

Taxing Profit

Corporation Tax (CT). Companies pay tax on their trading profits.

It is accepted, of course, that tax is payable on profits before distribution of dividends to shareholders.

The tax rate is currently 19% IIRC, which is low in comparison to many similar countries. It should be at least 25% or 30%, IMHO. But there seems to be more to gain from an adjustment to the definition of trading profit than from an increase in the tax rate.

Avoidance. There may be expected to be no limit to the willingness of tax accountants and other “professionals” to use their imagination in devising clever schemes to reduce payment of Corporation Tax by

- distributing trading profit in various ways, including paying money to shareholders other than by the payment of dividends
- reducing recorded trading profit by exporting it elsewhere.

Trading profit. So there can be a large difference between the true trading profit of an enterprise, the surplus directly generated by its trading activities, and the nett profit currently calculated for the purposes of taxation. It would be significantly beneficial to the nation’s tax income if steps were taken to specify clearly some additional payments and provisions which are to be excluded from the calculation of trading profit.

DISTRIBUTIONS. There are many largely voluntary non-trading expenses which are arguably as much a distribution of profits as are dividends, and therefore equally worthy of being excluded from the calculation of taxable profit.

Items which really should be considered for exclusion include a variety of arguably gratuitous payments to staff, including directors and contractors.

Bonuses. Large sums of money are distributed as staff bonuses

If these are paid in recognition of company performance, then they are, almost by definition, distribution of profits, and so should arguably be treated as such for tax purposes. They are equivalent to dividends.

At the other extreme, if they are paid in recognition of individual performance which contributes to profitability and which are in accordance with a prior agreement, then they are, almost by definition, part of the contracted remuneration package, and so should arguably be treated as such for tax purposes. They are much like piece rates.

In between there is an infinite range of possibilities. Where to draw the line? The only way to keep things tolerably simple might be to allow individual bonuses as specified and to tax all others.

Share options. One common form of additional reward, particularly to CEOs, seems to be by share options. AIUI, the beneficiary is given the option to buy a number of shares at a prescribed date at a favourable price.

This is arguably a highly pernicious practice, because it can cause a CEO to concentrate his efforts on the company’s share price at the expense of the company’s long-term well-being.

And presumably the beneficiary is liable for CGT when he takes his profit on the shares allocated.

But who pays for the benefit provided? Assuming the allotted shares are new shares, it would seem that all the prior shares are proportionally diluted. In which case it is the shareholders who pay the beneficiary, as a reward for making their shares more valuable. So this has nothing to do with CT.

I need to find out a bit more about all this, I think.

Salary. Some people receive what look like excessive salaries.

It seems to be widely believed that these result from a competitive market for the best talent to manage companies. But do people seeking to recruit highly paid executives ever look outside the pool of highly paid executives? And how many highly paid executives are also major shareholders in the companies they manage? The true competitiveness of the market could be deemed to warrant examination.

It is sometimes claimed that excessive pay is limited by the shareholders. But is it really? The majority shareholdings are often held by financial companies the directors of whom have limited interest in restricting the pay of directors. Notional controls on excess are not guaranteed to be effective. In any case, how many highly paid executives are also major shareholders in the companies they manage?

But the question could be just how much you really need to pay somebody to manage an effective, profitable company. Of course it is a job which, to be performed well, requires considerable capability and endeavour. But so does being an airline pilot, a brain surgeon, a senior social worker, or a Prime Minister. Why are executives (and bankers) so far out of line? The answer is possibly that it is because they can be: there is a lot of money in their hands and their cut of it makes no significant difference.

So it is arguable that it would be appropriate to take away the effect of that “opportunity grab” and to disallow for CT purposes all remuneration packages in excess of (say) £200K.

The argument against this would be that an extra £1M on the CEO’s pay can lead to an extra £100M in profit, and is therefore well justified. And if it were true it might indeed be justified from a shareholder’s short-term viewpoint. But it might not be in the longer term: such results are often achieved by harmful, and often socially undesirable, means such as cutting R&D, impairing the product, or mistreating staff. In any case, it makes relatively difference to the company whether the CT is levied on the £100M or the £101M.

Consultants and other contractors. Companies often make considerable payments to individual staff operating as consultants, contractors or sole traders. Where such arrangements are for specific named individuals, whether full time or for lesser periods, there is an obvious case for treating them as for salaries for CT purposes.

For comparison with salaries the total cost to the employer should be considered, including the complete remuneration package, including all pension contributions and other benefits in kind, and the value of holiday pay and sick pay, plus even employer’s NI contribution. Or to keep it simple, the CT limit for contractors could be just (say) 50% more than the CT limit for employees.

Non-executive directors. “A non-executive director is a member of a company's board of directors who is not part of the executive team. A non-executive director typically does not engage in the day-to-day management of the organization but is involved in policymaking and planning exercises.”

They arguably should be allowed for CT purposes: good “policymaking and planning” is more likely to contribute to longer-term profitability than short-term decisions made by executives! But their contribution to the current year’s profit seems unlikely, and there is a case for disallowing them for CT purposes.

Other. What other forms of expenditure are currently disallowed for CT purposes?

My memory tells me that when entertaining expenses, other than on overseas client, were disallowed for CT purposes, a significant number of restaurants in London W1 went out of business.

Are voluntary contributions, e.g. to political parties and charities, allowable expenses for CT purposes? They should not be.

Are there items on which VAT cannot be reclaimed but are allowable expenses for CT purposes? I'm sure some will be justified.

EXPORTATIONS. Even more significant than these secondary distributions seem to be the widespread use of cynical and artful means to reduce profits by exporting them. Calculated book profits may be disreputably exported by a variety of means, of which the following common are examples.

Sales. Book profit may be reduced by underpriced sales to parent companies and other associated companies. Auditors should be required to certify that all such sales are at fair market prices. Any shortfall should be added to taxable profit for CT purposes.

Purchases. Book profit may be reduced by overpriced purchases from parent companies and other associated companies. Auditors should be required to certify that all such purchases are at fair market prices. Any excess should be added to taxable profit for CT purposes.

Interest. Book profit may be reduced by interest on unnecessary loans from parent companies and other associated companies. All such loans, for whatever reason and in whatever form, should be regarded as investment capital, and any interest disallowed for CT purposes.

Tribute money. Book profit may be reduced by tribute money such as franchise fees, or other contributions to, parent companies and other associated companies. No such payments should be allowable for CT purposes.

CONCLUSION. Some of this seems well worth pursuing. But just how much additional revenue would each of the suggested change be likely to yield?

Bill Waghorn
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I am handicapped by ignorance but not inhibited by it!

Corrections and other comments eagerly sought.