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The Failure of the UK to Tax Adequately Tobacco Company Profits

By

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The Failure of the UK to Tax Adequately Tobacco Company Profits

Abstract

Background: A key driver of the global tobacco epidemic is the massive profit earned from manufacturing tobacco products despite high levels of product taxation. Two of the four major Transnational Tobacco companies are based in the UK, where there is growing evidence of corporate tax avoidance by transnational firms and where there are calls for the industry to pay more towards the harms caused by tobacco products.

Objectives/Methods: UK tobacco company profit and corporation tax data between 2009 and 2016 is obtained from publically available sources. The intention is not to perform a piece of forensic accounting but to establish the broad pattern of profit and taxation in order to inform consideration of tobacco product and firm taxation, and hence public health.

Results: Very little profit based taxation has been paid in the UK despite high levels of reported profits, both in the domestic market and globally.

Conclusions: The UK needs better reporting and corporate taxation standards. Tobacco companies should be made to pay more profit based taxation, such as by extending the surcharge on corporation tax currently paid by UK banks, and by making sure companies pay appropriate taxes when reorganising corporate structures.

Keywords: Tobacco Industry, Taxation, Corporation Tax, Profits, UK.

The Failure of the UK to Tax Adequately Tobacco Company Profits

Introduction

Manufacturing tobacco products is inordinately profitable despite high taxation of the resulting products(1, 2). For instance, in 2015 the combined profit after taxation of the four transnational tobacco companies (TTC) –British American Tobacco (BAT), Philip Morris International (PMI), Japan Tobacco (JT), and Imperial Brands– was US$20bn (£13bn)(3-6). Such profitability has been highlighted as a key driver of the global tobacco epidemic given that public tobacco companies have a fiduciary duty to continue to seek profits for their shareholders, which currently means selling deadly tobacco products(7, 8). Furthermore, two of the four major TTCs are based in the UK, a very profitable tobacco market in its own right(9, 10), and where all four have significant market shares. In 2017 £9.5bn was generated in excise duty from the sale of tobacco products in the UK(11), while the UK Department of Health estimated the cost of smoking to the economy was in excess of £11bn per year in England alone(12) (84% of the total UK population) and other estimates suggest an even higher cost(13, 14). In light of this imbalance, the funding shortfall for the UK National Health Service(15), growing evidence of corporate tax avoidance by large transnational companies(16-21), and recent calls for tobacco companies to pay for the harm they cause(22), we explore the corporate profit taxation (corporation tax) paid by tobacco companies in the UK between 2009 and 2016. The intention is not to perform a piece of forensic accounting, but rather to use publically available information to establish if they are paying the full UK tax rate and how their tax payments compare to the harm their products cause, in order to inform consideration of tobacco product and firm taxation, and hence public health.

Background

Since 2009 the UK, like many countries, has operated a territorial tax system, meaning all firms (both tobacco and other) are required to pay UK corporation tax on just the profits earned in the UK market(23). Other countries, such as the USA, operate a global tax system so profits reported in (for example) the USA are taxed irrespective of where they originated. A further complication is that accounting standards and reporting requirements differ across countries, meaning that companies based in different countries report their performance in slightly different ways, with different levels of detail and different measures of profit(26-28).

Methods and Definitions

The intention was to identify profit earned and tax paid by the tobacco companies operating in the UK, and to compare these to the payments expected based on the published rates of UK Corporation tax(29). We therefore extracted profit and tax data from the annual financial statements and associated notes within the 2009 to 2016 annual reports/accounts of the four major tobacco companies operating there: the two TTCs (Imperial, BAT) based in the UK and their largest UK subsidiaries, and the UK subsidiaries of JT (Gallaher Ltd), and PMI (Philip Morris Limited)(3, 4, 30-58). However, all of the required information was not available as the UK government has only required that transnational firms submit details of their group activities on a country-by-country basis from December 31st 2016. Not only is this after our period of study, but this detailed information is both unpublished and also unavailable to the public due to confidentiality, making it problematic to establish the profits on which UK tax is due(24). Further opacity is created by the UK tax code which allows firms to reduce their corporation tax bills with allowances for things like research and development, and other types of investment, and by allowing these allowances to carry-over from one year to the next, meaning firms using these do not pay at the levels implied by the tax rate and their reported profit levels(25). Each set of accounts includes a taxation note offering some detail on the calculation of the tax charge included, but this does not offer detailed calculations or cover the use of such allowances so is of limited value.

We therefore utilised the reported information covering tax charges and (3, 4, 30-51)two definitions of profits (Box I): adjusted operating profit; and profit before tax, which is the basis of corporation tax payments in the UK. We first identified global profits and the associated overseas tax charge (i.e. the total amount of tax paid in all individual markets combined), and used these to calculate the effective overseas tax rate (tax charge divided by profit before tax) to provide context. We then looked at the UK using profit data to calculate the theoretical corporation tax due if it had been paid at the rates in force without any allowances/deductions. This was compared with the actual tax paid (i.e. the reported UK tax charge in the accounts), and the effective tax rate calculated (tax paid divided by profits). Inadequate and varying UK profit reporting in the annual reports required us to use previously published profit estimates where data were not reported(9, 10), and to take a somewhat bespoke approach for company specific estimates as detailed in the footnotes to the tables below. Several data series have been given as a range where an appropriate single estimate wasn't possible.

Box I here

Findings

Imperial Brands

Imperial Brands, based in the UK and long-time market leader in the UK tobacco market, has made around £3bn in global 'adjusted operating profit' from its global operations in each of the last 8 years (Table I), paying hundreds of millions in taxation to foreign governments when doing so (further details of which countries and how these were incurred are not provided in the annual reports), an effective tax rate of 16% to 51%. In the UK market, the company seems to have made adjusted operating profits of over £577m annually since 2009, likely making hundreds of millions of this as profit before tax (the latter not being directly reported), and yet has actually paid very little UK corporation tax. Indeed, despite the tax rate ranging from 28% in 2009 to 20% by 2015(29), we estimate the company rarely paid at anything like this, paying a highest effective rate of between 10.5% and 31.5% in 2009, and for three years actually receiving millions in corporation tax refunds/credits, the reasons for which are not specified.

Table I here

Take 2013: £623m in adjusted operating profit was earned from the UK tobacco market, suggesting UK profit before tax was £239m (based on the ratio between global adjusted operating profit and global profit before tax), but just £6m was paid in corporation tax. This represents just 0.96% of adjusted operating profits and 2.51% of estimated profit before tax, compared to the 24/23% rate of corporation tax due (it changed mid-year).

British American Tobacco (BAT)

BAT, the other UK-based TTC, has a relatively small share of the UK tobacco market (e.g. 8.3% in 2012(10)). Its financial performance (table II) reveals a similar but more extreme pattern. BAT made billions in global profits, including hundreds of millions estimated in the

UK market, but has paid virtually no UK corporation tax from 2010 onwards (effective rate of 0% in most years) despite paying considerable amounts of overseas tax (effective rates of 22-30%).

Table II here

Gallaher Ltd

As the main JT subsidiary in the UK, Gallaher Ltd accounts for a similar UK market share to Imperial (e.g. in 2012 JT had a 36.1% market share compared with 36.7% for imperial(10)) and although UK focussed, it reports a small international aspect to its operations(40-46, 50). Gallaher has, in all years, paid significantly more in UK corporation tax than the previous two UK based TTCs (Table III) despite being a UK subsidiary of a foreign firm. The reasons for this are unclear, but possibly relate to the history of Gallaher as an independent UK based company until 2007 and/or unknown details in the tax codes of the UK, Switzerland (the headquarters of JTI, JT's international operations), and Japan (the headquarters of JT, the ultimate parent).

Table III here

The actual UK corporation tax charge, the effective tax rate, and the theoretical tax due all vary widely year to year. One of the reasons behind this is a series of corporate restructurings that took place in 2009, 2011, and 2012, where Gallaher sold intellectual property assets (including brands) to other companies within the JT group, creating one-off exceptional increases in profit before taxation (but note, not operating profit)(43, 44, 46). The rationale behind this restructuring is not given, but might relate to the 2009 change to a territorial tax system in Japan, the home of Japan Tobacco (the ultimate parent company). In these three years of restructuring, one-off exceptional increases in profit before taxation (but note, not operating profit) were created, yet the company was able to reduce its tax liabilities on these larger profits since they paid an effective UK tax rate of between just 5 and 12%, compared with the 24% plus due(29). The exact means of reducing the tax liability in this manner is unclear, but it might relate to the ability to treat these one-off profits as a capital gain on assets rather than operating profits. Following these restructurings, Gallaher's "*profit is substantially lower than [in] prior years, reflecting lower margins earned by the company as a limit risk distributor for brands now owned by JTI SA*"(44, p.4). This is seen in the way that both operating profit and profit before tax are relatively high prior to 2011, and then significantly lower from 2013 once restructuring was complete. Thus although the effective tax rate in these latest years is higher, it is paid on a far lower profit.

These corporate reorganisations don't mean that JT was suddenly less profitable in the UK. Instead it highlights that tobacco companies, like other large companies, can use group legal structures, the complicated nature of tax codes, and accounting practices to shift corporate profit centres to other (presumably more attractive) tax jurisdictions. In this case it also suggests that in recent years the operations of Gallaher Ltd don't reflect the full profitability of JT in the UK. It is however, noteworthy that since 2013 the company has effectively been paying above the UK rates in force, and the accounts suggest that this is due to (50, p.30) "adjustments to tax charge in respect of prior years" (40, 41, 50).

Philip Morris International (PMI)

The final TTC with a significant share of the UK market is PMI (7.5% share in 2012, broadly similar to that of BAT(10)). Unfortunately, no reliable information on its current UK position are available as PMI doesn't directly report on the UK market and their UK subsidiary -Philip Morris Ltd- is very small relative to the size of its UK market share, suggesting it doesn't reflect anything like the true extent of their UK operations. For instance, in 2012 Philip Morris Limited reported revenue of £174m, with an operating profit of £4.7m(62). In contrast Gallaher, with about 5 times the market share, reported revenue of £4,740m(43), suggesting that true PMI UK revenue would be about £950m given their respective market shares. Only in 2016 does Philip Morris Ltd come close to this, when revenue was £877m, but operating profits were only £9m and tax was actually a refund of £0.6m(51) suggesting these accounts still don't fully reflect the entire actives of PMI in the UK.

Discussion

Main findings of this study

This paper makes three key findings, all of which likely extend beyond the tobacco industry. First, that reporting standards in the UK are wholly inadequate. Imperial has been allowed (from 2014) to stop reporting UK adjusted operating profits, BAT and PMI have never (to our knowledge) done so, and none of the four TTC have reported profit before tax for the UK. At the very least companies should be required to report all measures of profits for each individual market in which they operate, and the cases of JT and PMI in particular show this needs to cover the activities of all group companies when doing so. The new requirement that transnational companies notify the UK government with country-by-country information is a welcome step in the right direction, but such information needs to be made public in annual reports, and further steps are needed.

Second, the example of JT and Gallaher Ltd highlights that companies can easily re-organise their corporate structures in ways that result in profits being shifted overseas. The UK government needs to learn from these practices and make sure they can't occur without paying an appropriate amount of tax. Unfortunately, such events might become more common as the UK adopted a 'patent box' regime from 2013 which now charges lower levels of corporation tax (10%) on the sale of intellectual assets(63).

The third key finding is that the major tobacco companies operating in the UK are generally not paying UK corporation tax at anything like the level their reported profitability might initially suggest. For the last seven years Imperial has only paid an effective rate of 20.45% and generally a lot lower, BAT has paid virtually nothing, while PMI's subsidiary reports its UK profits in a way wholly out of line with the size of its UK market share. Only Gallaher has paid at anything like the UK rate in the recent years, and that is only since it completed a corporate restructuring during which it paid at rates as low as 5%. The exact reasons behind such poor levels of industry taxation are unclear but it is likely to do with the territorial nature and other details of the current UK tax code, and the corporate structures adopted. The lack of tax revenue generated from such a profitable industry, together with reports of firms in other industries being similarly positioned(16-20), suggests that UK corporation tax policy needs urgent reform to make sure all firms pay meaningful amounts.

What is already known on this topic

The production of tobacco products is already known to be inordinately profitable and these profits have been identified as a key driver of the global tobacco epidemic and hence the associated harms to public health. Information on tobacco use and associated policies has also been highlighted as being a key element to addressing tobacco use(64). Large transnational companies, such as Google and Facebook, have been identified as paying little UK corporation tax despite being very successful in this market(16-21).

What this study adds

The issue of corporate taxation appears has been identified as being particularly acute for the tobacco industry given that it is causing immense societal harm, the cost of which is significantly borne by the public purse despite high levels of taxation on tobacco sales. The shortfall between the societal costs of tobacco and the excise revenue generated from tobacco of at least £1.5 billion in England alone(11, 12) is clearly not addressed by the paltry sums of UK corporation tax being collected and illustrates how much of the costs of tobacco are still externalised. Imperial, BAT, and Gallaher collectively paid just £83.6m in corporation tax in 2016. The very low rates of UK corporation tax paid despite high profits stand in contrast to the larger reported sums (and higher rates of up to 51%) paid in overseas profit taxes by the British based TTCs. This and the fact that tobacco companies based elsewhere pay significant amounts of domestic tax suggests this is not an insurmountable issue and that the UK government is particularly poor at taxing this and most likely other industries too. For example: in 2015 Swedish Match reported an accounting profit of (Swedish Kroner) SEK3,545m on which they paid SEK742m income tax at about the Swedish rate of 22%(65, p.70); US based Altria reported earnings of $8,078m in 2015 on which they paid $2,835m in income taxes, a rate of 35%, which includes both federal, state, and local taxation(66, p.59). Taxation of international companies is clearly complex, and is the result of many factors, including the system of taxation adopted and the details of the tax codes in force in their country of residence (and their merits relative to other possible locations). Nevertheless, OECD and EU co-operation and co-ordinated corporate tax reforms(28, 67, 68), plus additional domestic UK measures like the recently introduced diverted profit tax(69) suggest real progress in reforming corporate tax is possible if there is sufficient political will.

Given the inherent incentives of high industry profitability and the funding shortfall facing the NHS, there is both the scope and need to have tobacco companies make a greater contribution towards the harm they cause, and it is likely to be popular with the voting public too(70). There are a number of ways this could be achieved. For instance, a corporation tax surcharge, like the additional 8% currently charged on the domestic operations of UK banks(71), could be extended to the UK market operations of the tobacco companies. Based on the corporate profitability of the UK market outlined above, an 8% corporation tax surcharge on UK adjusted operating profits could have raised up to an additional £74m in 2013 if no allowances or deductions were allowed, thereby increasing the tax take by more than 100%. The intention should be to increase this rate (over time) to ensure that the companies more meaningfully meet the societal costs they are responsible for. This larger surcharge could be applied only on the profits from combustion tobacco sales, with a smaller surcharge applying to profits from reduced risk products in an attempt to reflect their relative harm and encourage a corporate shift away from combustible tobacco(8, 72).

Limitations of this study

The present study is limited by the available public data on tobacco company profitability and tax liabilities/allowances, both globally and for the UK market in particular. These limitations mean that estimates have had to be made where reported data is lacking, so care is needed when considering some of the detailed findings herein. Furthermore, the limited data prevents more detailed exploration of issues such as: the utilisation of tax allowances; taxation of international activities; intertemporal tax liabilities; or impact of corporate restructurings.

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Competing Interests:

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Table I: Imperial Brands profitability and corporate taxes paid

	2016	2015	2014	2013	2012	2011	2010	2009
Global Adjusted operating profit	£3,541m	£3,053m	£2,981m	£3,180m	£3,161m	£3,103m	£3,067m	£2,933m
Global Profit before tax	£907m	£1,756m	£1,525m	£1,219m	£1,081m	£2,153m	£2,118m	£945m
Actual Overseas taxation charge	£467m	£449m	£405m	£472m	£490m	£350m	£534m	£346m
Effective Overseas Tax rate	51.49%	25.57%	26.56%	38.72%	45.33%	16.26%	25.21%	36.61%
UK adjusted operating profit	£630m*	£637m*	£625m*	£623m	£627m	£577m	£614m	£601m
Estimated UK profit before tax$^{\varphi}$	£161m	£367m	£320m	£239m	£214m	£400m	£424m	£194m
Theoretical UK corporation tax due (% rate)$^{\alpha}$	£32m-£126m (20%)	£73-£127m (21/20%)	£67-£131m (23/21%)	£55m-£143m (24/23%)	£51-£150m (26/24%)	£104m-£150m (28/26%)	£119m-£172m (28%)	£54m-£168m (28%)
Actual UK corporation tax charge	£33m	£36m	£7m	£6m	-£112m	-£29m	-£37m	£61m
Effective UK Tax rate$^{\beta}$	5.24%-20.45%	5.65%-9.82%	1.12%-2.19%	0.96%-2.51%	-17.89%--52.23%	-5.03%--7.24%	-6.03%--8.73%	10.5%-31.5%

Source: (3, 26-31, 45, 49-55, 58)

* Estimates (Imperial stopped reporting UK data in 2013) calculated using the reported gross profitability of the main UK subsidiary of Imperial, adjusted because on average between 2013-2009, these represented only 134.44% of the final figure reported by the group overall.

φ: Estimates produced by assuming the same relationship between UK adjusted operating profit and profit before tax exists as is the case at the global level.

α: Theoretical UK tax due estimates what would be payable on UK adjusted operating profit (high level) and UK profit before tax (lower level) if no allowances/deductions were allowed. Corporation tax rate changes all took

place on the 1st April, meaning two rates applied to individual company financial years which run from October to September. In such cases, the lower rate was applied for the full year.
β: Calculated using reported adjusted operating profit (lower rate) and estimated profit before tax (higher rate).

Table II: BAT profitability and corporate taxes paid

	2016	2015	2014	2013	2012	2011	2010	2009
Global adjusted profit from operations	£5,480m	£4,992m	£5,403m	£5,820m	£5,641m	£5,519m	£4,984m	£4,461m
Profit before tax	£6,245m	£5,855m	£4,848m	£5,799m	£5,592m	£4,931m	£4,388m	£4,080m
Actual Overseas taxation charge (Million)	£1,395m	£1,324m	£1,450m	£1,567m	£1,538m	£1,470m	£1,294m	£1,147m
Effective Overseas Tax rate	22.34%	22.61%	29.91%	27.02%	27.50%	29.81%	29.49%	28.11%
Estimated UK adjusted operating profits*	n/a	n/a	n/a	£78.2m - £152m	£72.7m- £141.4m	£57.5m - £111.9m	£50.2m - £109.8m	£40.2m - £105.7m
Theoretical UK corporation tax due (% rate due)$^{\gamma}$	n/a (20%)	n/a (21/20%)	n/a (23/21%)	£26.4m (24/23%)	£25.7m (26/24%)	£22.0m (28/26%)	£22.4m (28%)	£20.4m (28%)
Actual UK corporation tax charge	£7m	£5m	£0	£0	£0	£0	-£16m	£16m
Effective UK Tax rate$^{\delta}$	n/a	n/a	0%	0%	0%	0%	-20.00%	21.93%

Source: (4, 10, 26, 32-36, 46, 59)

* BAT does not report profit by country so previously published estimates have been utilised where available(10). The main BAT subsidiary in the UK, British American Tobacco UK Limited(60), offers no meaningful insight given the reported figures are not in keeping with the size of BAT's market share in the UK – see section discussing the performance of PMI for illustration.

n/a Estimates unavailable

γ: Theoretical UK tax due estimates what would be payable on UK adjusted operating profit if no allowances /deductions were allowed. Global profits before tax and adjusted operating profits do not differ hugely during the period of analysis so these represent reasonable estimates even though they are based on adjusted operating profits rather than profits before tax on which corporation tax is payable. Corporation tax rate changes all took place on the 1st April, meaning two rates applied to individual company financial years which run from January to December. In such cases, the lower rate was applied for the full year. Since profit estimates are a range, the mid-point has been used.

δ Note, this is calculated using adjusted operating profit rather than profit before tax on which corporation tax is payable since the latter was unavailable. At the Global level these do not differ hugely during the period of analysis so these represent reasonable estimates. The mid-point of the profit estimate was utilised.

Table III: Gallaher Ltd profitability and corporate taxes paid

Year	**2016**	**2015**	**2014**	**2013**	**2012***	**2011***	**2010**	**2009***
Global Adjusted Operating Profit	£172.1m	£181.5m	£174.1m	£175m	£172m	£160m	£404m	£372m
Global Profit before taxation	£165.1m	£196m	£136.4m	£158m	£643m	£2,404m	£440m	£752m
UK adjusted operating profit	£153.6m	£161.4m	£152.8m	£152m	£156m	£140m	£345m	£312m
Estimated UK profit before taxation$^{\lambda}$	£147m	£176m	£115m	£135m	£627m	£2,384m	£381m	£692m
Theoretical UK corporation tax due (% rate due)$^{\varepsilon}$	£29.3m (20%)	£35.2m (21/20%)	£24.17m (23/21%)	£31.05m (24/23%)	£150.5m (26/24%)	£619.8m (28/26%)	£106.7m (28%)	£193.8m (28%)
Actual UK corporation tax charge	£43.6m	£51.3m	£68m	£33m	£33m	£280m	£78m	£77m
Effective UK Tax rate	29.74%	29.16%	59.08%	24.44%	5.26%	11.74%	20.47%	11.13%

Source: (26, 37-43, 47)

* In 2009, 2011 and 2012 Gallaher Ltd sold assets to other subsidiary companies in the JTI group, creating one-off exceptional increases in profit before taxation (and hence large differences between Operating Profit and Profit Before Taxation).

λ: Given the overwhelming UK focus of the company, calculated by removing the overseas adjusted operating profit (i.e. different between UK and global) from global profit before tax.

ε: Theoretical UK tax due estimates what would be payable on UK Profit before tax if no allowances /deductions were allowed. Corporation tax rate changes all took place on the 1st April, meaning two rates applied to individual company financial years which run from January to December.