"TAXATION & PUBLIC SPENDING" Talk at Labour Party's STATE OF THE ECONOMY CONFERENCE, held at Imperial College on 19 May 2018

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I would like to connect with a couple of themes from Lord Turner's speech earlier today. He rightly expressed concern with rising household and corporate leverage and deep inequalities in the distribution of income and wealth.

LEVERAGE

1. Some people think that the increased corporate leverage leads to higher corporate investment. No, that is not necessarily the case.

2. Higher leverage is being used by companies to secure tax relief. Interest payments attract tax relief and that reduces after tax cost of capital and increases shareholder returns.

3. UK companies are being loaded with debt even though debt is not necessarily used for any productive purposes or even in the UK. It has become a means of enhancing shareholder returns. Here are some examples:

- **Boots**, the High Street chemist, was acquired through a leveraged buyout in 2007 by a hedge fund located in the low-tax jurisdiction of Zug in Switzerland (Change to Win, Unite the Union and War on Want, 2013). It operated though entities in the low/no tax jurisdictions of Caymans, Luxembourg, Monaco and Gibraltar. Soon after acquisition Boots found itself with £9 billion in borrowings, more than 12 times the company's annual earnings, even though the loans were not entirely used in the UK. The company's annual accounts show that for the period 2008-2013, the company claimed some £4.2 billion tax deduction for interest payment resulting in a reduction of its UK tax bill by an estimated £1.12 to £1.28 billion.

- From December 2006 to March 2017, **Thames Water** was owned by Macquarie Bank based in Australia. For 11 years Thames operated through a labyrinth of companies, with some registered in Caymans. The annual accounts show that the returns for Macquarie and its investors averaged between 15.5% and 19% a year. For the period of its ownership Macquarie received estimated £1.2 billion in dividends, but this was not the only return. Thames Water was loaded with intragroup debt through entities in the Cayman Islands and elsewhere. Its debt ballooned from about £2.4 billion to £10 billion and interest payments swelled the charges for customers. Tax relief on interest payments reduced corporate tax liability. For the period 2007 to 2015, the company's accounts show that it paid £3.186 billion in interest to other entities in the group alone. This would have been paid without deduction of any withholding tax as the UK is a party to international tax treaties which facilitate the payment of gross amounts to most foreign-resident companies and individuals. Entities in the Caymans and other low/no tax jurisdictions would have received the amounts tax free. At the same time, Thames water would have been able to claim a tax deduction for the interest payments in the UK and reduce it corporation tax liability. It paid about £100,000 in corporation tax for the period 2007 to 2016.

- In June 2014, **Maplin Electronics Limited** was bought for £85m by Rutland Partners, a private equity firm. The purchase and related expenses were funded by bank borrowing and a £72 million loan from the new owners, carrying a high interest rate of 15% per annum via a labyrinth of companies. The business structure is complex but Maplin Electronics Limited was ultimately owned by Rutland Partners, a limited liability partnership (LLP). The complex corporate structure gets in the way of analysis – it is the funding model which matters here. The choice of investment through loans rather than equity (or shares) is interesting: returns to shareholders in the form of dividends are not a tax-deductible expense. But the payment of interest *is* a tax-deductible expense. This can reduce the tax bill of the company (although HMRC can challenge the interest payment deductibility).

  The loans from Rutland were 'secured'. This means that in the event of bankruptcy the shareholders – in this case Rutland in their capacity as secured creditors – get paid before unsecured creditors. The normal order of distribution places shareholders at the end of the queue. But by funding the Maplin investment through loans rather than shares, Rutland (the shareholder) placed itself at the head of the queue for its loan repayments.

  The audited accounts of Maplin's parent company MEL Topco for the years to March 2017 and 2016 show that despite operating profits of £2.4m and £6.9m, the company reported a loss before tax of £16.1m and £11m. What turned operating profits into losses?

  The answer is the company's financial model and interest charges. For the years 2017 and 2016, the interest *payable* (but not paid) to Rutland was £12.1m and £10.8m. So the reported losses were created by the funding model of the company.

  Maplin did not pay interest to its parent companies. Instead, the amounts are rolled over and added to the overall *debt*. Thus the amount of debt – in this case to Rutland – continues to grow.

  If Maplin had paid *dividends* and they found their way to Rutland, rather than being held in any of the intermediary companies, this would in theory have augmented the taxable income of the partners in Rutland (the word 'income' is important here – LLP partners are taxed as individuals, and do not pay corporation tax).

  That income would have been taxed at the highest marginal rate which is 45%. On the other hand, if the interest is not paid, and monies are instead recouped via the *sale* of the company, then partners at Rutland may claim to have made a 'capital gain'. The gains passed to its partners may well be taxed at the (lower) rate of 20%, rather than the income tax rate of 45%.

  Maplin was placed into administration. Rutland Partners, which acquired Maplin in 2014, is deemed to be a secure creditor and is claiming £102 million. Wells Fargo, Maplin's lender and another secured creditor, has received £10.6 million. Maplin's suppliers, employees and other unsecured creditors, plus HMRC, stand to lose almost £217 million.

4 Variations on the above arrangements are used by numerous companies to secure tax advantages.

5 The 2007-08 banking crash showed us that highly leveraged companies become financially unstable and cause losses to creditors, employees and taxpayers. We have an odd

situation in that regulators want banks to expand their equity base but actually incentivise them to take on higher leverage.

6 The effective reform would be to abolish tax relief on all interest payments by corporations, with the exception of interest paid on savings by retail banking. Inevitably, there would be howls of protest from businesses that have got used to public subsidies and tax avoidance.

7 Businesses receive tax relief for numerous costs (purchases, rent, rates, wages, plant and machinery) incurred for the production of goods and services, but payments of dividends and interest are distributions of profits rather than costs of producing goods/services and therefore should not receive any tax relief.

8 Whether assets are financed by debt or equity is a matter of managerial risk preferences and how the returns are to be shared by various providers of finance. Those risk preferences and profit sharing arrangements should not be subsidised by the state or taxpayers

9 Ordinary individuals cannot claim tax relief on interest payments whether for the purchase of sole residence on anything else. The rationale is that tax relief on interest payments distorts markets, creates bubbles, unfairness and financial instability. Yet the same is forgotten when public subsidies are handed out to corporations. We need to abolish the tax relief on all corporate interest payments. Without this companies will continue to play their selfish games.

10 Taxes lost through interest payments on contrived debt do not form part of the HMRC Tax Gap (i.e. taxes not collected due to evasion, arrears and other factors), which it claims is running at around £36bn a year.

11 The tax gap estimates also ignore the tax revenues lost due to related party transactions (i.e. transaction between a company and parties who can exercise significant influence on it). Here are some illustrations:

- **BHS** was bought for £200 million in May 2000 by Sir Philip Green and the shares were held in offshore companies controlled by his wife, Lady Green. Sir Philip remained the chief executive of BHS. Lady Green was resident in Monaco which does not levy income tax or corporation tax. She controlled offshore companies which were independent of the BHS Group of companies.

  In December 2001, BHS sold a number of its properties to Carmen Properties Limited, a company registered in Jersey, for around £106 million. The cash enabled BHS to pay dividends and bulk of these went to Lady Green. The properties in question were immediately leased back to BHS in return for annual rent payments. Lady Green was the ultimate beneficial owner of Carmen. Therefore, the sale and leaseback transaction was between companies under the control of the Green family. Over the lifetime of the sale and leaseback agreement (2002-2015), BHS paid £153 million in rents to Carmen. These rents were a tax deductible expense and reduced the UK corporation tax liabilities of BHS. The profits of Carmen were not taxable in Jersey as corporate taxes are normally levied on profits made on the Island. Carmen paid out its profits as dividends to its beneficial owner Lady Green, who was resident in Monaco and not liable to pay income tax on the dividends. In 2015, the board of BHS planned to sell BHS, and did so in 2016 for £1 to Retail Acquisitions Limited. The properties in questions were sold by Carmen back to BHS for £70 million. The sale proceeds (net of costs, if any)

went to Lady Green as she was the sole shareholder of Carmen. These proceeds were also tax free.

- The related party transactions at BHS were not just confined to property. There were also loans and other financial arrangements. For example, note 12 on page 16 of the 2001 accounts of Bhs Group Limited mentioned a “subordinate bond (repayable within 2-5 years)”. This bond was issued at a price of £19.5 million and carried an interest rate of 8%. The bond was redeemed during 2006 and page 30 of the 2006 accounts of the accounts stated, “Bhs Group Limited paid £28,975,000 to Tacomer Limited, a company under the same ultimate control as Bhs Group Limited”. Tacomer Limited was another company registered in Jersey. Its ultimate beneficial owner Lady Green received a return of £9.475 million. The interest payment of £9.475 million became a tax deductible expense in the UK and reduced BHS’s tax liability. At the same time, the receipt was not taxable in the hand of Lady Green resident in Monaco.

12 The transactions described BHS are not unique. Numerous companies enter into sale and leaseback and funding arrangements with related parties. However, such innocuous and legally permitted transactions can be used to secure tax advantages.

13 The above do not form part of HMRC’s tax gap estimates.

14 The only way of stopping the loss of tax revenues with the type of transactions mentioned above is through the imposition of withholding taxes on the payment of all dividends, interests and other amounts to parties located in designated jurisdictions i.e. deduct 20% tax before paying anything and pass that to HMRC. To do so, tax treaties may need to be revised.

15 There will plenty of complaining by neoliberals. But we have a choice – we can accommodate free flow of money or raise tax revenues from profits/trade in the UK to improve public services, infrastructure and redistribution.

THE TAX AVOIDANCE INDUSTRY

16 The tax avoidance industry, consisting of accountants, lawyers and financial experts, is often the driver of all kind of tax dodging schemes. Even if we abolished tax relief of interest payment and introduced withholding taxes, it will dream-up new schemes. No government will ever succeed in shackling avoidance unless it shackles the big accountancy firms. They operate with impunity.

17 On a number of occasions, tax courts and tribunal have declared the avoidance schemes designed by big accounting firms to be unlawful. Yet there has bene no investigation, prosecution, fine or anything. Accountancy profession has not disciplined anyone.

18 In 2013, the government introduced a Procurement and Tax Compliance policy. Anyone engaged in tax avoidance was supposedly going to be banned from securing public contracts. To date, no one has been barred.

19 In a weak regulatory environment, tax dodging flourishes and has been normalised. People rush to become accountants as the profession offer high rewards and no retribution. The UK already around 350,000 professionally qualified accountants, the highest per capita in the world and more than the rest of the EU put together. Around 25% of these are probably involved in “tax planning” - a euphemism for tax avoidance. The activities of these experts add nothing to GDP but they prevent elected government from delivering their promises by undermining tax revenues.

Inequalities

20 I also want to briefly touch on inequalities, another issue raised by Lord Turner. There are calls for a wealth tax. Yes, that is desirable but which wealth and how should it be taxed?

21 All wealth is not the same. Should we differentiate as some wealth may be used for social production with possible benefits for others?

Wealth may be created through

1. Innovation
2. Production
3. Trade
4. Windfalls, speculation, gains through social expenditure (e.g. the construction of M25 increased the value of land around it even though the owners did nothing)

22 So which wealth should be taxed more? Should all wealth be taxed at the same rate? Type 4 ought to be severely taxed as it is rarely the outcome of much personal labour and often benefits society the least.

23 Then the next question is how to collect data about accumulation of individual wealth. Some data is collected e.g. about income, inheritance and capital gains because of some specified events, but we know little about personal wealth. So need to think about how to collect data and also collect data about what?

24 Even the taxes that are currently levied are badly thought out. For example, capital gains are taxed at a lower rate than income. Unsurprisingly, the tax avoidance industry dreams up schemes for converting income to capital gains and thus avoid its clients to dodge taxes.

25 There is a very simple way of stopping this form of tax avoidance. Add all capital gains to the income of the taxpayer for that year. This means that capital gains would be taxed at the highest marginal rate relevant to that level of income. At least one of the tax avoidance industry’s alchemy can be laid to rest. We should be looking at develop laws that stop tax avoidance.