TAX FACULTY

Taxing corporate profits: hard choices

TOWARDS A BETTER TAX SYSTEM INITIATIVE

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The Tax Faculty's Towards a Better Tax System initiative explores major public policy issues around tax in order to inform and educate decision makers and the broader public on the way tax systems are designed and operated. For more information on this initiative, please contact Frank Haskew, Head of the Tax Faculty, at frank.haskew@icaew.com.

This paper also draws upon our expertise in financial reporting, led by ICAEW's Financial Reporting Faculty. If you have comments or enquiries on this paper, please contact Andrew Gambier on Twitter at @nairobiny, on LinkedIn at linkedin.com/in/andrewgambier, or by email at andrew.gambier@icaew.com.

TAXING CORPORATE PROFITS: HARD CHOICES

SUMMARY

Currently there is widespread public concern that many businesses, particularly large multinational corporations, are not paying enough tax on their profits. This is a serious issue at a time when public finances are under strain.

This concern is based on the idea that it is fair to levy a corporate tax based on 'how well a company has done' and the profits figures in accounts are, generally speaking, expected to provide a suitable basis for assessing this. Companies are expected to pay more tax if they are 'doing well'. However, governments also wish to use the corporate tax system to satisfy a variety of policy objectives and in doing so, they cause taxable profits to diverge from the figure in the accounts. This creates a dilemma: achieving government policy through the corporate tax system risks undermining the credibility of the tax system and company accounts because of differences between how each measures profits. Broadly speaking, government policy allows companies to pay less tax if they are 'doing good'. This can lead to complex and sometimes contradictory views of what is 'fair'.

The current situation is bad for business. Because of possible public criticism, businesses face uncertainty as to whether to respond to incentives in the tax system that allow them to pay less tax. These incentives are designed to boost investment and sustainable economic growth. Yet if businesses do not feel able to respond, there is a risk that economies will fail to reach their full potential. If responding to tax incentives also undermines trust in business, it will deprive economies of growth and jobs and erode the tax base on which tax is levied. Companies that operate internationally may face criticism in one country for the tax incentives received in another and claims that this gives them an unfair advantage over local businesses. Consequently, companies face uncertainty as to what is the 'right' course of action.

The current situation is also bad for governments. A widespread belief that some businesses are able to pay less than their fair share can undermine confidence in the tax system and 'tax morale', the belief that the tax system is fair and should be complied with. Low tax morale damages public finances by reducing the overall tax that is collected and making it more expensive to collect. Furthermore, governments are ultimately responsible both for the management of the economy and public finances and for the perceived fairness of the tax system. It is difficult for politicians to face the public if these two responsibilities are seen to be in conflict, especially if they need to reach international agreements to reconcile them.

While transparency can go some of the way to bridge the gap between taxable profit and other measures of profit, there are limits. In particular, deferred tax, which aims to explain the future tax treatment of items recorded in the accounts, does not appear to be well understood by commentators or the general public. Therefore public credibility will continue to be tested by the gap between corporation tax liabilities and reported profits.

It is in everyone's interest for there to be open well-informed debate about how to address tensions between the management of economies and perceptions of fairness in taxing corporate profits. It is vital to maintaining the public credibility of business, tax and government institutions. Drawing on its expertise in accounting and taxation, ICAEW is contributing to that debate and will work with governments, businesses and other stakeholders to do more.

WHY ARE COMPANIES TAXED ON THEIR PROFITS?

There is no major economy in the world that doesn't tax company profits, and there are good practical reasons for this.

Business comes in many forms and sizes: not just companies large and small but also other legal forms, such as partnerships and mutuals, and individuals. An individual typically pays income tax on their wages from employment. An individual who is in business as a sole trader will also pay income tax, but this is levied on their profits, not their total income, by allowing business expenses to be deducted.

If a sole trader becomes a company, it would seem sensible and fair for their business also to pay tax on its profits, just like it would have done before incorporating. This prevents an individual from obtaining a significant tax advantage from incorporating or not incorporating. It is an example of a basic principle that a tax system should not present so-called 'arbitrage' opportunities which arise because similar things are treated differently.

An alternative approach would be to abolish the tax on corporate profits, wait until profits are distributed and tax the individuals that receive them. However, this would incentivise companies to delay the payment of dividends. Taxing profits directly means that governments don't have to wait for a dividend payment to receive tax revenue from companies.

The idea that companies should pay tax on a similar basis to individuals also fits with the notion that companies are considered 'persons' under the law. While both incorporated and unincorporated businesses, like individuals, pay a lot of other taxes, including sales taxes, employment taxes and other levies, in most countries the idea that all businesses should be making a fair contribution to the public finances based on their profits is one that resonates with wider society.

WHAT ARE PROFITS?

At their most basic, profits are the amount by which a business's sales exceed its costs and they are therefore a measure of how 'well' the business has done. In measuring profits, it's important that sales, costs and other income and expense are measured fairly. This leads to careful consideration of how best to measure these items to avoid overstating or understating them and how best to match costs to sales. The accountancy profession plays a vital role in doing this to support the management of businesses.

The calculation of the profits that companies must report in the accounts required by company law is governed by financial reporting standards. These standards aim primarily to provide information useful to current and future shareholders and creditors to help them decide whether to do business with the company. While other users of company accounts, such as tax authorities, might find this information useful, standards are not written to satisfy their objectives.

WHY ARE TAXABLE PROFITS DIFFERENT?

The objectives of accounts and corporation tax are different

There is much debate over how to determine profit for financial reporting purposes. For example, many argue for prudence on the basis that it is important that income isn't recognised too early and that costs aren't recognised too late, otherwise profit will be overstated and accounting information will be less useful for current and potential investors. Others disagree and think that information should be completely neutral.

However, the objectives of corporate taxation are different. The tax system exists to serve government and, through government, society as a whole, whereas financial reporting exists to provide relevant information to members of society in their capacity as current and future investors. A tax system will need to raise tax revenue to fund projects and activities that society thinks should be operated collectively and influence economic outcomes in line with society's expectations. This means that a lot of forces will be at work in determining the tax a company will pay on profits which are adjusted for tax purposes. Policy objectives and considerations of fairness will be highly relevant.

Governments want to offer tax incentives and disincentives

Governments view taxes on company profits in the same way as any other part of their country's tax system. The two principal goals are to raise the required tax revenues for public expenditure and to use tax incentives and disincentives to encourage and discourage various types of economic activity in line with political and social priorities. For example, governments want to use taxation to incentivise businesses that 'do good', such as investing, boosting growth and creating jobs. Governments have to do this while also complying with their obligations under international treaties and keeping their economies internationally competitive. For example:

- businesses may get generous capital allowances to reduce taxable profits to incentivise them to invest in plant and machinery;
- some governments provide additional incentives to invest in R&D; and
- some costs, such as fines, penalties and directors' entertainment, may be disallowed for tax purposes.

Tax needs to be fair for companies and other taxpayers

Fairness is a complex concept that encompasses many considerations, both for the company itself and for other taxpayers. Fairness in corporate tax may lead to the following:

- removal of choices that are permitted in accounts;
- exclusion from the tax base of income and expenditure that have no corresponding cash flow, for example the charge against profits for defined benefit pensions even when no contributions are paid; and
- companies not receiving 'negative tax' on losses unless tax has recently been paid on profits.

Fairness is not judged solely on the basis of tax that is paid. Another aspect of fairness, which may conflict with this, requires that businesses can understand the tax implications of their business activities and plan accordingly. This may lead to outcomes which, in retrospect, don't appear to be fair, because it can look like the ‘wrong’ types of business have paid more or less tax than others.

A further area of complication arises because tax systems are concerned with where profits are earned and therefore which country has the right to tax them, whereas this has not been a major focus of company accounts.

WHERE DO PROFITS GET TAXED?

Small businesses get taxed where they are based

Where a business manufactures and sells its products entirely within a single country, it is clear who has the authority to tax that business’s profits: they are taxed in the country where it is based. For businesses with one-off sales in foreign countries, this basic principle is often still applied. The business accounts for all its profits in the country in which it is based and does not pay tax in any of the other countries in which it sells.

This approach has the advantage of simplicity for small businesses, which do not have to file foreign tax returns every time a customer from another country wants to buy from them. While a country may ‘lose’ tax in this way, this approach means it ‘gains’ tax from sales its own small businesses make in other countries.

More complex businesses require a different approach to taxing their activities

Larger businesses tend not to fit this simple model. Many multinational groups establish separate companies in each country in which they operate. Some centralise business functions such as manufacturing, finance or intellectual property into separate companies, which charge other group companies for the benefit of using them. Because multinational groups have profits in more than one country, it is fair that they should be taxed in more than one country.

This incentivises countries to compete against each other on tax to encourage companies both to undertake and to record economic activity in their country rather than another. The corporate tax system is often used by governments to provide incentives to invest in their country because it can piggyback off the administration of the tax system and because countries may be limited by international trade conventions or membership of regional economic groupings like the European Union from providing state aid to businesses. Again appeals to fairness are complicated. It is often only seen as unfair when other governments use tax incentives to attract business to their countries.

In order to prevent the corporation tax system becoming a ‘race to the bottom’ and to ensure that the tax system is fair, countries need a set of international tax rules to help establish a fair way to tax multinational businesses. As a result, many countries have signed bilateral tax agreements that conform to the model tax convention of the Organisation for Economic Co-operation and Development (OECD). This gives the tax authorities powers to overwrite the amounts in subsidiary company accounts where they are deemed not to have taken place on an arm’s-length basis.

These rules can occasionally fail to keep up to date with changes to modern business. The OECD’s current project on Base Erosion and Profit Shifting (BEPS) seeks to ensure that all business profits are taxed somewhere, avoiding situations where one group company claims a tax deduction for an intercompany transaction which does not give rise to taxable income in another. The development of information technology has led to some companies conducting a lot of business activity in a virtual world, involving participation by people in many different countries. Financial reporting, which is concerned primarily with a single, consolidated profit figure, does not help determine where economic activity takes place.

WHAT HARD CHOICES DO BUSINESSES AND GOVERNMENTS FACE?

The answers to the questions posed so far in this paper give rise to hard choices for business and governments, some of which are outlined below.

Should business respond to incentives or just pay their taxes?

Because of possible public criticism, business faces uncertainty as to whether to respond to incentives in the tax system that allow them to pay less tax. These incentives exist because an objective of the tax system is to encourage business to act in ways that boost investment and sustainable economic growth. Yet, if business does not feel able to behave in ways policymakers believe are best for investment and growth, then there is a risk that economies will fail to reach their full potential. If trust in business is undermined in an economy, a business may choose to invest in other markets instead, depriving the economy of growth and jobs altogether.

This problem is particularly acute internationally. A business that operates internationally faces a complex series of overlapping and competing incentives offered by different countries which, taken together, erode the tax base on which tax is charged and undermine trust. In particular, an international company may face criticism in one country for the tax incentives received in another and claims that this gives it an unfair advantage over local businesses. Consequently, businesses face uncertainty as to what is the 'right' course of action.

Can governments maintain public confidence while providing incentives to business?

The availability of tax reliefs to business helps fuel the belief that some businesses are able to get away with paying less than their fair share. This risks undermining confidence in the tax system. Lack of credibility in the tax system can be damaging to 'tax morale', the belief that the tax system is fair and should be complied with. Low tax morale reduces the overall tax that is collected and makes tax collection and the enforcement of tax law more expensive.

The dilemma is worse at an international level. In order to manage the economy to be internationally competitive, governments risk being seen as discriminating against individuals and local businesses.

IS DISCLOSURE THE ANSWER?

These choices are hard, and it may be tempting to seek to use transparency to avoid having to make them. Disclosures in accounts and elsewhere aim to bridge the gap between taxable profit and other measures of profit. In particular, the accounting concept of deferred tax seeks to explain the future tax treatment of items recorded in the accounts. There are also helpful requirements to explain why, even after taking account of deferred tax, effective tax rates on reported profits might look low.

However, while transparency can enhance credibility, it can only go so far. Deferred tax does not appear to be well understood or appreciated by commentators or the general public. Because there are so many factors that feed into the tax base, no amount of disclosure can hope to encompass them all and few readers of accounts will be able to absorb all that is disclosed. For a multinational business, its published financial information will comprise the consolidation of many companies and its tax charge will be calculated from the results of each of those companies. Public credibility will continue to be tested by the gap between corporation tax liabilities and reported profits.

WHAT NEXT?

It is easy for business and governments to try and avoid the reality of the hard choices they face by blaming each other for public perceptions of unfairness or by blaming those who administer or support tax systems. In this respect, blame can also be attached to the accountancy profession and this paper focuses on the loss of credibility that can be suffered by both company accounts and corporate taxation when the public sees levels of tax paid that are out of line with what a business might be expected to pay on its profits.

However, it is in everyone's interest for there to be open well-informed debate about why there are tensions between government responsibilities for the management of economies and for perceptions of fairness in taxing corporate profits. It is vital to maintaining the public credibility of business, tax and government institutions. Drawing on its expertise in accounting and taxation, ICAEW is contributing to that debate and will work to help businesses and governments rebuild public confidence.

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