TAX TRANSPARENCY: HOW DOES HMRC DEAL WITH BUSINESS?

How to calculate taxable profits - or why HMRC ‘deals’ with businesses?

1. This short paper tries to give some of the main contentions and some of the context within which HMRC deals with businesses. It looks at how HMRC approaches large business, other papers look at tax policies and tax laws. It does not come to a conclusion favouring one side or the other but the authors hope it removes some misunderstandings and gives people the chance to make up their own mind. It is written by a Trade Union inside HMRC and was accepted by a diverse group of organisations and people close to the debate.

2. To many non-tax professionals it may seem puzzling that HMRC does, in any way, “deal” with businesses. Most taxpayers in the UK are employees (about 30mn)¹ who’s only contact with HMRC may be once a year when they get a Notice of Coding telling their employer how to calculate PAYE tax and pay it over to HMRC. So PAYE taxpayers can easily be forgiven for assuming that something similar happens with businesses. They may well not know that business have to submit a tax return, as well as make payments to HMRC, or that there are things called accounts.

3. However, even then things are not as simple as this description paints. Accountancy principles and rules that convert a business’s economic activity into accounts are applied independently of HMRC and serve a number of purposes, for example; to show the business if it is profitable, to show a lender that the business is viable, or for submission to Companies House. Larger businesses are also subject to an audit to make sure the rules have been applied correctly.

¹ See Annexe 1 for some facts and figures on taxpayers and tax paying.
4. There are then the principles and rules that must be applied to those accounts to arrive at the taxable profits. Generally, accountancy rules OK. But sometimes the law or the Courts overrides the accountancy. There are tax laws, that adjust the commercial accounts for tax purposes increasing or decreasing the taxable profits. Some allowances may apply to one company or activity but not another; others are time-limited; some can be expressed as percentages and others as money. So it is probably true to say that calculating a taxable profit, or the tax bill, is not an exact science. To compound this differences of opinion have, in the past, required the intervention of the Courts to arrive at an answer and that will continue to happen.

5. When HMRC receives the tax returns and accounts it has to take a view on the accuracy of all this work and the amount of tax that might be at risk. Only in Utopia could any tax authority assume it was getting the right amount of tax without at least some checking. And it is from here that decisions have to be made about what action, if any, HMRC takes.

6. Clearly it is not a good use of resources to check each and every tax return. That is simply not a viable proposition on either resource or cost grounds for either Government or the customer. And the tax at risk may be low, or outweigh the cost. But HMRC has to choose where and what to check. For smaller business the risk of unrecorded sales, or overstated costs, like wrongly including private expenses, might be high. There might be an incorrect treatment of capital expenditure or the business may believe it is due a deduction but HMRC might disagree on its application of the law.

7. The business may have engaged in tax planning, i.e. using the reliefs and allowances that are there. This is not as simple as it may sound. Business and individuals are entitled to and can be expected to minimise their tax costs. However decisions are taken as to how aggressively one might want to reduce those costs and in doing so business need to consider the consequences of their policies. In addition a business may have taken part in a scheme or arrangement designed to avoid paying tax on part of their activities. They may even have had to declare to HMRC that they have used such a scheme.

8. Faced with this variety of possible risks HMRC adopts a variety of approaches. These depend on the nature of the risk and range from a simple correction of obvious arithmetical errors rising through technical challenges on a specific part of the accounting treatment or tax calculation to full-scale investigation of the business books and records and litigation via the Courts on bigger cases or significant points of principle. In the most extreme cases a criminal prosecution may follow.

**Does HMRC do "Deals"?**

9. Does HMRC do “sweetheart deals” with big businesses? Is it too soft and not aggressive enough? Do small businesses get chased up and hounded while the fat cats are pampered? These are some of the accusations made over the last few years.

HMRC and Government ministers categorically deny any of these charges and point to its Litigation and Settlement Strategy which requires that for cases settled out of court, the settlement terms, in every case, must be fully consistent with the law. This applies both to the amount of tax agreed to be due, and to the rationale in law as to why that tax is due. Following the Vodaphone and Goldman Sachs cases five HMRC settlements were reviewed by the National Audit Office (NAO) who said that the final payments were “reasonable and the overall outcome for the exchequer was good”. However, it did criticise HMRC for failing to follow strict official processes, for refusing to consult its own lawyers before agreeing to drop litigation, and for weak internal communications.

10. David Gauke (Exchequer Secretary and responsible for HMRC) says that the government is trying to make the UK the most attractive OECD country in which to do business but is not a push over. He said at the Tax Journal Conference on 21 November 2013 that “I suspect many of the public remember the allegations of sweetheart deals, but far fewer would have noticed that such allegations were subsequently discredited. We don’t do sweetheart deals in the UK. We have a
transparent approach where everyone gets equal treatment under the law.” Campaigners say that the scrutiny is shallow and possibly even a sham.

**HMRC Approach to compliance**

11. Like any organisation HMRC has spent time in looking at all its customers and how it can be most effectively organised. Its main function, set out in law, is the collection and maintenance of revenue, so its role is to ensure maximum compliance and tax from all customers. It has publicly stated that most people and businesses are honest, and pay over on time the tax they believe to be due. But not all of them pay the right amount, some because of errors or misunderstandings, others due to lack of care, a small proportion deliberately bend or break the rules, and there are organised criminals who try to defraud the Exchequer.

12. HMRC has a limited and declining number of staff, with a budget that Governments have chosen to reduce. Numbers declined from 97,073 in April 2005 and will reach c53, 000 by April 2015. Even if it was desirable it would not be possible to adopt the same approach to every business in terms of ensuring its compliance with tax law.

13. HMRC groups customers in a variety of ways but primarily by behaviour The result is that customers are placed within the following groups:

- Mass market - willing and able, 50% of SMEs
- Mass market - needs help around customer life events, 15% of SMEs
- Mass market - always need help
- Mass market - potential rule breakers/negligent, 28% of SMEs
- High value/large/complex customers - 10,100 large businesses (companies with a turnover in excess of £30 million) and high net worth individuals
- Rule breakers, 7% SMEs
- Organised criminals

**Tax Gap**

14. A similar categorisation is used for the Tax Gap. The Tax Gap is described as the difference between the receipts the tax system is designed to deliver and what it actually delivers. ARC has published separate papers on the basis for calculating the Tax Gap and on some of the major issues of evasion/avoidance. Both affect the way HMRC categorise behaviours by large businesses. The latest figures estimate that businesses provide 75% of the Tax Gap; £16bn (50%) from SMEs, and £8bn from large businesses (25%).

**Ensuring businesses comply**

15. HMRC does not routinely investigate every business tax return. It has neither the staff nor resource to do so. Treating all customers equally before the law is not necessarily the same as treating them in identical ways. An approach that devotes less time to cases with lower tax and more time to those with higher tax has been approved by the Courts.

16. HMRC has made a conscious choice (which is mirrored around the world) not to examine and question each business’s tax return or claim. Nor would customer/taxpayers, or their agents, welcome this assumption of lack of honesty. Instead, HMRC segments its business customer population and applies different approaches to those segments. It uses risk criteria, e.g. assessing businesses tax control framework, automated risk assessment and data-matching, on a segmented basis.
17. In practice, whether with business or non-business customers, HMRC only intervenes in a very low proportion of cases. Increasingly, it prefers to adopt a “one to many” approach, aimed at changing behaviour so that more people comply voluntarily. These include the “nudge” techniques of personalised approaches to debt collection, Taskforces in geographically focused high risk areas, and national Campaigns on specific risks.

Large Businesses

18. But HMRC takes a different approach to larger businesses where a one to many approach is not deemed appropriate. It is the scale and impact of the very largest corporates that leads to so much attention being paid to them, even if they are only a small fraction of the total number of UK businesses. In 2011/12 450 of these paid 44.4% of the total UK company tax receipts. And of course even more attention has been paid to those very large firms that have been in front of the Public Accounts Committee, or publicly questioned over their very low tax rates.

19. Part of that attention has been the perception, and accusation, that the very largest businesses are being treated much more favourably by the tax laws, tax policies and by HMRC.

Co-operative compliance

20. HMRC declares its approach to large businesses is ‘enhanced relationship management to improve disclosure and transparency through cooperation, encouraging an open and honest dialogue’. Whilst critics conclude this is nothing more than a cover for a soft touch, corporate capture and “an easy ride”, at a time when the failure of “light touch” is apparent in many other regulatory regimes. It is essentially a case of HMRC making use of what business and their advisers do, rather than repeating that work.

21. This approach to large business is not unique to the UK. The OECD discussed this model in 2008 and reported in 2013 on its results. At least 16 countries now adopt this approach, including Australia, Canada and the Netherlands. One firm of accountants described it as a “relationship between revenue body and taxpayer based upon mutual transparency, cooperation and collaboration. As such, they can be characterized as a form of voluntary disclosure: the taxpayer promises actively to notify the tax authorities of any issues with a possible or significant tax risk and to disclose all facts and circumstances regarding the issues without hesitation or reservation.”

22. HMRC has published how it goes about this process of risk assessment. It examines

- Inherent Risk (How is the customer’s ability to make accurate tax returns affected by their size, complexity and the nature of their transactions?)
- Assessing Behaviour, what does the customer do to mitigate this inherent risk in terms of their relationship with HMRC, their attitude to tax avoidance and the strength of their systems and processes?
- Conclusions on Overall Tax Compliance Risk.

23. For a business to be classed as low risk it must demonstrate a tax control framework that is part of the business control framework; solid tax risk management, real time transparency, show and earn justified trust (e.g. have a history of accurate and timely returns, declarations, claims and payments across all relevant taxes and duties), and a tax strategy that does not structure transactions in a way which gives a tax result contrary to the intentions of Parliament.

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4 See HMRC Manual TCRM 1000 onwards.
24. There are also obligations on the tax authority. Under co-operative compliance Revenue bodies have to understand how businesses operate, how they address tax risks, and their internal governance, including board level involvement.

25. HMRC points to the recovery in the three years to 31/3/13 of an additional £23bn tax over and above that originally reported by large businesses. They regard this as clear proof that co-operative compliance is working, not failing. The OECD believes there is a link between this approach and the OECD Base Erosion and Profit Shifting (BEPS) report, introduced to help governments work together to tackle taxes lost through using international tax treaties and ‘legitimate’ tax planning.

26. In weighing up the pros and cons of each side’s claims of doing/not doing “deals” it is not possible to produce any clear cut evidence that supports one side and weakens the other. Some large businesses may pay very low rates of tax but it is hard to separate that from the effects of tax policies, tax laws and tax treaties that permit it. As the BEPS Action Plan put it “No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.”

Big business, big risk?

27. HMRC agrees that the very size of such firms carries their own and different set of risks to the Exchequer that require special attention from HMRC. HMRC divides large businesses into low risk (about 40%) and non-low risk. It has a specific Directorate responsible for the affairs of the very largest businesses operating in the UK. The Large Business Service has c800 staff and deals with the very largest businesses almost all of them companies. HMRC’s basic premise is that such firms do not engage in the sort of evasion, rule breaking or careless behaviour seen in smaller firms (e.g. failing to record sales, or misallocating non-deductible capital spending as deductible revenue expenditure). This is for a variety of reasons. Large businesses tend to employ a range of professionally trained and qualified in-house people, supported by similar external professional advisors. They and their advisers are very sensitive to the reputational issues and potential impact on share price that would arise if they were shown to have done things like deliberately understated sales.

28. For the top 2,000 large businesses HMRC deploys Customer Relationship Managers, supported by teams of trained tax specialists. There is a Large Business Strategy that applies to around 10,400 businesses with an annual turnover greater than £30m and/or at least 250 employees. Over 3,000 staff are employed to deal with these companies.

29. For very high risk cases HMRC uses a policy of specialists and engagement with customers at Board level the High Risk Corporates Program (HRCP). It says that over 45 businesses have been through this since 2006, bringing in additional revenue of £13.7bn.

30. It is hard to obtain evidence that indicates that HMRC are failing to bring in significant amounts of avoided tax in this area. Some analysts have tried to work back from the published accounts of large companies to estimate what the taxable profits might be and compare them to the published figures however published accounts do not contain all the possible adjustments that are made for tax purposes, so analysts are forced to make assumptions. In fact, the combined effect of how group accounts of multinationals are compiled and presented, and the existence of deferred taxation, means that these exercises can only be a broad indicator. Others have pointed out that the proportion of UK tax paid by ‘small’ companies has increased, while overall corporation tax has not risen at the same rate as corporate profits. But corporation tax receipts

have not consistently declined as a proportion of GDP, as illustrated by this OECD graph. In fact, the UK has been at the upper end of the range, suggesting receipts are holding up\textsuperscript{6}.

![Figure 10.4. Corporate tax revenue as a share of national income](image)

**Disputes with businesses**

31. There is a long standing process of legal oversight of how HMRC deals with customers who disagree with HMRC decisions.\textsuperscript{7} There is a legal right to appeal, starting with an internal review and working upwards via the layers of the Tribunal system, including the possibility of Alternative Disputes Resolution. In 2011/12 customers sent 55,764 requests for HMRC to review a decision, most of which resulted in the decision being upheld. 1395 cases went to Tribunal, with 952 decided wholly or partly in favour of HMRC.

32. Until matters are made public in the Courts HMRC says that it is not legally possible for it to disclose the existence of any dispute, or release any specific taxpayer confidential information. Any unauthorised disclosure is a criminal matter. Others have challenged this. They believe HMRC can and should disclose to committees like the PAC. It is hard to see how this can be tested in the Courts - if HMRC will never disclose then there can hardly be any “breach” of the legislation.

33. At the same time there is a growing public debate about increasing the transparency/disclosure of tax affairs of large companies\textsuperscript{8}. Companies are recognising this and disclosing more. In fact, the accounts rules already require a fair amount of disclosure but the presentation is not helpful and requires a degree of professional expertise to extract it.

\textsuperscript{6} Table from Institute of Fiscal Studies
\textsuperscript{7} http://www.hmrc.gov.uk/complaints-appeals/how-to-appeal/index.htm
\textsuperscript{8} See the recent launch of the Fair Tax Mark and the initiative by Mazars to increase transparency for advisors. http://fairtaxmark.net/ and http://www.mazars.co.uk/Home/Our-expertise/Tax/Tax-Transparency
Litigation and Settlement Strategy (LSS)

34. Disputes with large businesses are worked under a policy called the Litigation and Settlement Strategy. There can be genuine differences of view between HMRC and a business on how tax law applies to a particular transaction or series of transactions. This need not indicate avoidance but a disagreement on the facts, or the application to those facts of accounting standards, or tax law. The LSS means that if HMRC thinks there is a realistic chance of winning its case then it will not settle for less than it believes is due and if settlement on that basis is not possible it will litigate.

35. But critics say that HMRC has only taken a handful of cases to court and there are “deals” which are not available to other businesses (or to other HMRC customers like Tax Credit claimants). The PAC complained that HMRC had never challenged an internet-based company in the Courts on the question of its permanent establishment. Campaigning groups have asked why HMRC does not challenge, even if they are not sure on the strength of its case.

36. HMRC responds that it does take cases before the higher courts. In 2012-13 it took 18 cases, and won 14. The tribunals and courts also issued decisions on 33 avoidance cases with 27 going in HMRC’s favour, protecting more than £1 billion of tax. But it notes it has to operate within the law and cannot challenge if it has no realistic prospect of success, especially with declining resources. If litigation were used more frequently then cases will take longer to be heard, more resources would be needed to work them, and businesses be impaired in their normal commercial activity. Like others, HMRC points to weaknesses in legislation that make successful challenge on international cases unlikely, especially given the haphazard and out of date rules that apply to international trade.

HMRC disputes handling reviewed

37. The PAC publicly criticised HMRC’s handling of some specific cases (Vodafone, Google, Starbucks, etc). As part of that critique the NAO engaged a retired judge with tax expertise (Sir Andrew Park) to examine 5 specific cases. Park reviewed HMRC files and concluded that all the settlements were at least reasonable, although he found some of the governance was not up to the mark. On the other hand, critics say that ordinary citizens, or the PAC, were not given access to the papers so we do not really know the full story. They also say that the NAO had pre-determined the results by agreeing with Dave Hartnett that it was unlikely Park would find anything seriously wrong.

38. This type of concern was amplified when a separate case was taken by UK Uncut against HMRC’s admitted failure to charge interest in a settlement with Goldman Sachs. They claimed that Dave Hartnett (HMRC Deputy Chairman) had deliberately let the firm off the hook because of too cosy a relationship with Goldman Sachs, as well as to save the Chancellor from embarrassment. The case was lost. The judge commented it had not been a glorious day for HMRC, with several procedural shortcomings. But he did not agree the decision was unlawful.

39. To address concerns around transparency and accountability HMRC introduced a package of changes in February 2012. These included a Code of Governance to improve transparency around the structures in place to resolve disputes and a new post, the Tax Assurance Commissioner. The Commissioner does not engage with taxpayers on their tax affairs and does

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9 [Link](http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/11204.htm)
11 See, for example, the OECD work on Base Erosion and Profit Shifting.
12 [Link](http://www.hmrc.gov.uk/adr/resolve-dispute.pdf)
not manage caseworkers. They publish an annual report on tax disputes.\(^\text{13}\) HMRC also introduced strengthened governance for the Department’s largest and most sensitive cases, using a cross-departmental board to make recommendations to 3 Commissioners for a decision.

**Conclusion**

40. The material above can only give a brief outline of some of the main areas where commentators and campaign groups have expressed concern that HMRC seems to be doing nothing in the face of widespread and overt tax losses. This paper has hopefully started to explain where some of these concerns are fuelled by a lack of understanding. The position is, inevitably, more complex than HMRC failing to get a grip. We think there should be more public attention on other issues, such as the interlocking issues of policy, both domestic and international, policy goals and objectives; Legislation, is it clearly drawn and unambiguous, its fit with other (international) legislation, did Parliament scrutinise it properly; and Resourcing, do regulatory bodies have appropriate powers and resources to administer legislation.

\(^{13}\) This provides information on how the governance arrangements are working and reports on the outcomes of a review of cases that looks at compliance with governance processes. 
Annexe 1

Some facts and figures

1. In very simple and general terms a business is something that has been set up to provide an income for those running it (technically making a profit). There are only a relatively small number of businesses and most of those are not set up as companies. There about 2m businesses in VAT, and 2m companies (who pay Corporation Tax, not Income Tax).

2. 10mn people have to send in an Income Tax self assessment return but most of these are employees, not businesses. HMRC’s other customers comprise nearly 30mn people with an employment who are taxed under PAYE, 8mn who claim Child benefit, and 6mn who claim Tax credits. This paper focuses on business customers.

3. Small businesses make up 99% of all UK businesses\(^{14}\). In 2010/11 HMRC figures showed about 5.7m small and medium enterprises (SMEs), comprising 3.8 million sole traders, 490,000 partnerships, and 1.4 million companies. They employ about 60 percent of the private sector workforce\(^{15}\). In terms of profits and tax, 98% of sole traders and 82% of partnerships had profits below £50,000, and 68% of sole traders and 50% of partnerships made profits of less than £10k. Only 7% of businesses have a turnover above £500k and 76% employ 4 people or less.

4. In 2012/13 HMRC calculated that the top 1% of income tax payers paid 24.2% of total income tax, and the top 10% 55.3%. Or, looking it from the other end, 50% of income tax payers pay 10.8% of all income tax.

5. The picture with companies is even more extreme. By tax paid, companies form a very tall pyramid, with very steep sides. An Oxford University study in 2011 estimated that the top 1% of companies paid about 81 percent of all corporation tax\(^{16}\). In 2011/12, 65% of companies paid corporation tax of £5,000 or less. Put another way, 450 companies (0.05% of all tax paying companies) paid £19.433bn tax (44.4% of the total)\(^{17}\).

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\(^{14}\) European Union Enterprise Size Classification

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<th>Total Assets (£m)</th>
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<td>249+</td>
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Note: The values shown are the upper limits (except in the case of the large category). To be classified as a certain size, a business must meet one or other of the Turnover and Total Assets limit and also the Employee limit.

\(^{15}\) Source: BIS Business Population Estimates 2011


\(^{17}\) http://www.hmrc.gov.uk/statistics/ct-receipts/table11-6.pdf. A PWC study of the UK’s top 100 groups notes they employ 2.1m people (7.2% of the UK workforce) and invest 31.1% of UK business R&D.