Tax authorities failing at their basic job

The basic job of a tax authority is to collect tax. In many countries, where multinational corporations are concerned, they are failing at that job. Salman Shaheen finds out why.

Recent tax avoidance scandals heard by the court of public opinion have placed both corporations and governments in the dock. Corporations for finding inventive ways to pay little or no tax, and governments for failing to devise laws to stop them doing it. Certainly both must accept a good deal of responsibility for the size of the tax gap. But responsibility must also be borne by the bodies responsible for collecting the tax itself: the tax authorities.

Whether understaffed, under-resourced, or unprepared to go after large corporations with which they have become too cosy, in many countries tax authorities are failing at their basic job.

UK

In the dying days of 2013, following a year of headlines dominated by the tax affairs of some of the world's biggest household names, the UK Parliament's Public Accounts Committee (PAC) delivered its damning report on HM Revenue & Customs (HMRC). According to the PAC, the UK tax authority is failing at its basic task and is not fit for purpose.

The report found that the tax gap, as defined by HMRC, grew in real terms over the past year to £35 billion ($57 billion). But as this figure does not include the kinds of tax avoidance strategies employed by multinational companies like Google, Amazon and Starbucks, the report concluded HMRC has failed to recognise the true tax gap.

HMRC hit back by arguing that it can only collect that tax that is due under the law.

"The Public Accounts Committee already knows that we cannot prosecute multinational companies for activities that are lawful within the international tax framework and has itself acknowledged that the kinds of international tax planning by large businesses that it has reviewed are lawful," an HMRC spokesman said.

But the PAC's strongest criticism was not on how HMRC estimated the tax gap, but how it pursues tax. The committee accused HMRC of going after soft targets like small and medium-sized enterprises (SMEs), while letting the big multinational corporations off the hook.

"In pursuing unpaid tax, HMRC has not clearly demonstrated that it is on the side of the majority of taxpayers who pay their taxes in full," said Margaret Hodge, PAC chairwoman.

"HMRC holds back from using the full range of sanctions at its disposal," Hodge added. "It pursues tax owed by the smaller businesses but seems to lose its nerve when it comes to mounting prosecutions against multinational corporations."

The PAC has called on HMRC to be more willing to pursue prosecutions against individuals and large businesses to test the boundaries of the law and to demonstrate firm action against those who have knowingly misled or withheld information.

Source of the problem

Ray McCann, a former tax inspector at the UK tax authority who is now with Pinsent Masons, believes the problem is one of under-resourcing and understaffing.

"The government has operated a campaign to cut staff at HMRC," McCann says. "Staff numbers will have fallen from 100,000 in 2005 to 65,000 next year. But as many of these are senior staff, the problem is actually much worse. HMRC has lost hundreds of thousands of man years in experience."

McCann says he is surprised HMRC is not performing worse given such difficulties.

But Richard Brooks, also a former tax inspector at the tax authority, who has since become a journalist for *Private Eye* magazine exposing tax avoidance scandals, says the problem is not just one of under-resourcing, but one of attitude.

"HMRC has lost the appetite, at a very senior level, to take on evasion and avoidance," Brooks says. "One reason why the German army was so useless on the Eastern Front in World War II is because Hitler killed or sacked all the generals that were awkward. At HMRC, the top layer of people don't know about avoidance, or they don't care about it. And anyone who is independent-minded and wants to go after avoidance is not brought up to senior level."

Although Brooks left the tax authority in March 2005, he has continued to offer to share with them information he has uncovered on corporate tax avoidance, but HMRC has refused to meet with him. While he was there, he reports that he was made unpopular for giving opinions that did not chime with the philosophy of HMRC's leadership.

"They don't want to talk to anyone outside the cosy circle of accountants and lawyers. They don't want to collect tax and haven't realised there's a cultural problem."

Businesses praise their good working relationship with HMRC.

"Our working relationship with HMRC is professional and effective," says Paul Morton, head of group tax at Reed Elsevier. "We have a transparent approach on both sides and we work in a collaborative manner in accordance with current best practice and OECD thinking on cooperative compliance."

Morton does not agree with the idea that HMRC is too cosy with business.

"The taxation of multinational businesses involves the application of highly complex international tax law and practice to highly complex businesses so it makes sense for tax authorities and corporate tax departments to work closely together," Morton says. "This is much more effective, for both sides, when relations are good and communication lines are open. I believe that HMRC generally applies the law fairly and consistently while maintaining open and professional relationships with large businesses."

But Brooks is critical of HMRC's light touch, exemplified by the employment of a customer relationship manager (CRM) to ensure the authority does not upset taxpayers. He believes only a heavy recruitment campaign for staff not drawn from the accountancy firms will bring in the long-term cultural change necessary for the authority to do its job properly.

Richard Murphy, director of Tax Research, believes the problem is systemic and change must come at the very top. He singles out Lin Homer, HMRC chief executive, as "incompetent" and Edward Troup, HMRC's top assurance commissioner, as "disloyal".

"Second in command is Edward Troup, the solicitor who in 1999 wrote in the *FT* that "taxation is legalised extortion,"" Murphy says. "That libertarian attitude is antithetical to the job he now holds but I suspect typifies the board of HMRC where far too many of the independent directors have little experience of tax and if they do got it in the likes of KPMG, PwC and Npower. Is it any surprise that we have a tax authority that does not wish to collect tax when it is directed by people who have made their careers out of ensuring it is not paid and who do not believe in its power to do good?"

Murphy argues that, with a board that does not believe in its own brand – collecting tax – HMRC lacks the desire to go to the government and demand the resources necessary to get its job done.

"HMRC is under-resourced and under-staffed, but the top management aren't committed to their task," Murphy says. "Their loyalty is to the companies and firms where they spent their careers before going to HMRC."

The Association of Revenue and Customs (ARC), the union representing senior staff at HMRC, however, lays the blame at Parliament's door, rejecting the PAC's report as simplistic.

"If Parliament wants HMRC to really tackle the tax gap one way would be to provide it with more resources," says Gareth Hills, president of the ARC. "While corporates may be using existing legislation or structuring their arrangements in a way which allows them to use international law to their advantage, HMRC has to operate within that existing legislative framework. Any successful legal challenges may require legislative changes and, crucially, the political will to drive through such change. Additionally, it is difficult to see how any changes to the international tax rules could be made unilaterally by the UK."

The PAC is holding HMRC to account
Source: David Masters/Flickr

Switzerland

The UK's is not the only tax authority in Europe that appears to be finding it difficult to collect tax.

Like HMRC, the Swiss Federal Tax Administration suffers from understaffing. Even more curiously, however, it does not even have such a function as a tax investigator.

"The tax forms are generally speaking checked, but abusive practice is, due to time constraints, not investigated," says Rudolf Elmer, the Swiss whistleblower who in 2012 revealed the names of 2,000 tax evading clients of his former employer, Julius Bar, to WikiLeaks. "This is definitely politically wanted even though I am pretty certain that a tax investigator would easily earn his salary only by doing a reasonably good job. If the investigator is brilliant he or she would collect millions of francs for the government."

Elmer believes that, like in the UK, the Swiss tax authorities have too cosy a relationship with business.

"The facts are that I filed complaints with stately and governmental prosecution offices about abusive tax practice and provided information to tax authorities but nothing happened except I was put in prison," Elmer says. "On top of it the Tax Commission of the State of Zurich decided not to investigate the data I have provided Swiss tax authorities and Prosecution confiscated in my home because I have committed a breach of trust giving Swiss tax authorities the information of Julius Baer Cayman."

The amount of unpaid tax in question, Elmer alleges, is CHF100 million ($111 million).

"Considering other cases, therefore, it can be said that Swiss tax authorities not only are cosy with corporations, they actually help to cheat average taxpayers by not investigating avoidance," Elmer says. "The methodology is that at the end of the day it is the man in the street who has to make up for the missing taxes which actually should have been collected from large corporations."

Part of the criticism of HMRC stems from the idea that it is too close to big business because its senior figures came from the world of big business. In Switzerland, this is not so much the case; indeed it is rare for tax authority officials to come from business backgrounds.

"On the contrary, Swiss tax authority officials once they know the tax law and the loopholes, they receive attractive offers from the business and accountancy firms," Elmer says. "They could double or even triple their salaries. Consequently, the best tax experts work for business, accountancy and law firms and not for the tax authorities."

France

Across the border in France, however, advisers do not see large companies being spared by the tax authorities, with audits regularly taking place.

"To facilitate the understanding of the tax specificities of a business sector and to adapt the constraints of a tax audit to the size of these taxpayers, the French Revenue has created in 2002 a specific office dedicated to large companies, the *Direction des Grandes Entreprises*, in charge of collecting tax returns and tax payments but also in charge of the tax audits," says Sonia Bonnabry of Lexcom.

Bonnabry also points out that large companies are subject to more obligations such as transfer pricing documentation, unlike SMEs. On October 30 2013, the French Parliament passed a new Act requiring large companies to provide a minimum transfer pricing documentation package within six months of filing their annual tax return.

"In 2010/2011, it was argued by Christine Lagarde (then finance minister) that large companies were subject to an effective rate of taxation significantly lower than the one suffered by smaller companies (19% versus 40% for a standard theoretical rate of 33.33%)," says Bonnabry. "To reduce the gap, several measures have been introduced under French law such as the limitation of the interest deductibility for intra-group financial schemes or the reform of the tax losses carry-forward."

Still, however, the French tax authority, in keeping with its European counterparts, suffers from understaffing and under-resourcing.

The service responsible for handling the regularisation process for French holders of Swiss accounts is composed of 25 tax inspectors, while there have been around 11,000 requests. The Ministry of Finance wants to double the number of tax inspectors assigned to that campaign but, even then advisers do not believe the tax authority will have the manpower to handle the task effectively.

Moreover, French Revenue staff numbers have been reduced by 20% between 2003 and 2011. Officially, the number of staff was around 115,000 in 2012 for more than 18 million individual taxpayers and more than five million taxable companies.

Italy

Italy is a country that has been particularly plagued by tax evasion and avoidance. Tax evasion in 2012 amounted to more than €180 billion, which makes up 18% of total tax evasion across the entire EU.

The Italian tax authorities have focused their attention on large corporations in recent years, targeting transfer pricing matters, hidden permanent establishments and international and domestic tax avoidance.

"The need to collect more taxes from reliable taxpayers inspires the tax authorities' strategy," says Antonio Tomassini, a former officer of the Italian Tax Police and now a partner at DLA Piper. "Actually despite the significant levels of evasion in Italy, this evasion concerns mostly little taxpayers – professionals or corporations that do not declare all the revenues or deduct non-existent costs."

Given the difficulty of tracing tax evasion perpetrated by myriad individuals and small companies, the authorities have instead focused on increasing revenues by targeting large corporations where insufficient tax may have been paid because of wrongful interpretations of the law or transfer pricing issues.

"In Italy above a certain threshold even such challenges are punishable under a criminal perspective," says Tomassini. "The high uncertainty on the outcome of the litigation and also the presence of criminal investigations towards the managers (the criminal liability is personal) allow in most cases the tax authorities to collect the higher taxes and penalties challenged already within settlement agreement procedures. In the end, even if debatable in terms of general principles of taxation, this is a quite effective and fast way to collect taxes."

Another recent initiative of the authorities is a voluntary disclosure programme for people who want to regularise assets owned in blacklisted jurisdictions, paying the taxes due with reduced penalties.

Unlike HMRC, which is facing cuts, the Italian tax authority is being bolstered to deal with the country's serious evasion problem.

"Since the fight against the international tax evasion is one of the most efficient way to collect taxes, specific courses and training have been organised internally in order to improve officers' skills regarding transfer pricing, permanent establishment and international and domestic tax avoidance or abuse of right," says Alessandro Martinelli of DLA Piper.

Change

While some tax authorities in Europe are clearly performing worse than others, the scale of, and public exposure to, avoidance and evasion will continue to heap enormous public pressure on them to up their game. After all, the public are taxpayers themselves, and if they feel authorities are effective in chasing up their taxes but failing to apply the same pressure to large corporations, they will lose confidence in the system.

In some ways the hands of tax authorities are tied by government legislation. If governments cannot outlaw aggressive planning strategies, authorities are limited in their ability to challenge them. And a healthy relationship with businesses can have a positive effect on compliance. But where authorities have become too close to the business world, and where there is a lack of will to perform their basic job because they are ideologically opposed to it, authorities like HMRC will continue to come under scrutiny.

McCann does not believe the issue is an ideological one, but argues that any change at HMRC will take time and HMRC has not yet caught up with the pace of political pressures arising from the recent focus on tax avoidance scandals.

"If you want to change the dynamic of how large corporations are policed, it's like a ship, it takes time to change direction," McCann says.

Brooks is sceptical any change will come.

"HMRC will respond to the PAC with a line and some misleading figures," Brooks says. "They will remain in denial – they're waiting for the next government when Hodge won't be PAC chair."

But the chances of a Labour government shaking things up at HMRC are slim-to-none. Opposition insiders have said that Shadow Chancellor Ed Balls would not touch HMRC.

Brooks' solution is the one that led him from tax inspector to investigative journalist.

"The deterrent effect of public exposure has done more to stop tax avoidance than HMRC has done in the last 20 years."