CORPORATE TAXATION

REUTERS/LUKE MACGREGOR

Profits are up but big firms in Britain pay less income tax than a decade ago. Is the tax department's approach too easy?

How the UK tax authority got cosy with big business

BY TOM BERGIN
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For Ian Barlow, Britain's tax authority has gone from being fearsome to being really rather nice.

In the 1990s, when the accountant was head of UK taxation for KPMG, he argued Her Majesty's Revenue and Customs (HMRC) was creating an "increasingly fierce environment" for corporations. But last month, Barlow, 61, said senior American business executives found the UK taxman's approach "refreshing."

"It is a tax authority that is much easier to deal with than their own tax authority, and I think that's no bad thing," he said over a banquet of salmon mousse and rib of beef at the Institute of Chartered Accountants in England and Wales.

Since July, Barlow has been head of the board that develops the UK tax authority's strategy. But his change of view reflects more than just his new job. It's a sign of a huge shift in the UK tax authority's approach to tax collection over the past decade.

In 2001, Labour finance minister Gordon Brown directed the tax collector to take a new approach which would come to be known in the financial world as an "enhanced relationship." The aim was to lighten the regulatory burden on business. The authority now says it aims to work closely with big businesses in an atmosphere of "mutual trust."

The government has found the approach to be "the most cost-effective way to increase revenue flows," an HMRC spokesman said in an email.

However, a Reuters analysis found that large corporations in the UK now pay less corporate income tax than a decade ago even though profits have risen sharply. According to one measure compiled by the Office for National Statistics, overall annual corporate profit has risen 65 percent since 2000, to 329 billion pounds ($532 billion) last year. In the same span, the amount of corporation tax paid by large companies fell, to 21 billion pounds, down 21 percent or 5 billion pounds since 2000/01.

TOUGH TALK: Gordon Brown, here addressing the Labour Party Conference in 2000, promised to clamp down on corporate tax avoidance but was finance minister during a period when HMRC moved to a more relaxed stance. **REUTERS/DAN CHUNG**

Barlow declined to comment, but the tax authority attributed the fall partly to declining revenues from the finance industry, as well as lower official rates of tax. The UK's official corporation tax rate was steady at 30 percent between 2000 and 2007 but has been gradually cut, and in the last tax year was 26 percent.

Tax campaigners argue the discrepancy shows big business and Britain's tax inspectors have grown too close, and that

$21 billion

Corporation tax paid by big business In UK in 2011, down 21 percent since 2001

Source: HMRC data

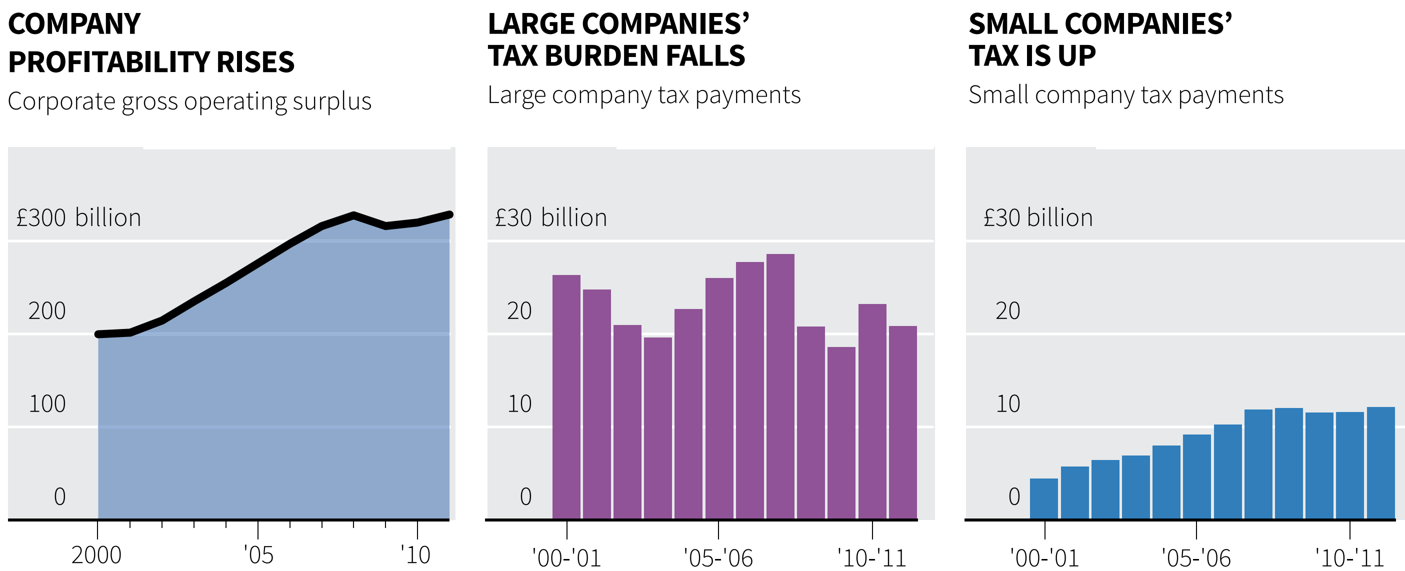
tax avoidance is on the rise. Swollen deficits and cuts in government spending make tactics like those used by multinationals such as Google, Amazon and Starbucks increasingly sensitive.

"What we're seeing is a scaling up overall, over the last 10 years, of tax avoidance," said John Christensen of the Tax Justice Network, which campaigns on tax issues. "It has become a much bigger issue. Successive (UK) governments have been sending out strong signals that they were going to be fairly lenient in their attitude towards this."

Internal HMRC staff guidelines shown to Reuters, as well as interviews with more than 12 current and former tax officials, suggest HMRC puts more emphasis on keeping big companies satisfied than on raising revenues.

"The remit now is to make the taxpayer happy," says one current HMRC official.

Britain's tax take



Sources: HMRC, Office for National Statistics

"If you go into HMRC to collect tax, you won't get very far."

The tax authority and the finance ministry said there is no reason to believe the revenue drop is due to tax avoidance by large corporations.

"We have been very successful in reducing tax avoidance by large businesses in recent years," an HMRC spokesman said by email. "We relentlessly challenge those that persist in avoiding tax and have recovered 29 billion pounds additional revenues from large businesses in the last six years."

GENTLEMAN'S CLUB

This is not the first time Britain has worried about how much tax big firms are paying.

In the recession of the early 1990s, former tax collectors said, UK officials were slow to understand how multinationals could shift income out of the UK into low-tax jurisdictions. Andrew McKenna, a former tax inspector who is now partner at accounting firm Smith & Williamson, said that until about 1994 the relationship between the tax authority and big businesses was "a gentleman's club. Then it toughened up from then on."

In 1994, the Conservative government set up an office to target big firms and boosted its funding and powers. Labour's Brown, who was in opposition, was also critical of big business's use of tax loopholes. When he took over as finance minister in 1997, he gave the tax authority even more powers of investigation and said he would introduce a General Anti Avoidance Rule (GAAR) - a broad set of principles aimed at blocking avoidance.

Brown appointed Chris Wales, a long-time Labour Party member and a former partner at accountants Arthur Andersen, as his policy adviser on taxation. "There was clearly a sense that the Inland Revenue were quite tough people to deal with," said Wales.

That attitude began to turn in 1999, when Brown abandoned his planned GAAR. The following year, the tax authority brought tax officials and representatives of big business together in a new consultative body which aimed to provide "a direct channel between some of the UK's key taxpayers and the office."

Brown declined to comment. He has argued that the correct approach to regulation, including taxes, is based on trust, and "no inspection without justification, no form filling without justification, and no information requirements without justification."

In 2001, he ordered the tax authority, then known as the Inland Revenue, to conduct a review of its links with business. This recommended "bringing business and the Revenue closer together." The shift was agreed by a broad group, Wales said.

At the time, more and more global enterprises were reorganising their businesses to base different activities in places which taxed them least. This fuelled competition between countries after investment.

In the UK, firms began demanding a more understanding hearing from the tax collector, which led to the creation of "customer relationship managers" to be a single point of contact on all tax matters. HMRC's website says the model is based on "mutual trust, transparency and resolving issues in real time." The customer relationship manager deals with the company, and tax inspectors work behind them.

A 2007 HMRC review of links with business recommended an even closer working relationship and in 2010, a new Conservative-led government also backed the co-operative model.

Since then, the authority has come under increasing pressure for doing "sweetheart" deals with multinationals. Mobile phone operator Vodafone and investment bank Goldman Sachs cut deals on disputed tax bills which parliament's Public Accounts Committee (PAC) said in December 2011 showed the tax authority was "too cosy" with big companies.

The National Audit Office, which scrutinises public spending for parliament, ruled in June that the deals had been reasonable. But it criticised the tax authority for not always involving its own lawyers when it agreed to settle them. The parliamentary committee said in a report this month that the tax authority was "way too lenient" with big multinational businesses operating in the UK.

David Gauke, the minister responsible for taxation, continues to champion the "enhanced relationship" approach. He has created more bodies through which businesses help guide government tax policy, including one named the "Business Forum on Tax and Competitiveness." In September, he addressed a Washington event for business leaders titled "UK tax reform: A road map for the U.S.?" at the conservative American Enterprise Institute think-tank.

"This strategy has been very successful, producing positive feedback from business, while also helping HMRC to maximise revenues by recovering the right amount of tax," he told them. Gauke declined to be interviewed.

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> **Chris Wales**
> Tax adviser to Gordon Brown

SHRINKING TAX TAKE

HMRC data shows that in the 2011/12 tax year, big companies - which the UK tax authority defines as those with annual profits of 1.5 million pounds or more – paid five billion pounds less corporation tax than they did in 2000/01.

In that period the economy grew by 55 percent and overall corporate profitability rose by 65 percent. Tax revenue from other sources was up: receipts of both personal income tax and small companies' income tax rose, according to HMRC data.

So what explains the lower tax take from big companies?

Prem Sikka, Professor of Accounting at Essex University, has written extensively about corporate tax avoidance and said it was hard to see how profitability and tax could diverge so sharply.

"How are they managing to reconcile higher profits with lower taxes?" he said. "It can't be done ... unless (firms) are booking these profits somewhere else."

Asked to explain the fall in tax revenues from big companies, HMRC pointed to a drop in the corporate tax rate and lower tax revenues from financial institutions following the financial crisis.

But that only explains some of the change. The government did lower the corporation tax rate, but this was offset by reining in other tax breaks. In all, the lower tax rate cost the government around 930 million pounds, according to Reuters calculations using data provided by the Office for Budget responsibility, the UK's independent budget watchdog.

And while the banking sector was hit hard by the financial crisis, tax payments from banks in 2011/12 were just 1.9 billion pounds lower than 11 years earlier, according to HMRC data.

That means that the lower tax rate and fall in revenue from financial companies account for around 2.8 million pounds of the 5 billion pounds drop in the big business tax take. Sikka, the tax expert, agreed Reuters' calculations were appropriate.

"HMRC's answers may explain part of the drop but there's still a big gap," he said.

"They also don't account for the fact ...

HEAD OFFICE: HMRC says it is collecting less corporate income tax because tax rates have been cut and because the financial industry was hit by crisis. **REUTERS/SUZANNE PLUNKETT**

FACE OFF: A demonstrator outside a London Starbucks coffee shop this month. Some British consumers have boycotted the coffee chain over its low UK corporate tax payments. Starbucks has said it will voluntarily pay 10 million pounds extra a year. **REUTERS/LUKE MACGREGOR**

corporate profits have risen, so you would have expected corporation tax payments to rise."

When shown the calculations, an HMRC spokesman said the 2000/01 figures may have been artificially boosted by "elements of double counting" due to a change in the way taxes were paid, but declined to quantify the impact of this. The finance ministry declined to comment on the calculations.

MIND THE TAX GAP

It's not easy to decide exactly how much tax should be collected. As the National Audit Office said in June, there is "no clear answer as to what represents the right tax liability." Neither is there an agreed measure to compare the performance of national tax collectors.

The UK tax authority's preferred measure of its performance is the 'tax gap' - the difference between the amount it collects and what it says should have been paid. It says the gap for large businesses has fallen sharply in the past decade and, though still significant, now accounts for 2.6 billion pounds in total for large businesses.

> "There was a theory that if you treated larger companies better, that they would respond in kind
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> **Ray McCann**
> former HMRC inspector of large businesses.

It also says its tax gap is smaller than others', including the IRS. But since experts say different methods are used to measure them, such comparisons are difficult to make.

A widely cited 2008 report by the association of UK trades unions looked at Britain's 700-800 biggest companies and put Britain's tax gap for them at a much higher 12 billion pounds.

The difference is partly explained by the fact HMRC's figures ignore vast amounts of profit shifting through places like Switzerland and Bermuda. That kind of arrangement has allowed Google, for example, to pay income taxes of just over three percent on $7.6 billion of overseas earnings in 2011. Google's CEO Eric Schmidt has defended the practice, saying "it's called capitalism."

Managers at the UK tax authority say international agreements around transfer pricing – the internal charges that multinationals make for goods and services - can make it difficult to push back against the use of these charges to shift profits to low-tax countries.

Yet other countries' tax authorities have done just that.In the past months, French tax inspectors have launched raids on the offices of Google and eBay, the Germans have raided Deutsche Bank and Unicredit's German unit HVB, and the Italians have swooped on Facebook.

Google, Facebook and eBay said they comply with tax laws in every country where they operate. Deutsche and HVB said they were cooperating with the authorities.

HMRC declined to say when it last raided a big company as part of an inquiry into corporation tax - UK tax advisers said they could not remember it happening.

In recent months France asked Google for 1.7 billion euros in back tax, a source close to the company said. In October Amazon, which channels its European profits into an untaxed Luxembourg vehicle, said the French tax authority had sent it a bill for $252 million.

The IRS in 2006 achieved a record transfer pricing settlement of $3.4 billion from GlaxoSmithKline. It had challenged how much profit had been assigned to the company's U.S. marketing operation while its drug patents resided outside the United States.

HMRC has taken three transfer-pricing cases to court, according to law firm Field Fisher Waterhouse. Asked to give evidence of its success in tackling abuses, HMRC said its inquiries into transfer pricing had yielded 4.1 billion pounds over the last four years.

"There was a theory that if you treated larger companies better, that they would

SAVINGS: Critics of HMRC says it has been softer on corporations than tax authorities in other countries. **REUTERS/DARRIN ZAMMIT LUPI**

respond in kind and therefore the Revenue's job would be easier," said Ray McCann, a former HMRC inspector of large businesses. "Many have disagreed."

Some current HMRC staff say the UK authority simply underestimates how important it is for big business to try to minimise the taxes it pays. A current 6-page internal staff guide on taxing large corporations seen by Reuters states that large companies are unlikely to conceal earnings to evade taxes.

"It is not in their interests to suppress profits because of the impact on share price," says the note.

Kimberly Clausing, Professor of Economics and an expert on corporate tax avoidance, dismisses this. "There are huge incentives to suppress the income reported for tax purposes in all the higher tax countries and to have it reported instead in places with lower or no tax," she said.

Starbucks showed big losses in the UK for years while telling investors its UK unit was "profitable," as reported by Reuters in October. It managed that in part because the UK unit made payments to a Dutch one for which the company had secured a very low tax rate.

After its low tax payments were exposed, the company promised to pay extra tax of 10 million pounds a year for two years – more than needed by law. HMRC declined to comment. Starbucks said it had always complied with UK tax law and the decision was part of "a process of enhancing trust with customers."

The HMRC guidance says tax avoidance by large companies is responsible for the tax gap, but notes this is usually due to "disputes over how the law applies to specific and complex transactions."

The main trade union representing HMRC inspectors has defended its members against charges they lack the qualifications to take on companies' well-paid tax advisers, so tackle easy targets such as small businesses and individuals instead. It highlights a lack of resources: HMRC's workforce has been cut to 67,000 from 99,000 in 2005.

HMRC staff are among the best paid civil servants in Britain, yet staff surveys show they are the least engaged with their work of any in British public service. This year's survey showed only one in five staff at the tax authority felt their employer motivated them to achieve their objectives, and just a quarter felt positive about the leadership.

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