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Companies and taxes in the UK: actors, actions, consequences and responses

2. THE CORPORATE TAX ENVIRONMENT

2.1 Actors and Actions

Figure 1 provides an overview of the participants (or actors) in the U.K. corporate tax environment. This section briefly outlines the role and incentives of each party with more detailed analyses on corporation tax rates and revenues available elsewhere

company differences in ETRs, or that a firm's ETR is less than the statutory corporate rate, therefore says little about the amount of tax avoided, although where companies do engage in planning or avoidance, this affects their ETR relative to what would have otherwise applied if the tax planning or avoidance had not been undertaken.[9]

Accordingly, research has examined whether there is a link between ETRs and firm size (e.g. Callihan, 1994; Holland, 1998) and has tested for associations with other characteristics such as capital intensity, leverage, industry membership as well as the influence of tax preferences (Gupta and Newberry, 1997).

Mills (1998) extended ETR research and pioneered U.S. efforts into differences between income for financial reporting purposes and taxable income (now known as the book-tax gap). Such gaps are not surprisingly associated with tax audit adjustments (Cho et al. 2006) and are treated as red flags in risk measurement exercises of various tax agencies (see Appendix).

Empirical tax researchers in the U.S. and more recently in the UK have recently addressed tax avoidance and tax shelter participation more directly, and in relation to financial reporting (including links with earnings management). Thus, the focus has now shifted to investigations of underlying motives and economic consequences (Desai and Dharmapala, 2006a; 2009b). This involves drawing a distinction between active steps, described variously as tax avoidance, tax planning or tax management, and passive or secondary effects e.g. reduction in corporate income tax arising from an operational decision to acquire an asset qualifying for capital allowances or issuing debt for primarily non-tax reasons (Frank et al. 2009) where such decisions are not ttie not

Tax avoidance has also been subject to qualitative research approaches (e.g. Freedman et al. 2009; Mulligan and Oats, 2009) and this U.K. based research has started to investigate the relationships between the parties in the corporate tax environment.[10] Exemplars include research on large companies' relationships with tax agencies such as HMRC and the IRS (Oats and Tuck, 2008; Mulligan and Oats, 2009; Toumi, 2008) and these researchers have stressed the company's risk attitude, desire for maintaining corporate reputation and good tax governance as important considerations for large multinationals. Similar research has also been commissioned by tax agencies themselves (e.g. HMRC, 2007), and the need for tax risk management is promoted by big four accounting firms (e.g. KPMG, 2010; PwC, 2004).[11] To our knowledge, there is no prior research in this area which has been conducted with SME's.

3.2 Accounting firms as intermediaries, tax practice and tax knowledge research

The research on tax planning and avoidance just discussed reflects the complex, technical and vested nature of the corporate taxation environment (Mulligan and Oats, 2009; Oats and Tuck, 2008). Prior work on tax knowledge per se, is however largely restricted to experiments exploring individual tax professionals' judgements and decisions such as search processes and expertise (Bonner et al. 1992; Cloyd and Spilker, 1999; Gibbins and Jamal, 1993). Our focus here is on aggregate tax-system wide knowledge flows and effects as schematically shown in Figure 1.

Accounting firms are brokers of tax knowledge. By definition, they operate as intermediaries between corporate taxpayers and tax agencies (OECD, 2008; Hasseldine et al. 2011). Prior research in tax compliance suggests that tax accountants enforce non-ambiguous tax law while exploiting ambiguous tax law (Klepper et al. 1991; NAO, 2010). The decision to hire an accounting firm as an adviser may be driven by a lack of knowledge about tax legislation (Morris and Empson, 1998), or as a form of 'insurance' pending a perceived response from a tax agency (Hasseldine et al. 2011), or the corporate taxpayer may hope to reduce the probability of the external auditor subsequently objecting to the proposed financial accounting treatment of a particular tax transaction in which the accounting firm was involved (Maydew and Shackelford, 2007), particularly when the tax adviser also acts as financial auditor.

'enforcer' role vs. the 'exploiter' and 'complexifier' role). Hasseldine et al. (2011) conclude that despite the use of co-operative compliance models, there remains an unavoidable tension between customer-friendly initiatives, based on responsive regulation and co-operative approaches, and policy and administrative responses targeted at tax avoiding companies which are now outlined.

Graham Aaronson QC (2011) recommended a GAAR to target artificial and abusive tax avoidance schemes with a consultation period in 2012 and likely legislation in 2013. Notwithstanding these developments we draw on themes in western tax agencies, over and beyond the co-operative compliance approach mentioned in Section two.

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Prior research by Hasseldine et al. (2010) highlights that demand for the role played by accounting firms is driven by the difficulties companies have in interpreting tax legislation and the ability of advisers to provide administrative compliance as well as promoting tax avoidance schemes. Accounting firms may not always recognise the motives of corporate taxpayers in engaging them. For instance, corporate taxpayers report one reason for purchasing tax advice is as a form of insurance, whereas this was rated as unimportant by accounting firms. Consequently, tax advisers may be inadvertently further increasing the demand for tax avoidance activities by reducing its potential costs, particular if they are unaware that they are providing such insurance. This has implications for restricting auditors on the extent to which they can provide tax related non-audit services and may justify regulation of all tax advisers and not just those who are members of a professional association.

This perspective paper also reinforces earlier work on the dual role played by accounting firms i.e., their superior abilities in tax knowledge management allow them to be both enforcers and exploiters in the tax system (Klepper et al. 2001). This suggests that the policy response to regulating tax practitioners, in which there is considerable international divergence, needs to be carefully balanced by governments and tax agencies.

In the future, we believe that archival corporate tax data will become more readily available and that research into corporate tax practice (including planning and avoidance activity) should remain high on the agenda not just for future researchers, but also for other users such as tax agencies, accounting firms and companies themselves, and society at large.

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Appendix: Tax Agency Use of Large Business Compliance Risk Indicators

United Kingdom

HMRC rates behavioural and organisational compliance risk in seven areas in order to determine the risk a taxpayer presents. These areas are listed below together with a couple of examples of high-risk behaviour.

In terms of tax contribution, the trend of receipts will show a significant falling pattern in one or more tax regimes with no clear reason and there is likely to be significant divergence of taxable profits compared with commercial profit levels.

In terms of complexity, the business typically operates within a highly complex structure but has no clear strategy or procedures to ensure completeness or best practice arrangements. Highly complex tax issues are considered on an ad hoc basis and there are likely to be very high tax throughputs in a number of different tax regimes.

In terms of boundaries, examples of major risk include a foreign owned business with a lack of knowledge or clarity around the global business interest. Others include complex and diverse business

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Compliance Risk indicators include, but are not limited to the following:

- extensive international business activities (opportunities for transfer pricing and cost sharing tax avoidance);
- transactions with corporate affiliates or third parties in tax haven countries (basis shifting, export of intangibles);
- transactions with other "tax advantaged entities" (tax-exempt entities, entities with unused credits, losses or preferential tax rates: asset/basis shifting, leasebacks, arbitrage schemes, etc);
- use of Special Purpose Entities (a.k.a. "Variable Interest Entities": entities set up to achieve a specific financial and/or tax planning purpose: to own specific assets, handle specific transactions, etc. These are often short-lived entities, often flow-through, often tiered);
- complex entity structures (consolidated financial reporting entity differs from the consolidated tax reporting entity: separate tax filings by some corporate affiliates, extensive use of flow-through entities to report some business activity, etc.);
- use of complex hybrid and derivative financial instruments (techniques for claiming tax