	24.5%	22.6%	23.7%	24.1%
Anglo American	25.9%	24.4%	26.0%	19.6%	21.3%	25.1%	24.6%	20.7%	21.5%	26.8%	23.6%
Lloyds	25.7%	25.0%	32.6%	20.6%	24.3%	20.2%	18.1%	19.2%			23.2%
RBS	23.9%	26.0%	22.6%	19.5%	22.0%	23.8%	23.3%	21.9%			22.9%
HSBC	22.5%	22.7%	18.2%	22.1%	18.6%	21.7%	22.8%	20.8%	32.6%	26.1%	22.8%
Cadbury Schweppes	27.3%	22.5%	26.1%	25.0%	14.0%	21.4%	14.8%	30.7%		0.0%	22.7%
Marks & Spencer	38.5%		28.5%	29.3%	26.3%	13.9%	20.3%	18.9%	10.2%	16.6%	22.5%
Assoc British Food		24.7%	24.4%	23.8%	23.3%	24.2%	18.0%	17.2%	19.1%	26.2%	22.3%
Xstrata	0.0%	0.0%	14.8%	5.5%	19.1%	19.7%	35.2%	26.0%	32.8%		21.9%
BSkyB		0.0%		35.6%	19.9%	20.7%	16.6%	23.7%		35.0%	21.7%
Land Securities	22.8%	25.8%	25.1%	12.0%	23.0%	39.3%	24.3%	21.0%	0.8%		21.6%
Legal & General	35.8%			8.2%	24.1%	22.5%	15.5%	33.0%		8.0%	21.0%
Centrica	31.9%	20.9%	23.4%	31.8%	14.4%	16.1%		15.0%		11.5%	20.6%
HBOS	0.0%	23.9%	22.6%	25.1%	25.4%	20.2%	18.9%	23.7%	4.2%	0.0%	20.5%
Man Group		21.9%	21.1%	19.1%	20.1%	20.1%	18.3%	16.3%	9.2%	22.1%	18.7%
BT	29.7%	26.5%	10.0%	17.6%	18.6%	22.8%	15.2%		7.6%		18.5%
Shire Pharma	3.6%	24.8%	27.8%	32.9%		17.6%		15.4%	1.6%	24.1%	18.5%
Diageo	25.5%	21.2%	21.3%		18.6%	17.4%	12.1%	17.4%	16.9%	14.8%	18.3%
Compass	24.6%	16.0%	3.3%	13.4%	20.9%	17.7%	23.5%	18.0%	24.6%	21.2%	18.3%
Rolls Royce	41.5%	22.9%	24.0%	18.1%	22.0%	11.6%	4.4%	13.3%		3.2%	17.9%
Reed Elsevier	25.0%	29.4%	6.0%	12.8%	19.9%	22.1%	11.1%		12.4%	7.2%	16.2%
Aviva				23.7%	17.7%		12.1%			10.5%	16.0%
Reuters	19.1%			24.7%	7.8%	6.8%	0.5%	22.8%	0.0%	0.0%	13.6%
Hanson	20.5%		6.4%	19.2%	14.4%	6.0%	15.0%	0.0%	0.0%	0.0%	13.6%
National Grid	0.0%	0.0%		5.7%	12.1%	8.3%	23.5%		7.8%	8.5%	11.0%
ICI		7.4%	9.6%		19.8%	16.2%	1.1%	0.0%	0.0%	0.0%	10.8%
British Land	13.7%	22.0%	0.1%	17.4%	4.8%		0.4%	17.7%	0.0%		9.5%
Average	27.7%	26.1%	22.7%	24.4%	22.7%	22.1%	21.0%	23.3%	21.5%	22.7%	

Key:

Over 50%
Shell
Highest 3
Loss
No data

Section three

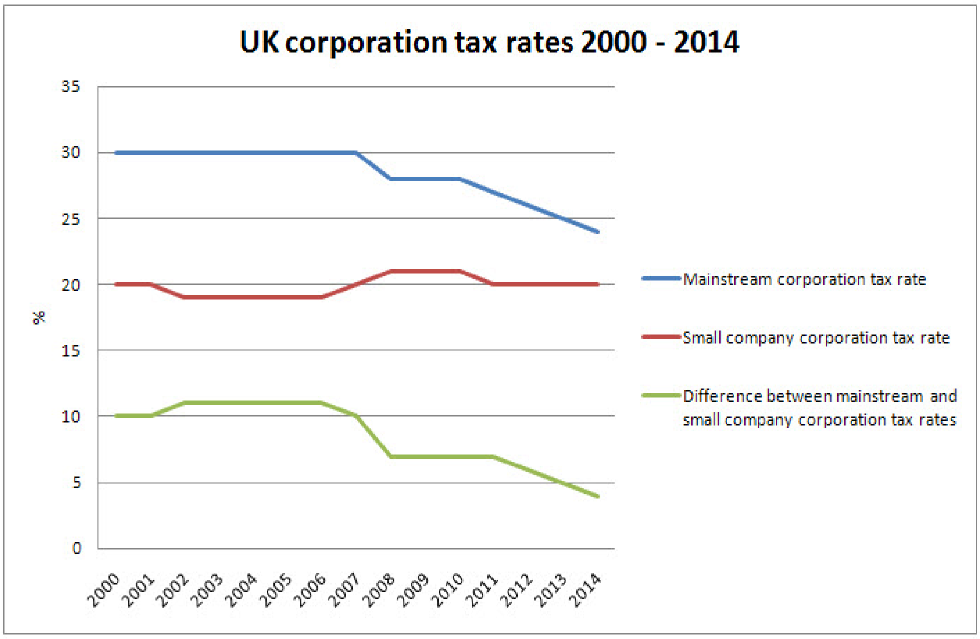
What the data shows?



This data shows an extraordinary trend in the corporate tax yield in the UK over a decade, as the graph above demonstrates.

The effective rate of corporation tax paid by the companies surveyed fell from just under 28% in 2000 when the headline rate was 30% to about 23% in 2009 when the headline rate was 28%. But, much more significant is the trend. Over a decade the trend has been for effective corporation tax rates of major corporations to fall by almost half a per cent a year with the trend rate in 2009 being just 21% - a figure 7% below the headline rate for that year.

It is, of course, always risky to extrapolate trends, and in the case of this data there is some evidence based on the above graph to suggest that current rates may be flattening – although this issue is returned to below. But even if this is true the trend shown reveals an alarming probability. This arises because of trends in UK corporation tax rates over recent years and those to come, which have been and are predicted to be as follows[12]:



The differential between the large and small company tax rates is closing rapidly. But whereas it is the commonplace experience small companies in the UK (and their accountants) that those smaller companies pay tax at rates in proportion to profit that are often higher than the nominal rate noted on the graph[13], above, as chart 1 shows large companies are seeing their effective rates of corporation tax fall steadily so that in 2009 on a trend basis they were some 7% less than the headline rate, a situation that replicated the 2006 finding.

Even if large companies' effective tax rates, using current tax rules were to stabilise at about 21% as Chart 1 suggests possible, which is a figure 7% less than the headline rate, the effective tax rate of those companies will still fall over the next four years as the headline rate of corporation tax for large companies (alone) is cut in the UK, from 28% to 24%[14]. On this basis the prospect exists that by 2014 large companies will be paying corporation tax at no more than 17% on average whilst small companies will be paying corporation tax at 20%, or more. This means that for the first time in UK corporation tax history small companies will be asked to pay tax on a regular basis at effective tax rates that are not just higher, but are significantly higher

[12] Note it is assumed that the small company tax rate will stay fixed until 2014: this cannot be guaranteed, but seems likely.
[13] This happens because of the high proportion of disallowable costs that small companies tend to suffer and their relatively low capital expenditure, on average.
[14] As announced by George Osborne in the Budget of June 2010

than those paid by large companies. What is more, those large companies will also be paying tax at effective rates lower than the marginal rate applied to the income of a majority of UK households. We will, in other words have a regressive UK corporation tax system.

This is important: small business in the UK plays a vital job in creating new employment, often at relatively low cost, and often as the precursor to economic recovery. And of course, most small businesses are run by self employed people paying income tax at the basic rate. We are not necessarily arguing that small business should have its tax rate cut: there are good reasons relating to tax avoidance why the rate of small company corporation tax in the UK should be pitched at least at the same level as the basic rate of income tax (or maybe higher) but we are pointing out that a fundamental inequality is being created in the UK economy which makes no sense at all. The tax system will be favouring large companies over small companies, and large companies over the self employed. It is hard to see how a more unequal and unfair playing field on which small business and its employees have to compete could have been created.

Section four

Bringing losses into account

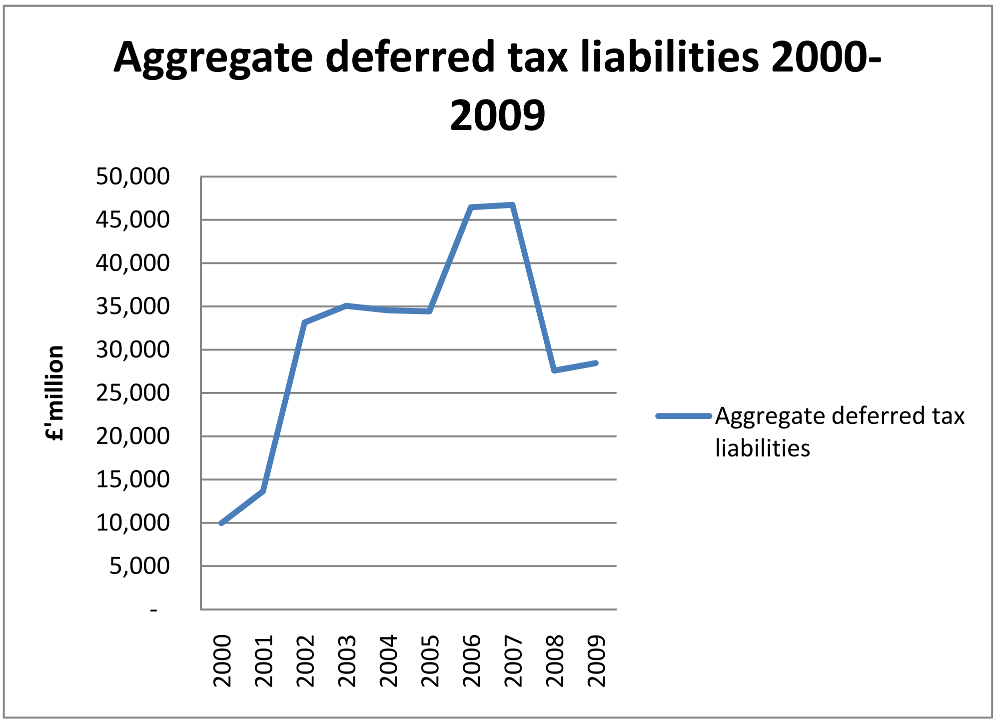
This extraordinary shift in the UK tax system so that we will now have a regressive corporation tax system is not however, the limit to what the data shows.

Most observers would expect that in practice the rates shown in Chart 1, above, might have fallen more than shown to reflect the difficulties faced by many major companies, and especially banks, in 2008 and 2009. As noted above, the impact of many of these difficulties and the resulting losses have been removed from the data because of the difficulty of objectively interpreting negative numbers when preparing data of this sort, but the impact of those losses can be assessed in another way. This can be done by looking at the impact of those losses on the deferred tax balances of companies surveyed.

Deferred tax is a complex issue – as noted already, above. Deferred tax might be defined as tax that might be payable at some time in the future as a consequence of transactions that have already occurred, but with there being no certainty as to when, if, or ever that tax might be paid. Since one of the objectives of tax avoidance is to defer payment of tax – for as long as possible – deferred tax balances are to some degree a clear indication of the success of companies in avoiding their tax obligations. They are also on occasion an indication of the value of losses they might have accumulated. Both statements need a little explanation.

Deferred taxes might arise for a wide range of reasons, some considered more or less acceptable by tax authorities, and certainly not all can be explained here, where examples must suffice. One example of the way they arise is when companies are offered higher rates of allowance for tax purposes on their capital expenditure than they claim as an equivalent cost in their accounts by way of depreciation. This has the consequence that in the year when the tax claims exceed the deduction for depreciation in the companies accounts, there is a lower taxable profit than accounting profit, and less tax is paid as a result – as most companies would wish. However, if the company were to ever stop net spending on investment (say, because of a recession which created business uncertainty about the value of investing) then it would be possible for taxable profits to then be higher than accounting profits and more tax would then be due than the accounts might superficially indicate. This equation is smoothed by deferred tax accounting – although it is stressed, this is an accounting methodology – it is not about tax payment at all.

From 2000 to 2007 the deferred tax balances of the companies surveyed rose, as this chart shows:



The situation changed in 2008. Total deferred tax liabilities in 2007 of £46.7 billion (up from less than £10 billion in 2000) suddenly went into dramatic reverse. In 2008 net deferred tax balances[15] fell to £27.6 billion – a decline of more than £19 billion in a year.

There is only one plausible explanation for this decline in deferred tax balances. That is that it was caused by tax losses carried forward for offset against deferred tax liabilities expected to arise in the future. This needs explanation. This phenomenon is the consequence of a particular feature of UK tax laws, also replicated in the laws of some other countries, where a loss is only allowed for tax purposes when it has actually occurred. So, for example, if someone refused to pay a loan to a UK based bank then that is a real loss for the bank and it can have tax relief on the loss and so pay less tax as a result of it. But if the bank just thinks the borrower may default at some time in the future, or more likely, that across its whole loan book it is highly likely that some people will default but it has no idea who will, then it creates what is called a 'provision'. This is prudent accounting – and it took place to very large degrees in 2008 and to a lesser degree in 2009. Most of the losses banks suffered in that period were the result of the creation of such provisions; they were not the result of actual losses. This however had two consequences.

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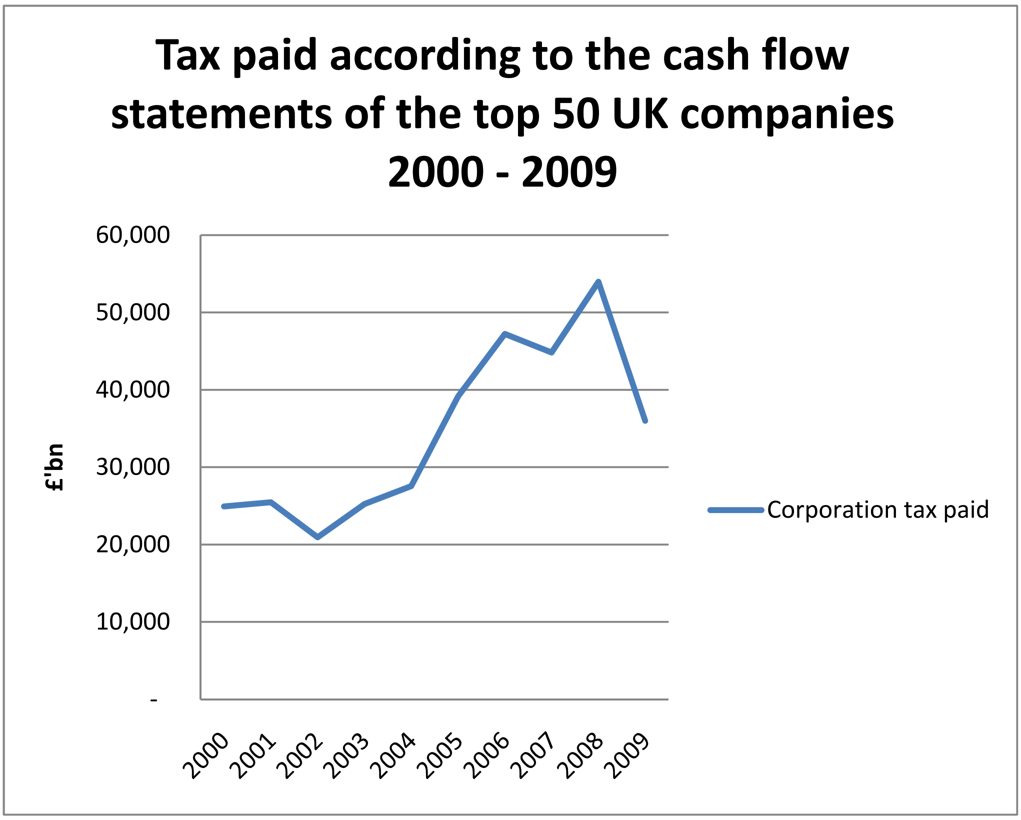
[15] Data here takes into account both deferred tax assets and liabilities.

Actual corporation tax paid did not collapse as much as might have been expected, as this graph shows:



The lag between losses occurring and tax being paid is explained first by the fact that overall corporation tax is paid approximately a year after profits are earned and because losses recorded for accounting purposes could not be offset against current tax bills and were instead set off against deferred tax balances. Because those deferred tax balances did not recover in 2009 (as Chart 3 shows) it is highly likely the losses have not been utilised as yet. However, as the UK allows losses to be carried forward indefinitely (a fact that has not escaped the attention of some tax planners who seem to have been, quite perversely arranging to shift losses into the UK as a consequence, to make sure maximum value can be made from them) there is little doubt that many of these losses will eventually flow through into lost UK tax revenue at some time in the future. The conclusion is clear: the chance that these largest companies in the UK will be making as large a contribution to the UK Exchequer as they have done in the past will for some foreseeable time be unlikely.

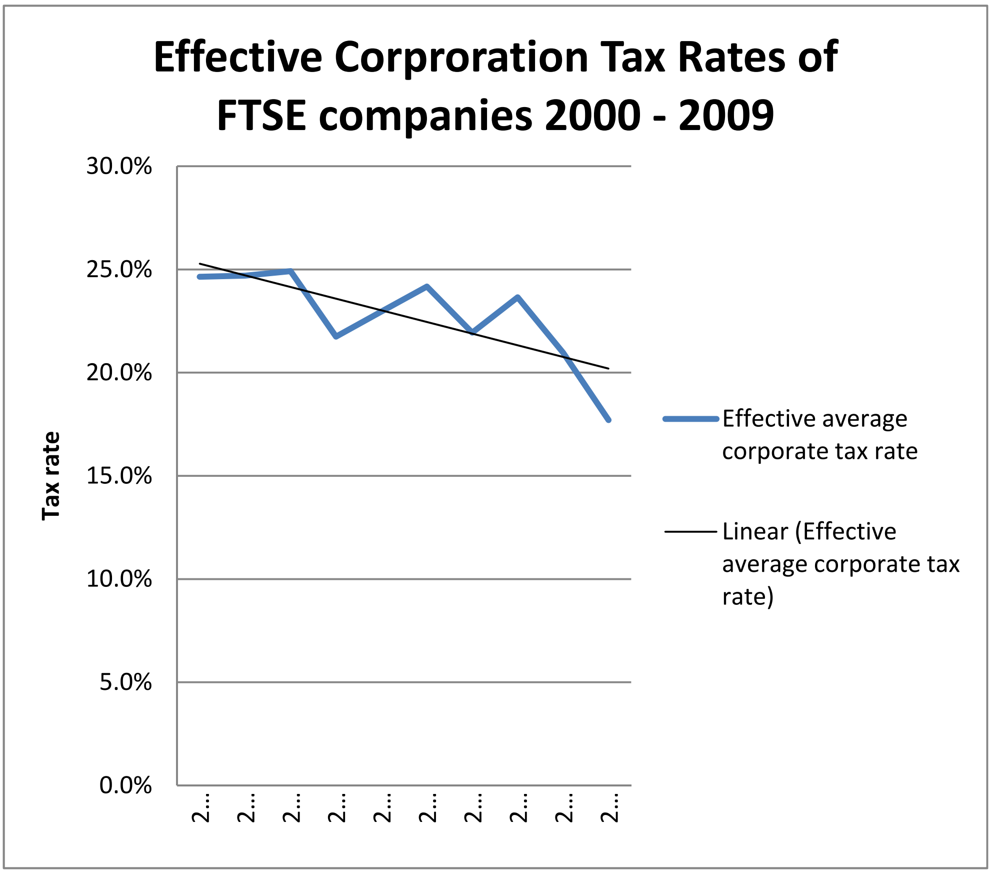
And what is most perverse is that some of the losses in question belong to banks that have already directly or indirectly been bailed out by the UK Treasury. This alone seems to justify some attention being addressed to our High Street banks that required so much support to get through the current financial crisis.

Section five

Looking at the banks

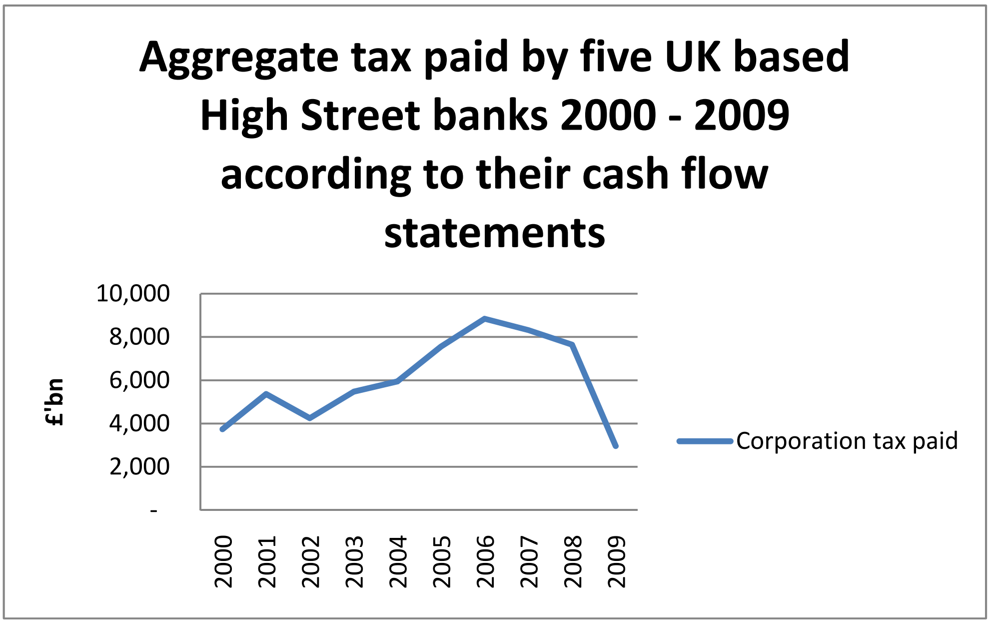
Six banks are covered by the survey data. One, Standard Chartered, has very few operations in the United Kingdom and was largely unaffected by the banking crisis, and did not require UK government guarantee or support as a result of the banking problems of 2007 onwards. Accordingly it has not been included in the data considered here which, as a consequence, relates to HSBC, Barclays, Royal Bank of Scotland, Lloyds TSB and HBOS and with regard to the last two, subsequently the Lloyds Banking Group.

If the effective tax rates of these banks, in aggregate, are plotted then the following graph results:

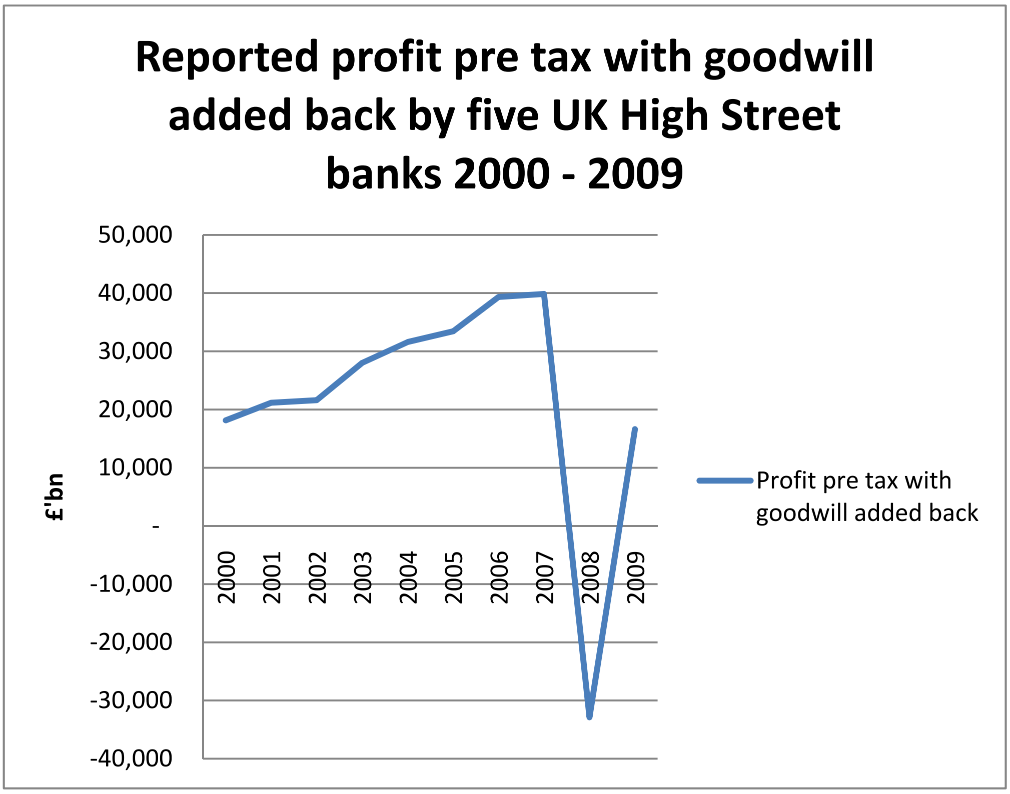


Whilst the sample sizes are much smaller (five in most years, but only two in 2009 due to HBOS becoming part of Lloyds in 2008 and both Lloyds and RBS making losses) the trend remains clear, and downward, as for the sample as a whole. By 2009 average tax rate for these banks was below 20%.

Trends in total tax paid by the sample are also notable:

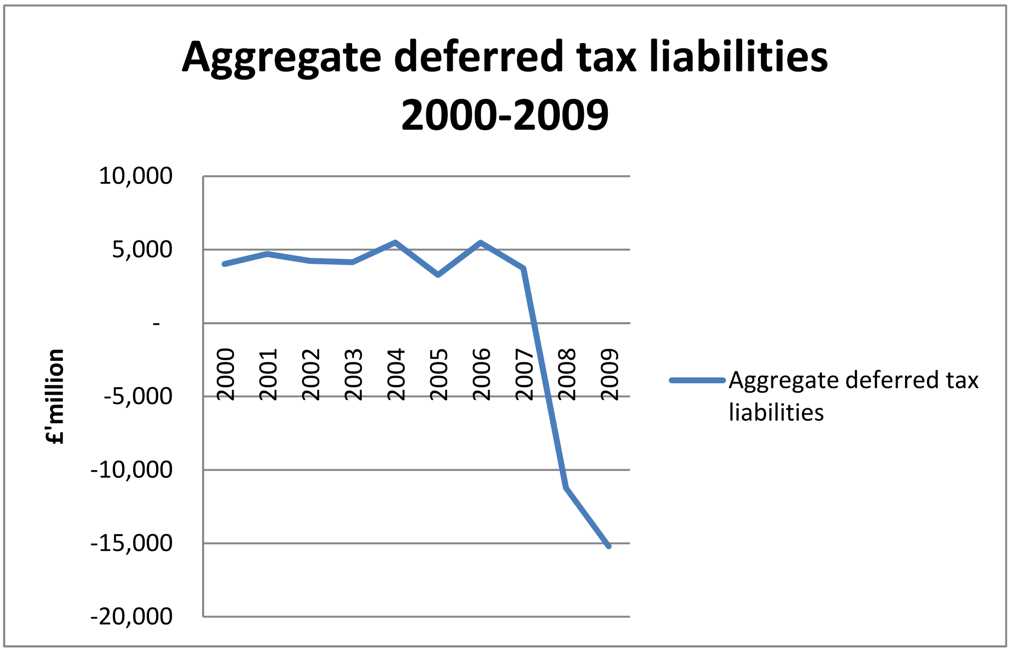


It should be noted that in this case all banks paid tax in all years bar HBOS in 2000 and 2009 (it did not exist in the first year and it had ceased to exist by 2009). The downward trend in absolute payments predated the crash by some way: other factors clearly paid a part in that case as profits did not reveal the same trend:



A marked disparity is readily apparent, especially in 2006 and 2007 when tax payments were falling but profits rising suggesting either tax avoidance behaviour or that profits being recorded as a consequence of the adoption of International Financial Reporting Standards in 2005 were not 'real' in the sense of giving rise to taxable cash flow – despite which the banks (and bankers' pay) boomed on the back of them.

The most notable feature of the bank's reporting is, however, the movement in their deferred tax reserves. In aggregate for all the banks in question (HBOS again being the exception in 2000 and 2009) these balances were as follows:



From dominating the overall deferred tax balances of the whole sample in 2000 these banks saw remarkably little increase in their deferred tax liabilities in subsequent years (in itself a matter for further investigation, and not considered here) before their situation suddenly changed in 2008 to being in a position of having substantial deferred tax assets. In total, £14.9 billion of the £19.1 billion increase in the total aggregate decline in deferred tax liability balances between 2007 and 2008 was caused by these banks alone. Their deferred tax assets increased again in 2009, the total movement between 2007 and 2009 by then having reached the sum of £18.9 billion. The overall decline in deferred tax balances of the whole sample over this period was £18.3 billion.

As noted previously, the causes for deferred taxation balances are numerous, and not all deferred tax assets relate to tax losses (some can, for example, relate to pension payment provisions for which tax relief has yet to be given). However, the exceptional move in these banks' deferred tax balances between

2007 and 2009 cannot have been caused, overall, by anything but the expected future benefit they believed might arise from the accounting losses they had suffered, and which had yet to be recognised for tax purposes although they had been included in their accounts.

If some £19 billion in tax might not be paid as a result at some time in the future, there is an extraordinary double subsidy going on for these banks. Not only were their losses underwritten by the state in 2008 (and in most cases they still are receiving some form of state support, if only by way of asset guarantees), but they will now receive a second round of subsidy when over years to come they will offset those state subsidised losses against the profits they might now make only because they have been saved for the benefit of their shareholders by the UK government.

Of course, not all the tax offset will be in the UK. These are multinational banks and not all their losses will arise in the UK. But there is some evidence that banks have been transferring losses into the UK precisely because of the generous way in which UK tax relief works.

In this case the question must, and should arise, about the alternative tax contribution banks can and should make if their corporation tax payments will be substantially lower than might reasonably be expected in years to come. This is especially true as it seems likely that no other corporate sector enjoys anything like the tax benefit that banks now do as a result of losses that this bailed out sector seems to benefit from.

The options available are that the banks in question might continue to pay bank bonus taxes, or pay a financial transactions tax, or have their right to carry tax losses forward limited so that they expire after a limited period if not utilised by that date, or a combination of all these factors, and maybe others.

What is clear is that the proposed bank levy now being considered will make little difference to the overall contribution these banks will make to the cost of remedying the current crisis, not least if their tax payments in the UK are reduced to anything like the extent their deferred tax assets might suggest likely.

As a result, action is now needed to ensure that banks contribute through their tax payments to government to the extent most in the UK would expect so that as cuts begin to impact on the UK economy as a whole they are seen to be bearing their fair share of the burden for the consequences of their past profligacy and recklessness. Without such action this will not happen, and that is unacceptable.

Section six

The tax gap

The 'Missing Billions' estimated a corporate tax gap, which amounted to some £12 billion a year of tax that it was likely the UK corporate sector did not pay as a result of some form of tax avoidance each year.

HM Revenue & Customs have since published different estimates, their total current estimate for the corporate tax gap amounting to £6.9 billion a year[16].

The basis of the estimate offered in the 'Missing Billions' was an extrapolation of the data for the sample population, taking into account data from the Large Business Service of HM Revenue & Customs, then recently published, and the total UK corporate tax yield. There are at present real problems in replicating that methodology. First, the Large Business Service has not published new data since that time, and therefore the basis for extrapolation may be out of date. Second, companies have also significantly changed the way they publish their own accounting data. This last point is important.

In 2000, half the sample of companies surveyed published information in their published accounts on their results arising in the UK. Usually this separate geographical information related to turnover, staff numbers, profit, tax and also to gross and net assets employed, although there was some variation from company to company. Then in 2005 companies ceased to publish accounts in accordance with UK Generally Accepted Accounting Principles and instead published them in accordance with International Financial Reporting Standards (IFRS), issued by the International Accounting Standards Board with the backing of the European Union. Under IFRS rules, data on what are called 'business segments' could be reported on the basis of the major business activities of the reporting company rather than on the basis of geographical location. The result is that many of the surveyed companies ceased providing any data on their UK based activities at all, so that by the end of the survey period just eleven were doing so. Wolseley plc was the only one to take up such reporting over the period surveyed. Some very notable companies, such as Barclays, Lloyds TSB (now Lloyds Banking Group, BP, BT, Glaxo Smith Kline, Centrica and Legal and General were amongst those giving up the practice. The result is that the sample base for extrapolation from the results of the survey group to the likely UK loss is now potentially too small to use, and the exercise has therefore not been repeated at this time.

That does not mean the tax gap has necessarily reduced: far from it. Since undertaking the original work it has become clear that many companies

[16] http://www.hmrc.gov.uk/stats/measuring-tax-gaps-2010.htm.pdf

surveyed, and many others (by no means all resident in the UK) are undertaking significant tax avoidance activities, either creating transactions for this purpose – of which some banks have been accused – or moving the recording of their sales activities outside the UK altogether to avoid UK taxation; the latter being the seemingly commonplace practice of many IT companies, for example. These activities may well have not been picked up by the methodology used in the 'Missing Billions'. This, and the fact that there is some evidence that the HM Revenue & Customs' estimates for the tax gap tend to significantly underestimate their true extent suggests there is no basis to change the estimate for tax avoidance offered in the 'Missing Billions' at this time.

There is, however, an important note to add. The fact that major corporations are not now reporting their activities (whether it is their sales, number of staff employed, profits or tax paid) in the UK is a cause for considerable concern. It seems that the major companies quoted in the UK no longer think they have any geographical association with this country, or indeed, any other. They do instead report as if they float above the reality of the geographical space in which the rest of us exist as if they belong to some other global space of which only they are a part and which leaves them without attachment to anywhere. This however, is a denial of corporate responsibility, which we believe to be based on the duty of the company to the state which first grants its limited liability charter and secondly (if different) in which its activities are hosted. This responsibility to that place or those places (for their can be more than one, and in a complex multinational corporation we are aware there may be up to 150, or more)is, we think, at least in part fulfilled by paying the tax that each state asks of the company with regard to its activities in that place. This is part of the culture of tax compliance which we believe is indicative of true corporate responsibility. Tax compliance is seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

A company may, of course, suggest it is tax compliant, but the right to limited liability also carries with it a responsibility to report how that privilege (for that is what it is) is used, and in that case we view this decline in the reporting of the national activities of multinational corporations as a serious retrograde step in their accountability. The difficulty it gives in estimating the UK tax gap is simply indicative of the problems this causes, and is in turn representative of the lack of accountability that has been created for multinational corporations during the period when the creation of regulation covering such issues has largely been under the control of the accounting profession.

It is for this reason that the TUC called in 'The Missing Billions' for greater accountability for multinational corporations including a requirement that they account for where they are located and where they pay their tax. This demand is incorporated in the call now made by many in civil society for what is popularly called 'country-by-country reporting' by multinational corporations[17].

Country by country reporting would require disclosure of the following information by each multinational corporation in its annual financial statements:

1. The name of each country in which it operates;
2. The names of all its companies trading in each country in which it operates;
3. What its financial performance is in every country in which it operates, without exception, including:
    a. It sales, both third party and with other group companies;
    b. Purchases, split between third parties and intra-group transactions;
    c. Labour costs and employee numbers;
    d. Financing costs split between those paid to third parties and to other group members;
    e. Its pre-tax profit;
4. The tax charge included in its accounts for the country in question split as noted in more detail below;
5. Details of the cost and net book value of its physical fixed assets located in each country;
6. Details of its gross and net assets in total for each country in which operates.

If this information had been available for each of the companies in the FTSE surveyed as part of this review calculation of the UK tax gap would have been an easy undertaking. It is for this reason, amongst others, that the accountability that country-by-country reporting cerates is important. Unless companies can be held to account for the tax they pay, an essential component of their accountability is lost, and reform to ensure this is possible, is vital if we are to guarantee that all companies make their fair contribution to the UK economy over the years to come.

[17] http://www.financialtaskforce.org/2009/06/17/country-by-country-reporting-holding-multinational-corporations-to-account-wherever-they-are/

About the author

This paper is written for the TUC by Richard Murphy.

Richard Murphy is a chartered accountant and graduate economist. He was senior partner of a London firm of accountants for more than ten years. He has also been a serial entrepreneur.

Since 2000 Richard has worked mainly on taxation policy. He is director Tax Research LLP and advises the Tax Justice Network (of which he was a founder), the UK Trade Union Congress and many other organisations on tax policy issues. He has been a consultant to the World Bank and a visiting fellow in tax and political economy at a number of UK universities.

According to the Accountancy Age Financial Power List for 2009 Richard is the 25th most influential person in UK finance.

Richard writes a daily blog at www.taxresearch.org.uk/blog.

He is co-author of 'Tax Havens: How Globalization Really Works' published by Cornell University press in January 2010.

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