UK UNCUT UNRAVELLED

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This paper examines four major tax cases that have been the focus of campaigns by the group UK Uncut. The criticisms of the tax affairs of the companies concerned are shown to be unfounded and ill-conceived. Furthermore, there would be major economic benefits from reducing corporate taxation.

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Introduction

UK Uncut, in its statements and demonstrations, manages to claim these two things:

- Vodafone, a UK company, should pay tax in the UK on their profits made from selling phones and airtime in Germany, to Germans, from German shops.[1]
- Boots Alliance, a Swiss company, should pay tax in the UK on their profits made from selling things in Britain, to Britons, from British shops.[2]

It is possible to support either of these ideas: that tax should be paid where economic activity takes place, or that tax should be paid where the entity undertaking the economic activity resides. But to claim both is a contradiction. Either Vodafone should pay tax in Germany, not the UK, or Boots should pay tax in Switzerland, not the UK. One or the other should prevail – not both. We can indeed tax on the economic activity basis: but we cannot tax on both, domicile and activity – not, at least, if we are to avoid simply taxing any and everyone just because we can, which is not quite the logical base for a desirable socio-economic system.

The rest of this paper looks at the four major tax cases that UK Uncut has been focusing on: Vodafone, Boots, Philip Green and Arcadia, and Barclays. There then follows a discussion of the economic theory of taxation which can be used to guide us to possible answers to the question: 'who should be paying tax and where on what?'

UK Uncut's targets

Vodafone

The arguments about how much Vodafone should or should not have paid in tax seem to have started when Richard Brooks, at *Private Eye*, made the claim that the company had managed to persuade Her Majesty's Revenue and Customs (HMRC) to let them off a £6 billion tax bill, forcing them to pay only £1.25 billion of what was truly owed.[3] This is less than the complete picture.

There was indeed a long running investigation by HMRC into Vodafone's tax affairs, and it revolved around a subsidiary based in Luxembourg. It was through this that Vodafone had bought a German company called Mannesman, a mobile telecoms provider in that country. This Luxembourg company did three things: first, it lent money to the now 'Vodafone Germany' organisation. When the interest on this was paid it was tax deductible in Germany, as interest payments are in just about every country, certainly every serious country, for interest is a cost of doing business. A company pays tax on its profits after deducting from its revenues all the costs of doing business. Secondly, the subsidiary received the dividends from the German operation. This is the payment, made out of profits, which goes to the owners of a company. Thirdly, and this is a little murky, if there were capital gains from having sold parts of Mannesman, these would also have gone into the Luxembourg company.

The way that UK company tax law works is that if a company has one of these foreign subsidiaries, then there are times when it has to pay UK tax on its profits as well as the tax that is paid in those foreign places. These are called the Controlled Foreign Company (CFC) rules. They are there to try and stop companies piling up their profits in tax havens. But we should note, the CFC rules only require that you must pay up to UK tax rates, deducting whatever you might have already paid in taxes elsewhere. This is perfectly reasonable and is a key aspect of international business taxation. If these rules did not exist, companies could end up paying tax on their profits several times over.

This leads us to our first observation: there never was a £6 billion tax bill. This seems to have been calculated by noting that there were £18 billion of profits in the Vodafone Luxembourg accounts using a corporation tax rate for the UK of 30% (appropriate at that time) and calculating that £6 billion must be owed. However, the dividends from the German operations would have been taxed in Germany, according to German rules, the interest in Luxembourg according to their rules and tax rates and so also with the capital gains. So the maximum that could possibly be owed would not be the full 30% UK corporation tax rate but the difference between the tax already paid and that 30% rate.

This is in Vodafone's accounts: we find a provision for a little over £2 billion for the tax they think they might have to pay if they fail entirely in their argument with HMRC. Do note, whether we like it or not, that trying it on with the taxman is considered a much lesser sin than trying it on with The City by lying in your accounts. So we should put greater weight on that £2 billion figure rather than the £6 billion: which has, after all, only appeared, unsourced, in a fortnightly magazine, rather than a document that the executives and auditors have had to sign off.

Our second observation is that, while the UK does indeed have these CFC rules, it is not actually clear whether they apply to subsidiaries in EU countries. This, in fact, was the very subject about which Vodafone and HMRC have been arguing over the years. The EU has very clear rules about the mobility of capital and what is known as 'freedom of establishment'. In effect, you can set up a company anywhere in the EU (and also in Iceland, Liechtenstein and Switzerland as members of the EEA) and do business as you wish. You must of course obey the tax laws of the country in which you have set up the company, but that is all. These laws, and they are absolutely basic to the whole concept of the EU's Single Common Market, conflict with the UK's CFC rules.

Everyone in the tax debate seems to agree that if Vodafone had set their subsidiary up in the Cayman Islands, or the Bahamas or other non-EU countries, then they would have had to pay the extra tax under the CFC rules. But if the company was set up in the EU then the EU laws normally override those of the UK. However, the matter has nevertheless been debated in court.

This case was first heard by the Special Commissioners (effectively a junior court just for tax cases) and they said that Vodafone was right. EU law meant that no UK tax was due on the profits earned through the Luxembourg subsidiary. This conclusion was reached as a result of applying the judgments from an earlier case involving Cadbury Schweppes.

HMRC did not like this answer and so appealed to the High Court which agreed with Vodafone again. HMRC appealed again and the Court of Appeal was slightly more nuanced. It said that maybe the CFC rules and the EU rules can co-exist but only if Vodafone's activities were real corporate activity rather than just designed as a tax dodge.

At which point HMRC and Vodafone settled, rather than take the matter to the Supreme Court, where we would have had the final answer once and for all. The general consensus among tax experts is that this settlement was because HMRC really did not want to lose this case. If they had won, they might have got a little more out of Vodafone (perhaps the difference between the £1.25 billion settlement and the £2 billion or so provision) but if they had lost . . . well, there are perhaps 100 other British companies with the same or very similar arrangements. By not losing HMRC may hope to negotiate some tax revenue from them all.

So the Vodafone case was absolutely not about a supposed £6 billion tax dodge. The sum over which the lawyers were arguing was much less than that and the argument was about which laws to apply, EU laws or UK laws? It is worth reiterating the main point. Vodafone had paid the relevant tax required in the countries in which the subsidiaries were operating. The only question is whether they should pay additional UK tax on the profits generated from economic activity that took place in a different EU country.

Boots

Boots was subject to an international takeover and when the dust had settled became a Swiss company. It was also burdened with vast amounts of debt, for the takeover had been financed by borrowing money against the asset value of the various companies that were merged and taken over at the same time. There was indeed a very large reduction in the amount of corporation tax being paid as a result of all of this. But contrary to UK Uncut's protests[4], little of this was because the company was now Swiss. The reduction in corporation tax arose because of the huge amount of interest that had to be paid on the money that was being borrowed. Interest paid out is a cost of doing business and therefore is not part of a company's profit: it is part of a company's costs, and needs to be deducted from revenues before profits are calculated. As the new company which Boots is a part of has not, after all this interest, been making much of a profit, there is not much profit for anyone to tax.

But, and this is where it gets much more interesting, there is no evidence at all that less tax is being paid overall. Less corporation tax is being paid but whoever is receiving the interest, whether it is another company or an individual, will be paying tax where they are based on that interest that they receive. For while profits and dividends are taxed by those who pay them, interest is taxed by any person who receives it. Further, given that income tax rates can be higher than corporation tax rates, it is even possible that the recipients of this interest are paying more tax than would originally have been paid if interest were taxed in the same way as company profits are taxed. It is worth noting too that, in many respects, when interest is taxed, this is a much more satisfactory way of levying taxation than the methods that are used to tax profits. Interest is taxed in the hands of the recipients according to their tax circumstances. Profits are taxed in the hands of the company and then remitted to shareholders net of tax. If those shareholders are non-taxpayers (such as charities) they cannot reclaim any of the tax that has been paid.

We cannot prove whether the holders of securities in Boots have paid more or less tax than they would have done if Boots had financed its business without debt. We do not know who lent the money for the takeover, nor where they live or what their tax rates are. But it is definitely true that to say that simply because the corporation tax collected has gone down all taxes collected have gone down is wrong: we must account for the tax that is being paid on the interest that is received by the holders of the corporate bonds issued by Boots.

And do note, for Boots and Vodafone, the conflict we have between the two demands being made by UK Uncut. It argues that if you sell in Germany you must pay UK tax, and if you sell in Britain you must pay UK tax; if you are based in the UK you must pay UK tax. On the other hand it argues that if you are based in Switzerland you must pay UK tax. It simply is not possible for all of these claims to be true: either you should pay tax where you are based or you should pay it where the business takes place.

Arcadia and Philip Green

The allegation here is that Philip Green paid a huge dividend from the company Arcadia.[5] But, instead of the dividend payment going to him, it went to his wife, Tina Green. As she does not live in the UK this dividend was not taxed, meaning that HMRC lost perhaps £300 million. This, apparently, is tax dodging.

First, we do not tax dividends from UK companies which are being paid to foreigners who do not live in the UK. We do not do it for foreigners who own BP shares; we do not do it for foreigners who own Rolls-Royce shares; so why should we do it for foreigners who own Arcadia shares? And the reason we do not do it is because we do not want to inhibit foreigners investing their money in the UK. More capital being invested means, everything else being equal, that workers in the UK are more productive. And the more productive workers are on average in an economy, the more those workers will get paid. Foreigners sending their money into the UK and investing in businesses in the UK makes us all better off. We do, however, tax the profits the companies make: and absolutely nobody has even hinted that Arcadia doesn't pay all the corporation tax it should. What is not paid is the additional tax on the dividends because those dividends are received by a non-resident.

There are two other complaints in this story. The first is that Philip Green 'gave' the company to his wife and that this is the tax dodge. But this is not true either. The company which owns Arcadia is called Taveta.[6] And when Taveta bought Arcadia, at least as far as it is possible to tell from the records, Tina Green owned Taveta. So what we have, on paper at least, is a woman who owns a company which then buys another company and she sends her husband in to run it. It is very difficult indeed to see that this is a tax dodge.

The final complaint seems to be that they are man and wife – they are not just any two potential owners of a company, they are really the same persons. The fact that Tina Green owns the company and Philip Green runs the company means that they should be treated 'as one' for tax purposes: money going to Tina Green is the same as money going to Philip Green and so tax should be paid it is argued. But the great social change of the last few decades has been that, finally, women are not treated as appendages of their husbands, fathers or legal guardians. It really wasn't all that long ago that a woman could not get a mortgage on her own. A little further back and she could not even open a bank account without her husband's signature. Part and parcel of this highly desirable move to considering women to be autonomous, independent, economic units, has been that men and women are now taxed separately, whereas 25 years ago they were not. It does not matter what your husband earns, your boyfriend, father or guardian: you as a woman will be taxed upon what you earn and you will be treated just like any and everyone else at this point.

It would be amusing to see some of the young protesters in UK Uncut trying to explain to some of the young women in UK Uncut that in order to get £300 million from Tina Green all those young women should lose their economic and tax individuality.

Barclays

Barclays is the fourth major case that UK Uncut has been complaining about.[7] There was much anger at the way Barclays had reported £11 billion in profits but seemingly only paid £100 million or so in corporation tax. The story's development was helped by the *Guardian*[8] and the protestations of Chuka Umunna[9], one of the new intake of MPs.

Once again, there is little to this story once the facts are unravelled. Of the £11 billion profit some £7 billion simply was not taxable at all. This is as a result of something called the Substantial Shareholding Exemption (SSE). If a company sells a subsidiary, or a substantial part of one, then no tax is payable on any profits from having done so. This rule was brought in by Gordon Brown and Ed Balls, Brown being Chancellor and Balls his advisor at the time. There are at least two reasons for this. First, it is important so that a company can reorganise itself without having to worry about the tax implications[10]. Secondly, the SSE makes it near impossible to claim a tax deduction on a loss when you sell a subsidiary. The system is symmetrical – no tax deductions on losses, no taxes on profits. It should also be noted that a capital gain is likely to arise as a result of anticipated future profits within the business. Those profits will, of course, be taxed when they accrue.

What made the *Guardian*'s trumpeting of the Barclays tax story amusing was that GMG, the company which owns the newspaper, had used exactly this SSE rule when it had sold off one of its subsidiaries the year before. They sold off 49% of Autotrader, making a £300 million profit, and paid no tax[11] – quite rightly, for the law said there was no tax payable, as there was not for Barclays on this £7 billion.

Mr Umunna has also managed to get himself somewhat confused. He seems to have forgotten that taxes are not paid simply on corporate profits. They are paid upon cumulative corporate profits. This is for the clear and obvious reason that companies often make a loss. So we net off their losses and profits over time, so that corporation tax is only paid on the total profits, not some artificial division of profits into any one year.

Many industrial projects take 20 or 30 years to complete. In the first few years a company might lose money (despite the attempts by modern approaches to accounting to avoid this) as the company builds the factory, trains the staff, develops the market and so on. The company might not start making profits until the fifth, sixth or seventh year of the project. So, should corporation tax be paid only on the years when the project is profitable? Or should we net off those losses against the profits and thus only tax the real profits from the project? Furthermore, if we did not allow a company to offset previous losses against profits, a company that had a steady profit stream (of, say, £50 million a year) would be taxed much less than one which had a variable profit stream (say, a loss of £50 million in year one, a profit of £150 million in year two and so on): this would be completely unreasonable.

And, of course, we do exactly the same thing within a company. If one part of a company is losing money then we net that off against another part that is making a profit. So, while there might be a profit over in one subsidiary, no tax is paid because there is a loss in another one. As, indeed, GMG has been doing for years, netting off the losses from the *Guardian* against the profits of its other businesses and thus paying no corporation tax.

Of course, the banks lost money coming out of the crash of 2008 and Barclays lost large amounts of money. This meant that they had tax losses which they could carry forward into the next tax year.

UK Uncut's arguments do not stand up with regard to any of the main focuses of their campaign. We move on now to discuss the underlying theory of taxation that might help us – and them – understand these issues better.

The economic theory of taxation

Companies do not pay tax, not a single penny. Corporations, of course, hand over the cheque to HMRC but the burden of the tax on profits is borne by the company's owners and sometimes by workers and customers. In general, the burden of other taxes is borne by consumers of the company's products or by its employees. We can see this principle easily enough with taxes such as income tax under the Pay As You Earn (PAYE) system. It is the company that hands over the cheque to HMRC but there is general agreement that in most circumstances it is really the workers who bear the burden of the tax as the money is taken out of their pay cheque.[12]

The same is true of corporation tax. It has been known for over a hundred years that it is some combination of the customers through higher prices, the shareholders through lower returns and the workers through lower wages that actually carry the burden of corporation tax. There have been a number of attempts over the years to work out exactly who and in what proportion the burden is borne. Joseph Stiglitz (who went on to win the Nobel Prize for Economics) pointed out in 1980 that it is theoretically possible for this burden upon the workers to be greater than 100%: that the amount the workers lose from their wages is higher than the total amount of corporation tax that is raised (Atkinson and Stiglitz, 1980). Mike Devereux at Oxford University has calculated that this is true in the UK today: that the burden of corporation tax falls on employees and may be greater than 100% (see, for example, Arulampalam *et al.*, 2009). Other estimates are lower. For example, the Congressional Budget Office in the USA estimates that the burden of corporation tax falling on workers is around 70% (Randolph, 2006).

It should be noted here that this is not a case of the company trying to impose the corporation tax bill on the workers. These are costs that arise naturally from the system. Average wages in an economy are determined by average productivity in that economy and labour productivity can be increased by adding capital. If capital is mobile and the amount of capital employed in a given country is reduced because of the cost of corporation tax then the amount of capital being employed will fall and this will lower the wages of labour.

This is the mechanism by which the burden of corporation tax gets passed on to the workers: not because it is intentional, but because there will be less capital, leading to lower average productivity and thus lower average wages.

Even insofar as the burden of corporation tax is not borne by workers it will be borne by the owners of a company. The owners are not necessarily well-off people but the members of pension funds, unit trust holders and so on – in other words, people saving for retirement or for a 'rainy day'. It is not 'Barclays' that would pay more tax if UK Uncut had its way but the owners of Barclays shares – in other words future pensioners – who would be worse off as a result. This is not a clever semantic trick: pensioners (and charities) today are suffering because of poor investment returns from UK equities over the last few years and increases in corporate tax would worsen their plight. One way or another it is real people – and not, in general, rich people – who bear the burden of corporate taxation.

The second thing about the economics of taxes is that all taxes have deadweight costs. This means that by having a tax we will make sure that some valuable economic activity which would have happened will not happen. This leads to lower economic growth.

Of course, we do need to have some taxes: we do have to run the government even if government is much smaller. Economists suggest that the taxes that have the least deadweight losses should be used: those that cost the least amount of economic growth for the money that needs to be raised (see Arnold, 2008). Again, it is well known within economics that there is a gradation of the deadweight costs of different types of taxation. The least cost comes from the taxation of property (council tax perhaps, although a land value tax is the one that most economists would point at as being least bad). After that, with higher deadweight costs per pound of revenue raised, come consumption taxes (perhaps the so-called 'sin' taxes on cigarettes and alcohol where demand is relatively inelastic) and then value-added tax. Then, with still higher deadweight costs, come taxes on incomes, and finally, with the highest deadweight costs of all, taxes on corporations. It is interesting that notable social democracies such as Sweden and Denmark have lower corporation taxes and higher VAT rates.

Reforming the tax system

In reforming the tax system we would probably want to raise the tax money we need at the least deadweight cost. This would involve reducing corporate taxation and income taxation and increasing property taxation.

More specifically, we might well want to abolish corporation tax. As discussed above, much of the burden is borne by employees. So if we abolished corporation tax and raised property or consumption tax rates, it would still be the same people paying the tax in the end but with a lower deadweight cost. If we tax returns to the owners of corporations then this is best done by taxing those returns – including capital gains – just like income from any other source is taxed without having specially high rates (above basic income tax rates) for taxing profits and additional taxes on dividends.

There are other possibilities that would not tax investment returns at all. A progressive consumption tax is one such possibility (for example, Shaviro, 2004). Essentially, individuals would only get taxed in any one year on what they spend. If they add to their savings in that year then that addition to savings is deducted from their income and only what is actually spent is used to calculate income tax. Equally, if money is taken out of savings then this is added to income before the calculation is made. And all returns from savings (interest, dividends and so on) are free. It is like having all of savings inside a giant ISA or pension fund.

Identifying the changes that we want to make is, at this point, less important than identifying the changes that we do not want to make. Corporations do not pay tax, ever. The corporation tax burden is borne by workers and owners. Owners should be taxed in a consistent way and not in an arbitrary way. Corporation tax reduces growth more than any other form of tax in common use. Far from demonstrating in shops to try to get companies to increase the tax they pay, we should be demonstrating to reduce the burden of taxes on companies – or to abolish it.

1. See http://www.ukuncut.org.uk/targets/tax-dodgers/vodafone.
2. See http://www.ukuncut.org.uk/targets/tax-dodgers/boots.
3. *Private Eye*, Issue 1271, 17 September 2010.
4. See http://www.ukuncut.org.uk/targets/tax-dodgers/boots.
5. See http://www.ukuncut.org.uk/targets/tax-dodgers/sir-philip-green.
6. See http://www.arcadiagroup.co.uk/about/.
7. See http://www.ukuncut.org.uk/targets/banks/barclays.
8. For example, 'Barclays Bank Forced to Admit it Paid just £113m in Corporation Tax in 2009', *Guardian*, 19 February 2011.
9. See, for example, http://www.bbc.co.uk/news/business-12511912.
10. Otherwise it is likely to defer reorganisations to avoid paying capital gains tax to the benefit of nobody.
11. See http://www.gmgplc.co.uk/gmg/faqs/#q9.
12. Again, there may be certain exceptions to this general rule such as when an employee has a very inelastic demand for labour for a particular reason. In this case, the costs of employment to the company might rise instead and the company's owners will bear the burden.

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