

The Tax Gap



How to calculate the tax not paid by
multinational corporations



Publishing Information

Written by Richard Murphy FCA

Published by Tax Research LLP
The Old Orchard
Bexwell Road
Downham Market
Norfolk
PE38 9LJ

+44 (0) 1366 383500

www.taxresearch.org.uk/blog

© Tax Research LLP 2008.

Written for use by Action Aid UK.

The supply of this document and associated spreadsheets does not imply that a transfer of the ownership of the intellectual property to the Tax Gap methodology developed by Tax Research LLP to Action Aid has taken place: it does instead recognise the grant of a perpetual licence to use that methodology by Tax Research LLP to Action Aid.

Important note

It is important to note that the Tax Gap methodology does not suggest that any company to which it refers, or any officer of any such company or any auditor to those companies has in any way acted illegally.

It is always assumed that if a company is referred to directly or indirectly in any report produced using this methodology that the tax gap referred to arose because of the use of legal methods of tax avoidance.

1. Purpose of this manual

This manual explains the methodology used by Tax Research LLP when calculating the ‘expectation gap’ with regard to tax paid by multinational corporations (MNCs). This methodology was used to produce ‘Mind the Tax Gap’ (Tax Justice Network, 2006)¹ and the corporate data in ‘The Missing Billions’ (TUC, London, 2008)².

2. What is the Tax Gap?

In ‘Mind the Tax Gap’ a wide range of tax gaps were identified. It is important that it be understood that there is not one such gap, but a whole range.

First of all it is important to appreciate what tax authorities and accountants think the tax gap is. The US Internal Revenue Service define the Tax Gap as:

*“the difference between what taxpayers should pay and what they actually pay on a timely basis”*³

By their reckoning, the US Tax Gap is about US\$330 billion a year.⁴ Another definition, provided by an accountant, is:

*“the difference between what ought to be paid by taxpayers given a certain level of economic activity versus what is collected”*⁵

The UK’s HM Revenue & Customs (HMRC) has a slightly more complicated definition:

“the tax gap measures the amount of tax we ultimately fail to collect, or, alternatively the amount of uncorrected non-compliance”.⁶

This means that HM Revenue & Customs believe that the tax that ought to be paid can be split into two parts:

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

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

¹ http://www.taxjustice.net/cms/upload/pdf/Mind_the_Tax_Gap_-_final_-_15_Jan_2006.pdf

² <http://www.tuc.org.uk/publications/viewPub.cfm?frmPubID=535>

³ US Internal Revenue Service Press Release IR-2005-38, March 29, 2005

⁴ ibid

⁵ Loughlin Hickey, Global Managing Partner for Tax, KPMG, speaking at the Institute of Chartered Accountants in England and Wales, 17 November 2005

⁶ http://www.hmrc.gov.uk/lbo/lc_forum_taxgap.htm

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

It is clear that the Tax Gap is not a simple subject. To really understand the Tax Gap we need to understand what its components are, what motivates it, and what its consequences are. That means it must be recognised that the Tax Gap is a broad economic problem consists of many component gaps. Those that were identified in 'Mind the Tax Gap' were:

Absolute Gaps

a. The Revenue Gap

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

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

b. The Proportionate Gap

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

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

c. The Poverty Gap

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

This is a measure of social justice within a society.

Corporate Gaps

d. The Reporting Gap

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

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

e. The Expectation Gap

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

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

Taxpayer Gaps

f. The Responsibility Gap

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

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

g. The Trust Gap

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

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

Government Gaps

h. The Transparency Gap

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

This Gap measures the accountability of governments.

i. The Corruption Gap

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

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

j. The Efficiency Gap

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

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

International Gaps

k. The Competitive Gap

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

This is a measure of tax competition.

l. The Resource Gap

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

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

m. The Multinational Gap

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

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

n. The Haven Gap

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

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

o. The Mobility Gap

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

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

The National Gaps

p. The Corporate Gap

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

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

q. The Large / Small Gap

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

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

r. The Social Security Gap

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

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

s. The Administration Gap

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

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

t. **The Direct / Indirect Gap**

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

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

3. What this means

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

- a. social justice;
- b. corporate responsibility;
- c. government accountability, and
- d. the stability of the income of the world's nation states.

These are issues of much wider concern than is suggested by the technical nature of the Tax Gap definitions used by taxation authorities. Each relates to poverty; establishing fair ratios for each of the gaps will make a contribution to tackling poverty by helping drive the closure of the gap in question.

However, no study can tackle all issues. The methodology proposed here deals with just one of the Gaps, but an important one nonetheless. This is the measure of the Expectation Gap, which is:

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

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

4. Why the Expectation Gap is important

The Expectation Gap is important because:

- a. The amounts involved are significant;
- b. The gap can be measured;
- c. The companies involved have a high profile;
- d. The companies for whom it can be measured almost invariably have a strong corporate social responsibility profile which might run counter to their tax payment policy;
- e. Many of the companies for whom this Gap can be measured trade with developing nations and some may pay little tax in those locations: this Gap does indicate in some cases at least companies who are not making a fair contribution to the societies in which they operate;
- f. This Gap would, if corrected, provide a substantial part of the funds needed to pay for the Millennium Development Goals.

5. How to Measure the Expectation Gap

The following are needed to measure the Expectation Gap:

- a. The accounts of the companies for whom the Gap is to be measured. Since tax reporting is not a precise art, and errors and adjustments are a feature of it, it is rarely wise to rely upon any one set of accounts in isolation for a company. A time series of up to five years provides much more relevant and reliable data which will substantially reduce the risk of producing a false impression.
- b. A rational sampling basis if more than one company is to be tested.
- c. A reliable and robust method of calculating the Gap.

The remainder of this report deals with topics (a) and (c). It is assumed that the user can tackle (b) without assistance.

6. Getting the accounts, and issued related to them

It would often be really useful to know the tax paid by an MNC in a particular location. It is rarely, if ever, possible to find this information, even for its country of incorporation. There are several reasons why this is the case:

- a. An MNC is usually made up of hundreds and maybe thousands of companies. Working out which of these is in a location is a problem. Even when their jurisdiction of incorporation has been identified there is no guarantee that they actual trade in that location: a company incorporated in one place is usually legally allowed to trade in another as well.

- b. Few companies provide any information on ‘country-by-country reporting’⁷. In consequence data for a location is rarely available.
- c. For this reason the group’s consolidated accounts have to be used to measure the Expectation Gap.
- d. Consolidated accounts are, to some extent, a work of fiction. They add up all the transactions between every group company and the rest of the world as if they were undertaken by one company (which is not true, of course) and all transactions between group companies are excluded from the accounts even though they do, of course, very often have significant impact on the level of profits reported and especially upon the amount of tax paid.
- e. Consolidated accounts for each of the last five years should be available as PDF downloads from the web sites of all the selected sample companies at no cost. In the USA SEC data might be used instead, assuming the company is quoted.

It can be argued that the consolidated accounts are an inappropriate tool for assessing a tax charge because they do not represent a real trading entity, no tax bill is ever based on the consolidated accounts and the consolidated accounts do not always show with any accuracy where the tax is paid (bar, in some cases the company of incorporation, but even then not always in detail). All these suggestions are true, but if they were to be accepted it would be implicit that:

- 1. The absence of data should mean that no questions are asked about a corporation’s tax liabilities;
- 2. The accounts as published are an unreliable measure of what is happening in the group as a whole;
- 3. The consolidated accounts give an unreliable view of the overall tax policy of the group.

Since quite explicitly accounts are meant to be an agenda for asking questions, consolidated accounts are meant to be reliable, and their auditors are required to say if they are, and each number within them is meant to be true and fair, within reason, none of these objections actually hold true. And, as a matter of fact there is no better tool available, so it will have to do.

It can also be objected that it is unreasonable to compare the headline tax rate of the country in which the parent company of a group is incorporated with the tax charge for the group as a whole, when that tax charge might represent tax due in many countries for the year in question. Again, there is substance to this, in part, but ultimately the objection is invalid for several reasons:

- 1. A company is run for the benefit of its shareholders. These shareholders own their shares in the parent company of the Group. That can only be located in one country.

⁷ See <http://www.taxresearch.org.uk/Documents/CbC1-08..pdf> for more information.

2. If the company is to be run in the interests of the parent company shareholders, as corporate economic theory says it should be, and as the company law of many countries, including the UK, requires, then the profits of all the subsidiary companies within a group should be available to the shareholders of the parent company. If that is to be the case then they will, ultimately, have to be paid to the group parent company at which point tax in its country of incorporation will usually have to be paid (with credit being given for that already paid elsewhere), and as such to compare the declared rate with that which prevails in the parent company country of incorporation is a fair measure of tax not paid not only for those interested in tax not paid to society but for the shareholders themselves as this measure might indicate the additional tax that might be due if they were to seek distribution of all the reserves which are rightfully theirs but which for a variety of reasons are rarely distributed in full⁸.
3. Given that there is no other measure that can be reasonably created due to the refusal of most groups of companies to provide information on their activities on a country-by-country basis it is the only fair measure available.

For these reasons the consolidated accounts that can be obtained from a company's web site are a suitable basis for analysis for measuring the Expectation Tax Gap.

7. How to do the analysis - background note

It would be of great benefit if the accounts of the sample companies as downloaded from the web could be used without modification to measure the Expectation Tax Gap. This is not possible for these reasons:

1. Accounting profit is not the same as tax profit. There is, of course, nothing wrong with accounting profit, but in most developed countries (but less so in developing countries) declared profit is not the sum on which a company is charged to tax. Instead a taxable profit is used. The differences between the two are innumerable, and vary from country to country, but in general terms the following hold true:
 - Charges for the use of fixed assets included in accounts are disallowed for taxation purposes, and different (usually more generous) taxation allowances are given in their place;
 - In the case of most goodwill, no tax relief is given, even though substantial amortisation charges may be included in the profit and loss account of the company;

⁸ This logic works in the UK and USA, it may not in some other countries such as France for a number of technical taxation reasons. It is assumed that the sample will comprise UK and US companies. In other locations different technical justification is required, but is available.

- Some expenses a company incurs are not tax allowable. These might include some legal costs; entertaining expenses in the UK; some costs of fundraising; and a wide range of other items;
- Some income is not taxable (for example, in the case of UK companies, dividends from other UK companies) or may be subject to tax at low effective rates (for example, capital gains).

For all these reasons, accounting profit can be the wrong basis for assessing the Tax Gap. That being said though, and given that companies are not required to publish their tax returns, there is only one adjustment that can be appropriately made to accounting profit when estimating the Tax Expectation Gap and that is to add back to reported profit the charge for goodwill amortisation included in the accounts since it is known that it is rare for tax relief to be provided on this charge and it is a number that has to be published within the accounts themselves.

To understand this adjustment it is important to know that goodwill is the excess of the value paid for a business over the value of the tangible assets, whether real or financial (e.g. trade debtors) that it owned at the time of acquisition. This difference is a measure of the intangible ability the business has created to make profit out of those tangible assets and is referred to as an intangible asset. The writing off of goodwill over time in the profit and loss account is called amortisation and it is this annual write off that is not tax deductible unless the acquired business is sold. This write-off has not been required in accounts in the USA since 2002 and is now rare in accounts published in that country as a consequence.

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

The important difference is that the current tax charge is the amount of tax expected to be due for immediate payment in respect of a period but the deferred tax charge is tax that might be due at some time in the future as a result of the transactions undertaken during the current year, but no one has any real idea when or if that might happen. In other words, it is a tax bill for which there is no current known payment date and additionally no certainty if it will be paid at all. Nonetheless if the possibility that the liability might exist can be calculated then the company must keep it on the balance sheet of the company, and it gets there through the profit and loss account tax charge (in the main). This means that the tax charge in the accounts can be quite misleading: there is no real expectation that it will necessarily be paid.

As research undertaken for The Missing Billions⁹ showed, the total deferred tax owed by the fifty largest companies in the UK in 2000 was £8.8 billion. In 2006 this had risen steadily to £46.7 billion. The evidence that this deferred tax charge was not giving rise to real cash tax liabilities in the majority of cases is unambiguous and clear.

It should be stressed that deferred tax is a notoriously difficult concept to grasp; many accountants never succeed in doing so. For current purposes, its most important feature is the fact that for many companies it is very unlikely that the deferred tax charges made in their profit and loss accounts will result in real tax liabilities being paid at any time in the foreseeable future. In that case, for all practical purposes deferred tax charges included in the profit and loss account can be, and should be, excluded from any consideration of taxes to be paid when measuring the Tax Gaps.

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

8. The data that is needed

This means the following data is essential to prepare an estimate of the Expectation Tax Gap:

1. Accounts for at least five years;
2. The figure for profit before tax;
3. The amount of goodwill amortisation charged against that profit;
4. The current tax charge shown on the profit and loss account of the corporation;
5. The deferred tax charge included within the current tax charge.

The adjusted tax rate used for calculating the Expectaion Gap is simply calculated. It is the ratio of the current tax charge expected to be settled in cash (calculated as the current tax charge shown in the profit and loss account of the corporation less the deferred tax charge for the period) divided by the profit before goodwill charges (calculated by adding goodwill amortisation charges back to the declared profit before tax for the period).

The resulting number is much more likely to approximate to the actual rate of corporation tax paid in proportion to taxable profits than the ratio of the current tax charge to profit before tax as shown on the profit and loss account will ever do.

⁹ <http://www.tuc.org.uk/publications/viewPub.cfm?frmPubID=535>

9. Analysing the data

The resulting data is used to calculate the tax gaps that arise. The data that might be calculated is as follows:

1. Percentage tax rate - published tax charge to published profit.
2. Adjusted percentage tax rate - profit adjusted for goodwill and tax charge profit adjusted for deferred tax. Almost invariably this second version will be lower than the figure calculated using the ratio in the previous paragraph. The difference between this rate and that calculated in the previous paragraph is a the percentage expression of the Expectation Gap.
3. The estimated tax lost. Multiply the profit pre goodwill charges by the expected tax rate for the country of incorporation for the year and then compare it with the current tax charge excluding deferred tax. The result is the monetary Expectation Gap.