Analysis

Making sense of the cost of tax avoidance

Speed read

Efforts to measure the extent of tax avoidance are in their infancy. HMRC's tax gap includes £2.7bn for avoidance but does not include BEPS. The OECD estimates that the global cost of BEPS is US$100–240bn. The OECD's Action 11 promises new indicators and analysis, but public and policy maker perceptions of the scale of the problem are also shaped by myths and misunderstandings such as Africa losing $38bn a year through transfer pricing or EU countries losing €190bn to BEPS.

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The art of estimating the scale of tax avoidance involves tentative extrapolations, careful assumptions and caveats. The data available is patchy, calculations are educated guestimates, and studies must first deal with the problem that the term 'avoidance' itself means different things to different people.

The tax gap

Perhaps the most well known estimate in the UK is HMRC's tax gap. HMRC defines avoidance as 'bending the rules of the tax system to gain a tax advantage that Parliament never intended ... It involves operating within the letter – but not the spirit – of the law.' What this means in practice is that the avoidance tax gap measures 'tax under consideration' which isn't successfully collected. The assessment is based on a bottom-up approach that looks at avoidance schemes disclosed under DOTAS and tax risks identified through individual risk assessments of large businesses. This gives an estimate of £2.7bn lost to avoidance (for 2013/14), with £1bn relating to corporate tax.

This £1bn of corporate tax avoidance amounts to 5% of total corporation tax liabilities, or somewhere around 0.2% of overall government revenues. It is significant in terms of assessing the effectiveness of tax administration, but does not support the popular perception that corporate tax avoidance is a massive drain on public resources, nor that large businesses are running rings around the tax officials. As David Gauke, then financial secretary to the Treasury, put it: 'There is understandable anger when individuals or companies are perceived not to be contributing their fair share, but we can reassure the public that the proportion going unpaid is low and this government is dedicated to bringing it down further.'

Few are reassured, however. A survey by YouGov in 2015 found that two thirds of Britons believe big companies are not paying their fair share of corporation tax; while 80% felt small businesses paid appropriate corporation tax but their larger counterparts did not.

Getting the measure of BEPS

Critically, the HMRC tax gap does not include base erosion and profit shifting which exploits gaps and mismatches in international tax rules. While such cases fall outside of HMRC's formal 'tax avoidance' definition, they define the issue in the public eye through cases such as Apple, Google and Starbucks; although these companies have argued 'we pay all taxes due under the law', the concern is that that the law has not kept up with the reality of globalised business.

Academic and government studies confirm that BEPS is a real problem. However, there is little certainty over the scale or extent of the problem. Rough estimates are emerging. The OECD calculated that effective tax rates experienced by large multinational companies are on average 4 to 9 percentage points lower than domestic entities, putting the overall fiscal effect of BEPS at 4–10% of the global CIT tax base, or US$100–240bn. Other recent studies come up with numbers in a similar range.

Such research confirms that multinationals do pay less tax than domestic companies and that the amounts can be significant. The OECD says that measuring the scale of BEPS remains challenging because of the complexity of the issues and data limitations. It is clear though that emerging estimates do not fulfil the perception of huge lost funding for public services; nor does it say anything about whether multinationals should be paying more tax in the US or in Europe.

> Without a common evidence base, it is impossible for tax experts, campaigners, politicians and business to engage together in thinking about the challenges, options and trade-offs

The European Commission presents the case for change in the tax system by saying that 1 in 5 tax euros are lost to corporate tax avoidance (see, for example, www.bit.ly/2dw56nK). However, its study says that if a complete solution to the problem of base erosion and profit shifting were available and implementable, it would have an estimated positive impact of 0.2% of the total tax revenues of the member states.

Mistakes and misunderstandings

Some of the most influential numbers which shape perceptions of the scale of the problem and of potential solutions are mistakes and misunderstandings. Many of these concern the scale of multinational tax avoidance in developing countries, as I have highlighted in a policy paper published by the Center for Global Development, *Can stopping 'tax dodging' by multinational enterprises close the gap in development finance?* (2015).

Often, the perception that clamping down on corporate tax avoidance would have outsized impacts on the finances of the poorest countries has been built up through simple wishful thinking. Estimates of tax avoidance in developing countries are frequently illustrated with a photograph of a child from one of the world's poorest countries and compared to global foreign aid. In practice, though, these estimates mainly relate to major emerging economies such as Brazil, Mexico, China and South Africa, rather than countries such as Malawi or Cambodia.

A much quoted figure is that developing countries lose three times more to tax avoidance by multinational companies than they receive in aid. The original source for this is a single sentence in a Guardian opinion piece by Angel Gurria, OECD secretary general, in 2008. In fact, Gurria was not offering an estimate of tax loss, or even talking about multinational corporations at all, but giving an estimate of the amount of capital held offshore by citizens of developing countries – gross amounts whose interest might be taxed. It is simply not, and never was, an estimate of revenue loss due to multinational tax avoidance.

Another fertile source of misunderstandings are the annual estimates of illicit financial flows (IFFs) through invoice fraud, produced by the Washington based NGO Global Financial Integrity. These figures (US$1trn a year) are sometimes misunderstood as an estimate of multinational tax avoidance. Kofi Annan, for example, has said that Africa loses $38bn to transfer pricing, based on this misunderstanding. Similarly, the High Level Panel on Illicit Financial Flows led by Thabo Mbeki argued that Africa loses $50bn to illicit financial flows, with the main culprit being multinational enterprises.

Not all wishful thinking relates to fiscal resources for developing countries. One figure often quoted to illustrate the problem of clever accountants and outdated tax laws is that EU countries lose €1trn a year to tax avoidance and evasion. This has been used to represent the scale of corporate 'tax dodging' in Europe by many MEPs and by Herman Van Rompuy and José Manuel Barroso, both former presidents of the European Council. (This also appears to be the basis for the European Commission's statement that 1 in 5 tax euros are lost to corporate tax avoidance.) However, this figure is based on a paper by Richard Murphy which mainly focuses on tax evasion in the grey economy, such as cash-based informal businesses. It was never intended as an estimate of tax avoidance by multinational companies.

Mind the perception gap

More research is certainly needed to understand the scope and scale of BEPS, and the OECD has promised to undertake this as part of the BEPS package. However, given inflated expectations, even those organisations trusted to provide careful and technical analysis of this complex problem have taken to exaggerating their findings. The OECD BEPS Action 11 report developed a core estimate that BEPS revenue losses amount to 4–10% of CIT revenues; however, the press release (and the letter to the *Financial Times* from then chancellor George Osborne, EU commissioner for financial affairs Pierre Moscovici and German finance minister Wolfgang Schäuble) ran with the racier headline of 'multinationals paying as little as 5% in corporate taxes'.

Similarly, the European Parliamentary Research Service (EPRS) commissioned a study by a group of academics which estimated that aggressive corporate tax planning costs EU countries €50–70bn a year. However, in the run up to the final negotiation of the EU Anti-Tax Avoidance Directive, the EPRS instead promoted another figure from the paper, €160–190bn (including €23bn from the UK), which the authors said was an overestimate. (For further detail on this figure, see the panel, right.)

Recent BEPS estimates

The number	The source	Scope	Reference
US$100–240bn	OECD	Global	*Measuring and monitoring BEPS*, Action 11: 2015 final report (OECD, 2015)
US$66–122bn	UNCTAD	Developing and emerging economies	*World investment report* (UNCTAD, 2015)
US$200bn	IMF	Developing and emerging economies	IMF working paper *Base erosion, profit shifting and developing countries*, (E Crivelli, R De Mooij & M Keen, 2015)
€50– 70bn	European Commission	EU	European Parliament Research Service paper *Assessment of the magnitude of aggressive corporate tax planning* (R Dover, B Ferrett, D Gravino, E Jones & S and Merler, 2015)

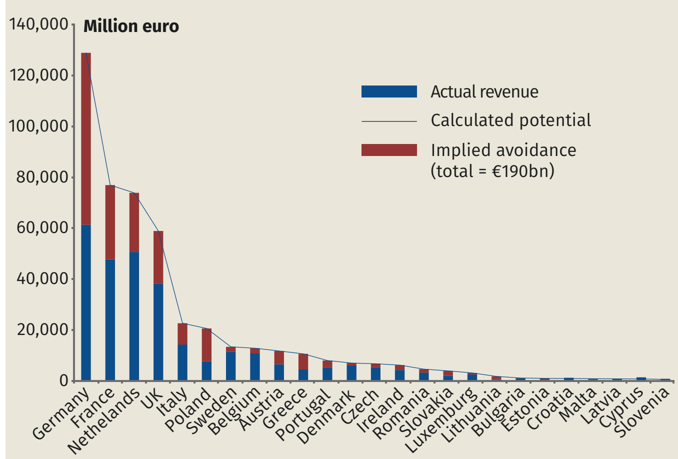
How did the European Parliament come up with a figure of €190bn?

This number is drawn from a research paper commissioned by the EU Parliamentary Research Services (*Bringing transparency, coordination and convergence to corporate tax policies in the European Union I: Assessment of the magnitude of aggressive corporate tax planning* (Dover et al), September 2015; see www.bit.ly/1L71Daf).

The paper defines aggressive tax planning and tax avoidance as 'ostensibly legal practices … using often sophisticated business and accountancy practices to minimise a company's tax liability'.

To estimate this, it uses data from national accounts as a gauge of the total net value-added generated by companies in each country. It takes this as a proxy for taxable corporate profits and multiplies it by the headline corporate tax rate. The €160–190bn figure is reached by the difference between this calculated tax potential and the actual amount collected (see chart below).

This means that the figure includes things that are not just ostensibly legal, but uncontroversially legal: such as differences between capital allowances for tax purposes; and the way that 'consumption of fixed capital' is reported in national accounts, double tax relief under tax treaties, real estate investment trusts and tax incentives for things like R&D, energy efficiency and employment, but misses controversial BEPS cases where the income is not reported in national accounts at all, such as where all European sales are recorded in Ireland.



Based on data drawn from Dover et al: 'Method 2' Average 2009-2013

The exaggeration of claims around tax avoidance is perhaps just one symptom of 'post-factual democracy', in which political narrative increasingly trumps evidence and analysis. But this risks policies being developed based on unrealistic views of potential gains and negative impacts.

Campaigners are right that the debate over shaping tax policy for the 21st century is too important to be left to the experts. But without a common evidence base, it is impossible for tax experts, campaigners, politicians and business to engage together in thinking about the challenges, options and trade-offs. While there is a clear case for anti-avoidance action, there is no way that it can deliver 'one in five euros' of tax revenues, as the EC suggests, or solve the problems of the poorest countries.

In other areas such health, scientific claims and political debates, fact checking initiatives have sprung up to support public understanding and the integrity of the debate. Perhaps the tax profession should take the lead in developing a public interest fact check initiative on tax. ■

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- Tax gap debate: measuring the cost of avoidance (Andrew Goodall, 9.3.11)

Briefing

Tax and the City briefing for October

Speed read

HMRC successfully defends another judicial review of its issue of an advance payment notice; this time, however, the court has some harsh words to say about HMRC's conduct of the tax dispute. Advisers and financial institutions will be required to issue client notifications on exchange of information by the end of August 2017, as regulations and related guidance are published by HMRC. The European Commission announces its 'scoreboard' – to help member states draw up a common list of non-cooperative tax jurisdictions. Draft amendments to the Change of Accounting Practice Regulations for loan relationships and derivative contracts are published by HMRC.

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Accelerated payment notices (APN)

HMRC has successfully fended off another judicial review of its decision to issue an APN. Under the FA 2014, where a disclosure of tax avoidance scheme (DOTAS) disclosure has been made, and the scheme is disputed by HMRC, an APN can be issued requiring payment of the tax in dispute to HMRC upfront. The purpose of the APN rules is to make sure that HMRC, and not the taxpayer, holds onto the tax until the dispute is resolved.

In *Vital Nut Co. Ltd and others v HMRC* [2016] EWHC 1797 (Admin) (reported in *Tax Journal*, 5 August 2016), HMRC argued that it could issue a valid APN whenever a DOTAS disclosure was made, and without the need to take a view as to whether a claim for relief under the relevant scheme was lawful and available to the taxpayer. The court did not accept this approach, however. It concluded that a DOTAS disclosure did not mean that tax was necessarily in dispute, although it was always open to HMRC to challenge the scheme, and Parliament could always change the law to stop it. Some DOTAS disclosures were also made on a protective basis. The court considered that it was for these reasons that the minister had reassured Parliament when debating the APN regime that disclosure under DOTAS did not necessarily mean that the taxpayer would be issued with an APN.

Given this, and the clear wording of the statute, the court concluded that a disclosure under DOTAS was not enough to trigger an APN. Instead, HMRC must also determine that the tax advantage being claimed is in dispute.

The court went on to find sufficient evidence in the public domain to show that HMRC would dispute the particular scheme that was the subject of the DOTAS disclosure in this case. It was clear that HMRC was aware of the scheme; had published its view (in a so-called 'Spotlight') that the scheme did not work; had entered into correspondence with taxpayers to confirm its position; and had even changed the law to prospectively stop the scheme. It followed that the taxpayer knew, or ought to have known, that HMRC would dispute the claim made under what was a marketed scheme disclosed under DOTAS, and could well enter into litigation. HMRC must therefore have discharged its burden in determining that the tax relief in this case was in dispute.

This is now the third case in which a taxpayer has failed to challenge the issue of an APN by HMRC using judicial review, although all three cases are on their way to the Court of Appeal. There were some helpful comments from the court, however. In particular, HMRC must make a decision that tax is in dispute before issuing an APN; a DOTAS disclosure in itself is not enough. It was helpful that the court reiterated that there were checks and balances in the rules, and that HMRC could not simply ignore these on the basis of its response to its own consultation. The court was also upset at HMRC's failure to explain why it had not already litigated this particular scheme, given its long held view that the arrangements did not work.

Client notifications

On 30 September, amending regulations came into force on client notifications (see the International Tax Compliance (Client Notification) Regulations, SI 2016/899). HMRC has also added guidance on the new rules to its *International Exchange of Information* manual.

Under the regulations, financial institutions and other advisers (including lawyers and accountants, referred to as 'specified relevant persons') must notify their individual clients about information HMRC will receive under international agreements to improve tax compliance, and to remind those clients about their tax obligations. The form of