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THE IRISH ACCOUNTING AND FINANCE ASSOCIATION

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The Irish Accounting Association was founded in 1987 to bring together academics from all parts of Ireland in order to advance teaching and research in accounting and related disciplines. In 1991, the name and objectives were changed to include finance.

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Membership is open to those engaged in teaching, research or educational administration in accounting, finance or related disciplines and to those engaged in similar activities acceptable to the Council for membership purposes.

The Association now has members in virtually all third level colleges that employ accounting and finance academics in both Northern Ireland and the Republic of Ireland. The annual membership fee is €35/£25.

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The *Accounting, Finance & Governance Review* is dedicated to publishing high-quality original scholarly work in accounting, finance and governance. It is eclectic and pluralistic. Papers in all categories of scholarly activity will be considered, including (but not limited to) reports on empirical research, analytical papers, review articles, papers dealing with pedagogical issues and critical essays. Possible topics include financial accounting, management accounting, finance, financial management, capital markets research, governance, performance management, auditing, taxation, public and not-for-profit sector accounting, social and environmental accounting, accounting education and accounting history. The journal encourages critical assessment of current practice, investigations of the impact of accounting, finance and governance on the socio-economic and political environment, and analysis of the implications of policy alternatives. Papers drawing on evidence from specific national settings or wider comparative international settings are welcome.

All submissions that pass an initial editorial scrutiny will be subject to double-blind refereeing. Referees will be asked to assess papers on the basis of their relevance, originality, readability and quality (including, for empirical work, research design and execution).

All submissions to the *Accounting, Finance & Governance Review* should be made to any one of the editors (by email):

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Notes for Contributors are contained on pages 111–112.

CONTEMPORARY ISSUES IN TAX RESEARCH

Guest Editor: Dr Elaine Doyle
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Taxation is pivotal in any economy and has a direct impact upon the lives of every individual. Public and media interest in tax has soared recently as a result of high-profile cases involving companies such as Apple, Starbucks, Amazon, Google and Facebook. Company executives have been questioned by the United Kingdom (UK) government's Public Accounts Committee and the United States (US) Senate regarding their corporate tax policies. Furthermore, the recent Organisation for Economic Co-Operation and Development (OECD) Base Erosion and Profit Shifting project (BEPS) has put global tax policy firmly on the agenda in both the international and domestic tax spheres, making this an exciting time for anyone with an interest in tax.

Arguably lacking a single disciplinary domain, tax is fertile ground for interdisciplinary research (Boden, Killian, Mulligan and Oats, 2010; Oats, 2012). Involving as it does complex questions of policy and practice, it draws from many disciplines, including law, economics, political science, social policy, psychology and philosophy, as well as accounting and finance (McKerchar, 2008). These diverse disciplines embrace different research paradigms, utilise different language and have differing perspectives, which makes tax research challenging but also exciting (Hanlon and Heitzman, 2010). The interdisciplinary nature of tax research is clearly evident from the range of contributions included in this special issue.

The motivation for this special issue was prompted by an increase in the number of tax papers being presented at the annual conference of the Irish Accounting and Finance Association and its accompanying doctorial colloquium – an extremely welcome development. It has been acknowledged that the life of a tax academic can be a lonely one. Research mentoring, access to collaborative networks and supportive colleagues are all important in nurturing both the current and the next generation of academics. In many higher level institutions, only one tax academic is required to support tax teaching on business programmes (Sadiq and Freudenberg, 2014). Tax academics may therefore need to look outside their individual institutions to find a critical mass of tax researchers to provide these necessary supports. This makes conferences that support tax researchers, and special issues such as this one, particularly important.

Turning to the papers included in this special issue, Professor Peter Clarke sets the context nicely by outlining the historical development of the Irish taxation system from the pre-Norman period to the present time. The author observes that, relative to other developed countries, very little has been written about the historical development of the Irish tax system. To remedy this, the paper outlines the background context and historical evolution of the Irish tax system with particular reference to the origin of the taxes that sustain our economy today. This historical perspective gives us a better understanding of our current tax system and explains why it evolved as it did to its current iteration. The second paper in this issue, contributed by Professor Penelope Tuck, provides an empirical study of the UK tax authority (Her Majesty's Revenue and Customs (HMRC)) in its capacity as a government regulatory agency and examines how external stakeholders respond to policy-driven change in a manner that potentially threatens organisational legitimacy. The paper focuses upon HMRC's move away from its traditional regulatory role towards enabling its 'customer', the corporate tax payer, to 'shelter' tax. The author positions this move as an organisational identity change. In theorising how organisational identity might be viewed by external stakeholders, the paper examines the need for a public sector organisation to maintain a 'virtuous' identity in order to retain legitimacy. This is deemed as particularly important in the case of tax collection, where there is a social contract between citizens and the State. If the State is discredited then taxpayers may not be so willing to pay their taxes to fund public goods. The paper suggests that policy makers need to recognise that their power in defining organisational identity has its limits in public service organisations, where the public and media are likely to debate their moral purpose.

The paper contributed by Professor Jane Frecknall-Hughes examines why and how accountants met the increasing need for tax advice and claimed this work domain as part of their professional jurisdiction. It explores the activities of UK accountants in the late nineteenth and early twentieth centuries to determine the nature of the tax work undertaken by accountants by looking at evidence provided by *The Accountant*, the accountants' professional journal. This journal provided information on tax and other activities at a time when accountants were establishing their credentials as a new profession. The paper considers issues surrounding income tax in this period, on the basis that the complexities associated with income tax provide the wider context and backdrop for accountants' activities. During much of the period covered by this paper (up to 1922), Ireland was part of the UK so both countries had the same fiscal income tax code, and professionals dealing with this tax throughout the UK would have been beset by the same issues.

The fourth contribution to this special issue (from Tom Collins and Dr Emer Mulligan) explores the rationale for Ireland's introduction of transfer pricing legislation in 2010, using the lens of new institutional theory. Transfer pricing practices are important because they dictate the level of corporate profit within a particular jurisdiction, thereby influencing the amount of tax that can be collected by the tax authority in that jurisdiction. Qualitative semi-structured interviews were conducted with senior tax advisors in order to explore the issues leading to the introduction of the transfer pricing legislation in Ireland. The findings suggest that Ireland's need to achieve and protect its international legitimacy as a mature fiscal jurisdiction underpinned the rationale for the introduction of transfer pricing. Both coercive and normative isomorphic forces were also at play in the introduction of the rules, emanating from mounting institutional pressure from various parties including the OECD, Group of 20 (G20), International Monetary Fund (IMF) and other governments.

Intercompany debt financing has long been used as a mechanism by which multinational corporations can minimise their corporate tax liability. The final paper in this issue (by Eoin Foley, Dr Thomas McCluskey, Patrick Mulcahy and Pauline Willis) examines the capital structuring decisions of foreign-owned UK companies in the context of a 2004 change to the UK's thin capitalisation rules. These rules limit the tax deductibility of debt interest in cases where debt financing is considered excessive. The study examines the effect of the legislative amendment on the debt–equity ratios of UK foreign-owned companies by conducting a longitudinal study of a sample of 432 companies during the period 2001–2010.

I would like to extend my sincere gratitude to all the reviewers who generously contributed their time and expertise to this special issue (Joan Ballantine, Patrick Buckley, Peter Clarke, Tom Collins, Peter Daly, Jane Frecknall-Hughes, Margaret Healy, Sheila Killian, Martin Mullins, Lynne Oats, Fergal O'Brien and Philip O'Regan). I am extremely grateful to the editors of the *Accounting, Finance and Governance Review*, Ray Donnelly, Noel Hyndman and Ciarán Ó hÓgartaigh, for inviting me to be the guest editor of this special issue. I am particularly pleased that this special issue includes papers from both Irish and international scholars and from both early career and more experienced academics. The papers included embrace a range of methodological approaches and will have appeal to the journal's wide and varied readership. I hope you enjoy the papers as much as I have enjoyed editing this special issue.

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THE HISTORICAL DEVELOPMENT OF THE IRISH TAXATION SYSTEM

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ABSTRACT

Relative to other developed countries, very little has been written about the historical development of the Irish taxation system. This is surprising since an early reference to an Irish taxation system is contained in the records of the City of Dublin in the year 1316. These records state that 'taxes be collected under the supervision of four or six good men duly sworn and that accounts be rendered of receipts and payments before their auditors' (Gilbert, 1889, p. 133).

In an attempt to partly fill this historical void, this paper explores the development of the current Irish taxation system from the pre-Norman period to the present time. By providing such a background, this paper seeks to provide a broader understanding of our taxation system and tries to explain why we have the taxation system that we currently have and the context in which it developed. It will be demonstrated that the Irish taxation system has evolved in response to economic, social and political influences. It also highlights that the Irish taxation system has a rich and colourful past, but it is not unique in this regard.

INTRODUCTION

Relative to other English-speaking developed countries, very little has been published on the taxation history of Ireland. This omission is surprising since an early Irish reference to our taxation system is contained in the records of the City of Dublin in the year 1316, which states that 'taxes be collected under the supervision of four or six good men duly sworn, and that accounts be rendered of receipts and payments before their auditors' (Gilbert, 1889, p. 133). To date, the main reference work on the history of Irish taxation has been written by Seán Reamonn (1981) – a former chairman of the Revenue Commissioners – entitled *History of the Revenue*

Commissioners; but he writes that his book is not a history of taxation in Ireland but, rather, is a history of the Revenue Commissioners, which begins with their establishment in 1923. More recently, O'Halloran (2005) provides us with a shorter but broader commentary on the theoretical framework of modern Irish taxation policy with reference to important criteria such as equity, efficiency and simplicity. This book also includes novel chapters on, for example, carbon taxes and e-commerce.

A number of shorter publications on Irish taxation history may also be noted. For example, Holden (1953) investigated aspects of property taxes in Dublin during the seventeenth and eighteenth centuries, including the separate hearth and window taxes. Ellis (1977) reported on the payment of scutage, which was a form of taxation that allowed a person to 'buy out' of the military service due to his lord or king. In technical journals, O'Broin (1983) discusses the relationship between the tax collecting agencies and the taxpayer and reviews the powers of the Revenue Commissioners with regard to tax avoidance and evasion contained in the Irish Constitution with corresponding practice in the United Kingdom (UK). De Cogan (2013) provides an in-depth analysis of the origins of corporation profits tax, which was introduced in Ireland in 1920. Clarke (2006) details the introduction of export profits tax relief in Ireland in 1956. This innovative legislation was one of the most important factors in the significant economic transformation of Ireland in the last decades of the twentieth century (MacSharry and White, 2000). Also, some unpublished theses should be mentioned. In a pioneering study, Kepple (1937) comprehensively reviewed the context and content of the early budgets of the Irish Free State from 1923 to 1935, while MacHale (1947) outlined, using questions that appeared on professional accountancy examinations, the (then) technical aspects of income tax, supertax/surtax, and corporation profits tax in Ireland. Clarke (1984) discusses the nature, history, reasons for and implications of income tax evasion in Ireland. More recently, the circumstances leading to the imposition of income tax on Ireland in 1853 have been discussed: this imposition represented a set-off against the remission of certain loans to Ireland from the British Exchequer for relief expenditure during the Irish Famine (Clarke, 2014). One should also note that there are many studies dealing with modern Irish taxation policy. For example, Hardiman (2002) reviews the development of the Irish tax system from the early 1960s and, using a variety of Organisation for Economic Co-Operation and Development (OECD) *Revenue Statistics*, reports that both total tax revenue in Ireland, as a percentage of gross domestic product (GDP), and the yield from personal (income) tax has increased substantially from 1965 to 1999. In an earlier paper, Hardiman (2000, pp. 822, 836) concluded that 'the narrowness of the personal income tax base in Ireland on those paying through the PAYE [Pay As You Earn] system is a good deal heavier than the aggregate figures might lead us to suspect' and comments on the 'injustices and inefficiencies of the PAYE system'. More recently, de Cogan (2013) comprehensively examines, in an Irish context, the wartime excess profits duty, which was succeeded by a corporation profits tax in 1920.

The growing importance of taxation history is highlighted in these islands, for example, by the bi-annual Tax History Conference at Cambridge University, in which a wide variety of papers are presented to an international audience of scholars. Knowledge of the historical perspective of taxation is important for three main reasons. First, as stated by the influential Accounting Education Change Commission (1990, pp. 308, 310), 'an appreciation of the flow of ideas and events in history [and] a knowledge of historical and contemporary events [is] essential to effective teaching'. At a minimum, an understanding of taxation history provides us with interesting facts and anecdotes to make our lectures more interesting. For example, the American War of Independence (1775 –1783) might have been averted by timely concessions from London on the controversial issues of tax and representation (Ferguson, 2012). Moreover, income tax was introduced in the United Kingdom in 1799 as a temporary measure to finance the Napoleonic Wars (Sabine, 1966). In addition, after years of unsuccessful efforts to jail the notorious Chicago criminal Al Capone, he was finally jailed in 1931 due to his failure to file income tax returns (Irey and Slocum, 1949). Second, knowledge of taxation history allows us to understand how and why certain issues were addressed in the past, and this understanding may enable us to avoid repeating past mistakes. This is particularly relevant when one appreciates that any taxation system is a human invention and evolves in response to changing needs and demands in society. Third, the study of taxation history can be viewed as offering an added intellectual input to our courses, and this is an appropriate response to a criticism that we teach only the technical aspects of taxation in order to obtain exemptions from professional bodies. Tinker (1985) colourfully suggests that our accounting students are becoming more like technical greyhounds, but are ignorant in relation to social analysis.

The purpose of this paper is to outline the context and historical development of the Irish taxation system from pre-Norman times to the present, with particular reference to the origin of different taxes that remain in modern Ireland. This historical orientation seeks to provide a better understanding of our tax system, and attempts to explain why we have the tax system that we have. The Irish tax system now generates some €38 billion per annum, which is summarised in Table 1.

TABLE 1: ANNUAL EXCHEQUER TAX RETURNS (2013)

Type of Tax	€m	%
Income tax (including Universal Social Charge)	15,758	42%
VAT	10,336	27%
Excise duties	4,891	13%
Corporation tax	4,270	11%
Stamp duties	1,340	3%
Capital gains tax	369	1%
Local property tax	318	1%
Capital acquisitions tax	279	1%
Customs duties	246	1%
Total Exchequer tax returns	*37,807*	*100%*

Source: Department of Finance (2013)

While Frecknall-Hughes (2014) outlines the different methods that researchers may use to investigate taxation history, this paper does not adopt a preferred conceptual framework. Rather, due to its pioneering nature, this paper seeks to highlight the economic, social and political influences that have shaped the evolution of the current taxation system in Ireland. The paper is divided into four main sections based on chronological convenience. The next section briefly outlines the Irish taxation system prior to the Napoleonic Wars. This is followed by a section that highlights taxation developments in the nineteenth century, with special attention given to those associated with the Napoleonic Wars and the introduction of income tax. This section will also review changes in capital taxes that occurred in the late nineteenth century. The section thereafter discusses the taxation system in the newly created Irish Free State (post 1922). The final section explains changes to the Irish taxation system post World War II, which were initially introduced to stimulate a flagging domestic economy and thereafter to allow Ireland's admission to the then European Economic Community (EEC) on 1 January 1973. A short concluding section ends this paper.

THE IRISH TAXATION SYSTEM BEFORE THE NAPOLEONIC WARS

The kings and chiefs of ancient Ireland collected their taxes using the simple expedient of forced hospitality extracted from their subjects (Chart, 1920). Between New Year's Day and Shrove Tuesday, these nobles, together with their entourage, would go on a circuit of their subjects and it was the duty of these subjects to provide adequate hospitality for their important visitors. Whatever the subject felt about this unusual form of taxation, there was very little he could do to escape its imposition except to change 'tax residency' – to use modern terminology. In an early analysis of revenues and finances of Ireland (Clarendon, 1791, p. 1) it was noted that none of 'the objects that anciently contributed to the treasury of its kings' remain 'in the fiscal code of the present day'. However, this early Irish society would undergo a radical transformation due to the Anglo-Norman invasion around the middle of the twelfth century. It is important to highlight two things about this Norman 'invasion'. Firstly, it began as a casual, almost accidental, affair (Moody and Martin, 1967). Simply, the Normans were invited to Ireland in order to assist a local lord in his struggle for political supremacy. They came with some reluctance but, having done so (in May 1169), they stayed. Secondly, it is sometimes stated that the Normans only brought violence and division to the island of Ireland. Rather, to their credit, the Normans were the first to give Ireland a centralised administration – strong, unified and methodically organised (Moody and Martin, 1967). Towns were established and their growth facilitated an expansion in trade so that commerce and agriculture began to prosper. From a taxation point of view, the introduction of coinage enabled custom duties from trade, both domestic and overseas, to be more easily collected and these provided the greater part of the tax revenue. In rural areas the Normans replaced the great nobles and existing tenants were liable to render services to their overlord. However, the payment of 'scutage' – a tax paid by a feudal tenant in place of military service – was permissible (Chart, 1920). A reference to scutage in Ireland first appears in 1222 and by the second half of the thirteenth century scutage had become a regular part of the revenue (Ellis, 1977).

Considerable research on Irish medieval tax revenue has been undertaken by Richardson and Sayles (1962). Based on their analysis of the surviving records of that period, they estimate the average annual tax receipts between 1278 and 1299 to be about £6,300; between 1299 and 1315 they estimate an annual figure of £4,190; and between 1315 and 1384 an annual figure of about £2,300 may be computed. According to many historians, this revenue decline was largely due to the shrinkage of the area over which the Norman administration retained control. Large parts of the country had returned back to Irish hands, which resulted in laws being unenforced and taxes remaining unpaid (Curtis, 2002). It required the Tudor dynasty to restore more effective rule in Ireland and by the end of Elizabeth I's reign in 1603, the English had undisputed rule of the entire country.

During the early 1600s, and prior to the Restoration (1660s), the Irish tax revenue fluctuated between about £35,000 and £70,000 per annum and included, for example, various custom duties and licenses (McGrath, 2000). The term 'custom' meant that they had been levied for a long time but, subsequently, custom duties were imposed by legislation. According to Treadwell (1976–1977), the first enactment levying customs in Ireland dates back to Henry VII (in 1500), which represented a 5 per cent duty on certain imports and exports. However, he notes that there were many 'havens' beyond the administrative reach of the Dublin and local officials.

The financial settlement of the Restoration of Charles II in 1662 contained the foundations for a secure and significantly increased tax base. Custom duties, on goods imported and exported, were regularised, expanded, consolidated and granted to the Crown in perpetuity in the 1662 Customs Act. The legislation also contained a substantial and permanent 'book of rates' for the guidance of collectors and provided rules for assessment and collection (McGrath, 2000). In addition, an excise duty, which had first been introduced in Ireland in 1643, was regularised and consolidated in the 1662 Excise Act. This Act imposed excise duties on a wide variety of items imported and home produced, including beer, ale and spirits (Donnelly, 1954). In addition, parliamentary 'additional duties' were adopted in Ireland in the 1690s and thereafter. These additional duties represented an increased levy upon the existing duties for a specific period of time, so as to provide an additional amount of tax revenue. The first additional duties imposed by the Irish parliament were contained in the 1690 Additional Excise Act, which levied additional duties on beer, ale and spirits, while subsequent legislation increased duties on tobacco and wine among other commodities (McGrath, 2012). In modern times similar duties still remain and have been extended to hydrocarbon oils. The result of these fiscal innovations was that the tax revenue of the country increased significantly and this growth is highlighted in Table 2, which covers the years 1691 to 1791, with 20-year intervals. Table 2 (adapted from Kane, 2014) demonstrates that customs, excise and additional duties – taxes on spending – dominated the Irish taxation system throughout the 1700s.

Two other taxes, around this time, can be briefly mentioned because they represent a form of property (wealth) tax rather than tax on spending. A 'hearth tax' was introduced in 1662, which imposed, with certain exemptions, a tax on the owner or occupier of every house for every hearth or other place for firing and stoves. As indicated in Table 2, it generated considerable revenue even though the tax collectors had revealed 'laziness, ignorance and corruption' in their administrative role (Dickson, Ó

TABLE 2: IRISH TAX REVENUES (1691 TO 1791) IN £

Type of Tax	1691	1711	1731	1751	1771	1791
Customs	38,012	88,874	102,703	174,850	235,983	255,370
Excise	57,739	134,949	194,524	275,676	272,830	400,780
Additional duties	Nil	43,881	71,396	141,080	225,315	716,416
Sub-total	*95,751*	*267,704*	*368,623*	*591,606*	*734,128*	*1,372,566*
As % of total tax	94%	84%	85%	88%	86%	89%
Licenses	6,123	8,816	12,276	21,416	30,167	57,751
Hearth tax	Nil	38,920	42,263	44,795	58,977	76,983
Miscellaneous	167	2,180	10,231	9,800	22,546	35,450
*Total tax**	*102,041*	*317,620*	*433,393*	*667,617*	*845,818*	*1,542,750*

* Crown and quit rents are not included here as they are considered non-tax items
Source: Kane (2014)

Gráda and Daltrey, 1982). A 'window tax' was introduced in Ireland in 1799, which levied a tax on every window in a house, although it had been levied in England since 1696 (Sabine, 1966). The Act provided exemptions, such as an exemption for any window occupied by or used for a loom which was really used for weaving. The use of the word 'really' was apparently inserted to prevent any person casually placing a loom in a window and sitting back tax-free (Holden, 1953). The yield from the window tax was not considerable and it is suggested that this low yield could have been due to a simple tax avoidance device resorted to by many householders – the 'half door'. Thus, the front door of the establishment was divided into two equal sections and during the daytime the upper section was left open, which admitted light, and the need for a formal window was reduced (Reamonn, 1981).

As indicated in Table 2, throughout the 1700s we see government revenues drawn largely from customs, excise and additional duties on consumption goods such as alcohol, sugar, tea and tobacco; these represented about 90 per cent of the Irish government's tax revenue. These commodity taxes facilitated the maintenance of a standing army in Ireland during the eighteenth century (McGrath, 2012). However, the Napoleonic Wars would create additional and significant financial pressures which required additional sources of tax revenues.

TAXATION IN THE NINETEENTH CENTURY

The main development in Ireland's taxation system during the nineteenth century was the imposition of income tax in 1853; this taxation source now generates just over 40 per cent of Ireland's tax revenue (Table 1). Estate duty was introduced towards the end of the nineteenth century, and a progressive rate structure for income tax in the early part of the twentieth century. These two developments will be discussed briefly towards the end of this section.

Income tax was introduced in England in 1799 (Government of Great Britain and Ireland, 1799) as a method of financing the Napoleonic War, which was a particularly difficult period for Prime Minister William Pitt. All the ingredients of a financial crisis were present: military costs were escalating and tax yields were inadequate, which resulted in the national debt increasing to an unprecedentedly high level. O'Brien (2011) points out that around this time Britain moved from the bottom to the apex of the European league table for government indebtedness. His figures indicate that the share of the total tax receipts allocated to service debt reached about 70 per cent around 1798. An additional source of taxation became inevitable. In 1799 – largely due to the extensive evasion of the 'Triple Assessment' legislation of 1798 – the first ever Income Tax Act was introduced. (As a result of the financial crisis in the first decade of the twentieth century, many countries would realise that excessive borrowing would ultimately create additional tax burdens or reduced government expenditure.) Pitt was well aware of the opposition to this new form of taxation. To reduce this opposition, a general (and unobtrusive) return of income was required from each taxpayer (Sabine, 1966). This general return of income (Exhibit 1) was simply a total income figure on which a taxpayer was willing to pay, and it was a system based on self-assessment.

Exhibit 1: General Return of Income

> 'I do declare that I am willing to pay the sum of … for my contribution from 5th April, 1799 to 5th April, 1800 in pursuance of an Act passed in the thirty-ninth year of the reign of His present Majesty intituled … and I do declare that the said sum of … is not less than one tenth part of my income, estimated according to the Directions and Rules prescribed by the said Acts, to the best of my knowledge and belief.
>
> Dated this day of … (and) signed …' (Cited by Phillips, 1967, p. 185).

The Act imposed a tax of 10 per cent on all taxable incomes in excess of £200 per annum of British residents, whether arising in England or abroad. There was complete exemption for taxable incomes below £60 per annum, with graduated rates applying to taxable incomes between £60 and £200. Deductions were available for the payment of interest, life assurance premiums and deductions for children (Lynch, 1964). However, this income tax legislation did not apply to Ireland because of the anticipated difficulty of assessment and collection – partly due to the 1798 Rebellion by the United Irishmen, who were assisted by the French – which would generate low yields (Coffield, 1970). The unsatisfactory Irish situation represented an urgent political problem that the British addressed through the Act of Union of 1800, which provided for complete legislative and commercial union between England and Ireland and was facilitated by the aid of bribes, peerages and pressures of all sorts (Moody and Martin, 1967).

In terms of tax yield, Pitt's income tax was a dismal failure, since the general return could only be checked with the greatest of difficulty and there was wholesale evasion (Phillips, 1967). In 1803, Henry Addington, who succeeded Pitt as prime minister, abandoned the general return of income tax and replaced it with five classes or schedules, namely, A, B, C, D and E, of which Schedules C, D and E still exist today (in addition to a Schedule F). A subsequent report by the Commissioners of the Inland Revenue notes that the system based on different schedules for incomes 'leaves unrevealed to all those connected with the assessment of the tax the total income of any person except those who claim entire exemption from it, or those who seek to obtain an abatement of duty' (cited by Monroe, 1981, p. 13). However, income tax was a wartime tax and with the British victory at the Battle of Waterloo (1815), the government repealed it and took the initial steps to reduce the role of the state in the name of the popular economic doctrine of laissez-faire (O'Brien, 2011). However, income tax was re-imposed by Sir Robert Peel and his Tory party in 1842 for a three-year period (Government of Great Britain and Ireland, 1842). It was envisaged (again) as a temporary measure in order to reduce the public deficit and to facilitate commercial reforms in order to improve manufacturing and trade in general (Commissioners of Inland Revenue, 1857). This is a stark example of how a temporary tax measure often becomes a permanent addition to our tax system. The legislation was largely based on Addington's 1803 Act. Again, income tax was not extended to Ireland due to the lack of a proper assessment and collection mechanism: the repeal of the hearth and window taxes in 1823 had abolished the machinery for the proper assessment and collection (Dowell, 1884).

Ireland's income tax exemption was finally withdrawn in 1853 (Government of Great Britain and Ireland, 1853). Gladstone, in arguing for the cessation of exemption to Ireland, argued 'Let me remind the Committee what exemption means, it does not mean that we have a bottomless purse, that we can dispense exemptions to one man without injuring another. No, sir. The exemption of one country means the extra taxation of another' (Hansard, 1853, 18 April). There is no doubt that the imposition of income tax on Ireland was made at an inappropriate time (Clarke, 2014). In 1853 the commercial prosperity of England was rapidly expanding whereas Ireland had recently experienced the terrible ordeal of the Great Famine of the 1840s, characterised by a population fall of some 20 to 30 per cent due to starvation, disease and emigration over a short period of time. The often-stated 'inadequate response' of the British government to this disaster may have been attributable to the prevailing philosophy of laissez-faire, whereby 'short-term suffering appeared to be a small price to be paid for long-term improvement, especially if the theoreticians did not have to participate directly in the experiment' (Kinealy, 2006, p. 356). In addition to imposing income tax on Ireland, Gladstone increased the spirit duties in Ireland with a view to gradually equalising Irish and British rates, and he remarked that it was unfair that 'an Irishman should be able to get intoxicated more cheaply than an Englishman' (Hansard, 1853, 18 April). By way of financial compensation, Gladstone wrote off a debt of some £4 million that had been incurred by the Treasury on relief works during the Irish famine. Income tax was introduced for a seven-year period and the total Irish yield about £2.4 million between 1853 and 1860 and considerably more thereafter (Clarke, 2014). Some years later, a well-known contemporary writer and economist, Henry George, denounced British rule in Ireland as generally arbitrary and despotic; and as 'the most damnable government that existed outside Russia' (cited by Lawrence, 1957, p. 15). Irish protests against the imposition of income tax went largely unheard in Britain due to immediate distractions such as the Crimean War (1853–1856), and eventually Ireland fell into the background of British thinking (Beckett, 1966). However, even though writing some 60 years apart, informed commentators such as Henry George (c. 1880) and Thomas Malthus (c. 1820) foresaw continued disturbances in Ireland unless decisive government action was taken to alleviate inequalities and poverty (MacDowell, 1977).

In 1894 a Royal Commission was appointed to determine the justice (or otherwise) of the growing claim that Ireland had been overtaxed, and this discussion arose primarily out of the Home Rule Bill for Ireland. Among their unanimous conclusions were that the increase in taxation upon Ireland between 1853 and 1860 was not justified by the then existing circumstances. They also pointed out that the advance of money for Irish famine relief was a matter of imperial necessity and should have in the first instance been treated as extraordinary expenditure, to be defrayed out of current imperial revenue and not as a loan to Ireland (Financial Relations Commission, 1896). Furthermore, Murray (1907) points out that the debt incurred due to famine relief would have been paid off in a certain number of years and thus, capital repayments and related interest charges would have ceased. In contrast, income tax became a permanent feature. Not surprisingly, Hynes (2013) concludes that report of the Royal Commission was a watershed event in British–Irish fiscal relations. Such arguments and findings provided a basis for the claims that Ireland was entitled to restitution for the monies raised in Ireland by the United Kingdom for imperial purposes (Meenan, 1970). Subsequently, Sinn Féin would tell the people not to pay their income tax while the country was still governed by Westminster (Reamonn, 1981).

Around the beginning of the twentieth century, two other developments to the Irish tax system should be noted: the introduction of estate duty and the graduation of income tax rates. In 1894, Sir William Harcourt introduced estate duty, which has been amended from time to time over the intervening years. (Apart from stamp duty in 1774, estate duty was the first major capital tax imposed in Ireland.) It was a tax on a property passing upon a person's death and was charged on the total value of the estate without regard to its destination. The tax was assessed on all property, moveable or immovable, situated in the state, regardless of the deceased's domicile, and property abroad was chargeable if the deceased died domiciled in the state. There was a threshold below which no duty was payable (Reamonn, 1981). In introducing the legislation, Harcourt declared: 'Nature gave a man no power over his earthly goods beyond the term of life' (Hansard, 1894, 16 April). Legacy and succession duties had been previously imposed and these three duties were commonly referred to as 'death duties', of which estate duty was the most important. Eventually, the impact of estate duty on family companies prompted the renowned chartered accountancy firm Craig Gardner & Company to devise tax-effective corporate packages to minimise the tax effect of death of a major shareholder. This was done by the establishment of investment holding companies and/or discretionary trusts (Farmar, 1988).

However, estate duty legislation recognised the principal of graduation, i.e. progressive tax rates levied on higher estate valuations, so it was inevitable that graduation be applied to the income tax system as a result of changing political and social values. The Dilke Select Committee on Income Tax was established to enquire into and report upon the practicality of graduating income tax and of differentiating between permanent and precarious incomes, and it reported in 1906 (Dilke Committee, 1906). The report recommended, inter alia, that graduation be introduced to the income tax code through the introduction of a new tax called 'supertax'. Supertax was introduced in the controversial Lloyd George Budget of 1909–1910, which was significant for its unqualified adoption of the philosophy that taxation should be used for the purpose of social regeneration, but which sparked off a spectacular constitutional crisis (Sabine, 1966). Thereafter, over a century since its introduction in 1799, it was considered appropriate to consolidate the law relating to income tax, and this was done in 1918 (Government of Great Britain and Ireland, 1918). The consolidating legislation is all the more remarkable given the wartime conditions that then prevailed (Robinson, 1964). An excess profits tax was introduced in 1915, which was designed to tax profits made during the war in excess of a pre-war standard. It was repealed in 1921, but to an extent it had already been replaced by a corporation profits tax (CPT) in the 1920 Finance Act (de Cogan, 2013). The Finance Act 1920 also prohibited 'artificial' transactions and provided that 'no deduction shall be allowed in respect of any transaction or operation of any nature which has artificially reduced the amount to be taken as the amount of profits of the company'.

TAX IN THE EARLY YEARS OF THE IRISH FREE STATE

The Irish War of Independence, originating in 1919, led to the Anglo-Irish Treaty in 1921 and the eventual establishment of a 26-county Irish Free State, i.e. Saorstát Éireann. (Ireland was partitioned as the northern six counties remained within the United Kingdom.) The Anglo-Irish Treaty of 1921 conferred sovereign powers of taxation on the government and parliament of the Irish Free State. In order to enable the Irish Free State to function quickly and effectively, the British Income Tax Act 1918 and the British Finance Acts 1919–1922 (inclusive) were adopted with the necessary modifications (Revenue Commissioners, 1926). By agreement, the Irish tax system for 1922–1923 was administered by the British government on an agency basis, for which the Irish Free State provided a sum of £183,000 in respect of salaries and expenses of the (UK) Inland Revenue service (Saorstát Éireann, 1923). Thus, as and from the commencement of the fiscal year 1923–1924, the Irish Free State became a separate, independent unit of taxation and all the jurisdictions, powers and duties in relation to taxation matters, e.g. customs, excise and inland revenue, were conferred on the (Irish) Revenue Commissioners (Revenue Commissioners, 1926). The Irish Free State voluntarily accepted the British taxation system, even though that system had evolved to suit the needs and conditions of the more industrialised Great Britain.

One economic consequence of partition was to cut off Ireland's major industrial region with the highest average annual incomes. For example, in 1912, of almost 300,000 industrial workers, only 80,000 were based in what became the Irish Free State (Daly, 1981). The possibility of the government of the new Irish Free State imposing additional taxes could not be seriously entertained, since it had long been an article of faith that Ireland had been over-taxed under British rule and therefore could be administered much more cheaply under native rule. Moreover, as income tax rates were gradually reduced in post-war England, Irish Ministers for Finance were obliged to follow suit, lest they should lose the comparatively few large payers of direct taxation, whose continued residency in the country could not be taken for granted, for either fiscal or security reasons (Meenan, 1970). Thus, it is not surprising that in the first Budget of the Irish Free State (1923) the existing taxes were continued for the year 1923–1924 according to the same rates and conditions as applied to the previous year. The (net) Exchequer receipts for 1923–1924 are summarised in Table 3.

TABLE 3: EXCHEQUER RECEIPTS (NET) FOR THE YEAR ENDED 31 MARCH 1924

Type of Tax	£	%
Customs	8,107,523	32%
Excise	9,351,753	37%
Estate duties	1,049,906	4%
Stamp duties	493,707	2%
Income tax	4,894,776	20%
Surtax	504,383	2%
Excess profits duty	92,199	2%
Corporation profits tax	363,081	1%
Other	247	–
Total	*24,857,575*	*100%*

Source: Revenue Commissioners (1926)

An important issue for the Irish Free State and the United Kingdom was that of taxation, including double tax relief between the two jurisdictions. Not surprisingly, the Belfast and District Society of Incorporated Accountants organised a lecture on the taxation of income in the Irish Free State (Bell, 1924). The first arrangements as to relief from double income tax were embodied, on the British side, by the Double Taxation (Irish Free State) Declaration 1923 and, on the Irish Free State side, in the Double Taxation (Relief) Order (No. 1) 1923 (Purtill, 1923). Of more significance was the revised Double Taxation Agreement, which was signed in 1926 and which was influenced by the Financial Committee of the League of Nations (Reamonn, 1981). This new agreement was based on the principle of 'fiscal allegiance' by reference to residence, with reciprocal exemption of the non-resident. For example, a company, whether incorporated under Irish or British law, was deemed to be resident only in that country in which its business was managed and controlled. It is interesting that this very principle, devised and agreed by eminent economists in the 1920s, is now under international scrutiny in relation to the reduction of tax liabilities on corporate income of multinational entities.

It is fair to say that the first 30 years of Irish independence were not characterised by any degree of fiscal innovation. However, it must be recognised that the Irish Free State was born from a War of Independence (1919–1921), followed by an Economic War with Britain (1932–1938), which also coincided with the Great Depression, and which was followed by World War II (1939–1945). In the early 1930s, a newly elected Fianna Fáil government, committed to self-sufficiency and the need to industrialise as a manifesto of Irish independence, embraced protectionism. By the mid-1930s, for example, Irish import duties were among the highest in the world (MacSharry and White, 2000). Moreover, legislation required that all companies established in the Irish Free State after 1 June 1932 that did not have a majority of native Irish shareholders must apply for a licence to conduct business, and such licences were to be issued or refused at the sole discretion of the sponsoring minister (Clarke, 2004). Whitaker (1973, pp. 412–413) argues that some economic progress was made during that period but companies were 'small in scale', producing for a 'stagnant home market' and there were 'obvious deficiencies of enterprise, management and technique in many protected industries'. With low standards of living compared to other European countries, some commentators had questioned whether, after nearly four decades of self-government, Ireland would be better off as part of the United Kingdom (Clarke, 2006). It is not surprising that after World War II, economic and social issues contributed to the defeat of the Fianna Fáil government in 1948 (Daly, 1981). It is during the 1950s–1960s that we see the next phase of significant developments in Ireland's taxation system and a reduced dependency on the United Kingdom, which absorbed over 90 per cent of Ireland's exports (Bradley, 2004).

ECONOMIC DEVELOPMENT, THE EEC AND TAXATION

Speaking in Seanad Éireann in 1952, the distinguished Professor of Economics at University College Dublin, George O'Brien, proposed 'that the law relating to income tax is in urgent need of revision' and requested that government appoint a commission to investigate the matter at an early date. He cited 'the existence of a large volume of dissatisfaction with the present income tax system' and he indicated that it was widely felt that the increased taxation of white-collar workers had very adverse social and political repercussions (Seanad Éireann, 1952). The immediate issue addressed by the Commission on Income Taxation was the collection of tax from employees, i.e. Schedule E. At that time, employees paid their income tax in two equal instalments but one year in arrears. Thus, the liability for, say, 1956–1957 was due in two equal instalments payable in January and July based on the income earned in the previous year of assessment, and the vast majority of employees in Ireland were obliged to pay income tax on demand, as Table 4 shows. The Revenue Commissioners had experienced great difficulty in collecting tax from employees and stated to the Commission that upwards of 80,000 taxpayers were in arrears with their tax under Schedule E. In addition, there was an estimated £3 million in arrears compared to the then annual yield from income tax of some £6 million (Commission on Income Taxation, 1958).

TABLE 4: COLLECTION ARRANGEMENTS WITHIN SCHEDULE E

	1955–1956	1956–1957
Under statutory provisions	40,000	44,000
Under voluntary provisions	8,000	13,000
Payable on demand	90,000	91,000
Total	*138,000*	*148,000*

Source: Commission on Income Taxation (1958)

The Commission pointed out that a practical difficulty with the collection of income tax under Schedule E was that the half-yearly income tax demands frequently exceeded the weekly take-home pay of many thousands of employees. It was noted that very few employees were making adequate provision for the prompt payment of their income tax liabilities. The Commission also reported that they had received representations from various groups of organised workers in the country recommending the introduction as soon as possible of a statutory scheme of tax deduction from employees. The Commission on Income Taxation (1958) recommended that the then current system of collecting tax from the main body of Schedule E taxpayers should be replaced by a statutory tax deduction scheme on the general lines of the Pay As You Earn (PAYE) scheme then operating in Northern Ireland and Britain. This was done in 1960 and the PAYE system would, in time, become the 'pivot of modern Ireland's tax system' (Hardiman, 2002, p. 36).

Prior to the introduction of the PAYE system, we see another significant development to the Irish (corporate) taxation system – the introduction of export profits tax relief, also referred to as export sales relief (ESR), which was contained in the Finance (Miscellaneous Provisions) Act 1956. This legislation is significant because the economic transformation of Ireland from that time is usually traced to the significant increase in foreign direct investment, encouraged by Ireland's (comparatively) benign corporation tax rate over the past six decades. This innovative legislation was introduced during a climate of despondency that enveloped Ireland. MacSharry and White (2000, p. 185) are specific:

> By 1951, the Inter-Party Government was faced with a depressing economic outlook. The post-war economic recovery had gathered pace in Europe, but left Ireland largely untouched. Some 41 per cent of the labour force was still employed in agriculture, with just 15 per cent in manufacturing industry. Emigration had resumed, economic growth was minimal and the economy was in the throes of the first of a recurring series of balance of payments crises.

The initial (1956) ESR legislation, subsequently amended, was framed in terms of a 50 per cent remission of corporate tax liabilities derived from profits on export sales of goods manufactured in Ireland. The idea of such a tax remission had been suggested earlier that year by the Irish Exporters Association in their submission to the Committee of Inquiry into the Taxation of Industry (Clarke, 2006). It is important to note that the initial ESR tax remission was drafted in terms of an *increase* in sales during a period with reference to the standard, i.e. previous, period. Clearly this provision would be more attractive to new companies than existing entities. The introduction of ESR was certainly associated with an expansion in industrial output and increased industrial exports. For example, exports (excluding live animals, which would not have attracted any tax remission as this was not a manufacturing activity) had increased from £62 million in 1956 to £142 million by 1963 – a 129 per cent increase in monetary terms (see Table 5).

Farmar (1988) notes that Irish exports increased from 25 per cent of gross national product (GNP) in 1960 to 51 per cent of GNP in 1985. But in addition to the economic impact of ESR, it is important to acknowledge the important role of grants for industrial development, first introduced in 1952 and greatly extended in 1956 and

TABLE 5: GROWTH IN IRELAND'S EXPORTS (1956–1963)

Year	Exports (Excluding Live Animals)
1956	£62m
1957	£76m
1958	£83m
1959	£91m
1960	£106m
1961	£124m
1962	£126m
1963	£142m

Source: Clarke (2006)

1959, and the considerable work of Irish development bodies such as the Industrial Development Authority, Bord Fáilte and Coras Tráchtála, which had commenced in the early 1950s (Kennedy and Dowling, 1975).

The final point in this brief story about ESR relates to Ireland's negotiations with the European Union (then called the European Economic Community (EEC)). It was noted by the European Commission that ESR offended the non-discrimination clause of the Treaty of Rome: it was biased in favour of export-orientated companies. A rather clever compromise was found since, at that time, the EEC had no agreement in place on corporate tax harmonisation. Thus in 1978, having sovereignty over the rate of tax that it applied, Ireland replaced ESR with a single, low rate of corporation tax (10 per cent) that applied to all corporate entities, whether manufacturing, retail or service and whether they were export-orientated or otherwise. (The corporation tax rate currently stands at 12.5 per cent.) A related point should be noted. Prior to the 1960s, the Revenue Commissioners were generally reluctant to give advance rulings on taxation matters on the grounds that answering hypothetical questions was not part of the Commissioners' functions. However, with regard to the administration of export sales relief in particular, the Commissioners became much more flexible in their approach and advance rulings were a common element in new projects (O'Broin, 1983). However, recently, the Revenue Commissioners has issued new guidelines that indicate that multinationals may not receive 'letters of comfort' from the Irish authorities informing them that the tax structures they have put in place are unlikely to be challenged. Such letters are an important part of Ireland's efforts to attract direct investment as they are highly valued by multinational enterprises when making long-term decisions as to where they will locate foreign subsidiaries (Keena, 2014).

Some other significant developments in the Irish taxation system during the early decades of Ireland's economic transformation should be noted. In 1962–1963, tax receipts from customs and excise duties accounted for over 40 per cent of total government revenue. The dominance of this source of revenue meant that the public finances would be highly sensitive to a fall in the yield from a limited number of goods such as beer, spirits, tobacco and hydrocarbon oils. In order to reduce the dependency of the Irish Exchequer on these commodities, and also with a view to potentially reducing rates of income tax, a (sales) turnover tax was introduced in

1963. While common in many countries in Western Europe, a turnover tax was new at the time to Ireland and was applied at a rate of 2.5 per cent (O'Halloran, 2005). To complement the turnover tax, a wholesale tax was added in 1966, but this was more selective because it did not apply to the sale of foods, medicines, clothing and fuel but was chargeable also on the importation of taxable goods (Reamonn, 1981). In 1972, as one of the conditions for Ireland to join the EEC, a value added tax (VAT) was introduced, which had already been introduced in the existing six EEC member states. The VAT system replaced the existing wholesale and turnover taxes which had existed since the 1960s. A very important element of the European dimension to VAT, and one which is often overlooked, is the fact that each member state contributes a portion of its VAT yield to the European Community in order to fund, for example, the Common Agricultural Policy, together with the various structural, regional and cohesion funds (Doyle, 2007). Farmar (2013) indicates that VAT, like PAYE, represented a substantial shift of tax-gathering effort from the Revenue Commissioners to business entities. In the future, businesses would act as unpaid tax collectors.

During the 1970s, other important changes to the Irish tax system took place. The newly elected Fine Gael-led government in 1973 had tax reform high on its agenda, and a rapid sequence of innovations followed its election: wealth tax, capital gains tax, capital acquisitions tax, taxation of farm profits, corporation tax and a unified system of income tax (Farmar, 2013). A broadly defined annual wealth tax was introduced in 1975 (to 1977 inclusive), which applied, inter alia, to the 'wealth' of investment companies and discretionary trusts, many of whom had been established to minimise the impact of estate duty. Subsequently, a residential property tax was introduced in 1983 (to 1997). Both the wealth and residential property taxes were abolished due to their unpopularity with the electorate. 'Rates' on private dwellings were abolished in 1977 for a similar reason. However, a local property tax was reintroduced in 2013.

A capital acquisitions tax (CAT) was introduced in 1976, which applied to assets passing from one individual to another by way of both gifts and inheritances received. This legislation replaced estate duties but introduced two new features. First, unlike estate duties, CAT applied to gifts as well as inheritances, although the former were taxed at a lower rate. Second, under CAT, the beneficiary is separately taxable for each gift/inheritance, so that the larger the number of beneficiaries, the smaller the aggregate amount of tax payable. Finally, the introduction of a capital gains tax (CGT) in 1975 should be noted. It was modelled on prior UK legislation, and it applied to both individuals and corporations. It was introduced as a means of collecting tax from persons disposing of assets, where the assets being disposed of have increased in value during the period of ownership. Capital gains were taxed only when realised rather than when they accrued, as otherwise a cumbersome annual valuation would be required. Thus, in order for a liability to CGT to arise, there must be a disposal of an asset, which usually arises when one person transfers ownership of an asset to another person. However, death does not give rise to a disposal for CGT purposes.

Changes were also made to the taxation of income and profits: in 1974, the dual taxes on an individual's income, namely, income and surtax, were abolished and replaced with a unified system of income tax that applied progressive tax rates to higher bands of taxable income. In 1976 the dual system of income tax and corporation profits tax, which applied to corporations, were replaced with a (single) corporation tax code. This allowed companies, who were liable to a separate corporation tax, to be taxed at different rates compared to individuals, who were liable for income tax.

While it may be considered a contemporary issue, the matter of tax avoidance and general anti-avoidance rules (GAAR) should be briefly addressed. Tax avoidance is associated with using activities, concessions or transactions that, although they are legal and comply with the tax code, increase the after-tax income of the taxpayer over what would otherwise have been the case. For many years, it was generally considered that 'tax avoidance' could not be overturned by the courts. However, in 1981, the House of Lords in the United Kingdom decided that where a transaction has pre-arranged artificial steps that serve no commercial purpose other than to save tax, the proper approach is to tax the effect of the transaction as a whole (*Ramsay v IRC*, 1982). This case involved a series of transactions that generated (artificial) losses for the purpose of cancelling a taxable capital gain. Subsequently, in *IRC v Burmah* (1982), this interpretation was upheld and Lord Diplock considered that in order for the *Ramsay* principle to apply there must be (i) a series of transactions which are (ii) pre-ordained, and (iii) into which there are inserted steps that have no commercial purpose apart from tax avoidance. While both of these cases were in the UK jurisdiction and involved capital gains tax, the decisions signalled a different approach to tax avoidance schemes by the Inland Revenue and the interpretation of such schemes by the judiciary, so that artificial tax planning could, in future, be ineffective.

Commenting on these cases, O'Broin (1983, p. 26) wisely noted that the Irish Revenue Commissioners had indicated that they would follow the decisions in *Ramsay* and *Burmah* and he argued that 'artificial' tax avoidance schemes 'are not to be recommended'. Thus, the Irish Revenue Commissioners sought the approval of the Irish Supreme Court to the principle of fiscal nullity in the *McGrath* case (*McGrath v McDermott*, 1988), but this was rejected by the Supreme Court. The Revenue Commissioners then introduced a new all-embracing GAAR, by way of section 86 of the 1989 Finance Act, which is now encompassed as section 811 of the Taxes Consolidation Act 1997. Subsequently, in the *O'Flynn* case, the Irish Supreme Court has ruled that the various steps taken by taxpayers in the company involved were a misuse of ESR, having regard to the purposes for which it was originally intended (*Revenue Commissioners v O'Flynn Construction*, 2011). A comprehensive discussion of how the Irish GAAR has developed and an examination of the central elements of GAAR in other jurisdictions, such as the United Kingdom and Canada, are presented by Maguire (2014).

In current times, tax avoidance and anti-avoidance legislation must be discussed in an international context. Also, a subtle change has taken place over the past decade wherein the macro-economic impact of tax avoidance techniques, together with their perceived morality, is likely to be discussed in conjunction with the tax effectiveness of such schemes. Thus, the OECD report entitled *Addressing Base Erosion and Profit Shifting* (Organisation for Economic Co-Operation and Development, 2013) stresses that tax avoidance by international companies constitutes a serious risk to tax revenues, tax sovereignty and tax fairness in many countries. A more recent document (Organisation for Economic Co-Operation and Development, 2014) has set out far-reaching recommendations to eliminate aggressive tax avoidance by multinational enterprises. This initiative is likely to prompt changes in the Irish corporate tax regime.

CONCLUSION

This paper has provided an overview of the development of the Irish taxation system over the past eight centuries, rather than focus on a specific episode or event. The objective is to identify and explain what happened in a non-technical manner and to place such changes in their appropriate political, economic and social contexts. For much of its history, the small island of Ireland was governed by its more powerful neighbour and therefore a 'tax adoption' decision, especially regarding income tax in Ireland, was taken by successive British governments rather than the indigenous population.

The basic function of any taxation system is to provide revenue for the government and, historically, such revenue was required for military purposes. In modern times, the state bears a large measure of responsibility for matters such as education, health, care and maintenance of the elderly, economic development and the redistribution of income and wealth in society. Thus, it is not surprising that since the foundation of the Irish Free State (post-1922) tax revenue has increased substantially. For the income tax year 1923–1924, the total revenue of the Irish Free State was approximately £25 million (Table 3), whereas actual tax revenue for 2013 amounted to just under €38 billion (Table 1). The modern role of our taxation system confirms the political context of any tax change or system. Governments require tax revenues in order to pursue their objectives in targeted areas such as economic growth and the redistribution of income and wealth in our society. In turn, taxpayers cannot be precluded from forming an opinion of their tax system and exercising their collective franchises at election time. In summary, any taxation system is influenced by political, economic and social considerations in both the domestic and international environments. These factors help us understand why tax systems have changed over time. They also suggest that, with the growing public awareness of the impact and intricacies of our taxation system, the demand for tax changes can be expected in the future.

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THE DYNAMICS OF 'VIRTUOUS' ORGANISATIONAL IDENTITY: THE CASE OF REGULATING OR ENABLING CORPORATE TAX COMPLIANCE

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ABSTRACT

Our empirical study of a government regulatory agency examines how external stakeholders respond to policy-driven change in a way that potentially threatens organisational legitimacy. Specifically, we focus upon the United Kingdom (UK) tax agency, Her Majesty's Revenue and Customs (HMRC), and its move away from its traditional regulatory role towards enabling its 'customer', the corporate taxpayer, to 'shelter' tax. We theorise such policy as one of organisational identity change. Focusing upon organisational identity as 'moral', we highlight that should a government regulatory agency lose the support of external stakeholders as it engages in identity change, it may threaten the legitimacy and survival of that agency. Policy makers need to recognise that their power in defining organisational identity has its limits in public services organisations, where the public and media are likely to debate their moral purpose.

INTRODUCTION

Organisational identity is a well-established concept within generic management literature used to explain organisational change processes, content and outcomes (Brunsson and Sahlin-Andersson, 2000; Dutton and Dukerich, 1991; Golden-Biddle and Rao, 1997; Humphreys and Brown, 2002). Following behind this, there is emerging commentary within public administration literature that similarly examines the identity change of public services organisations (PSOs) (Meyer and Hammerschmid, 2006; Rondeaux, 2006; Skalen, 2004; Waeraas, 2010). However, as yet, the public administration literature about organisational identity is still relatively under-developed. Our study extends the recent public administration literature about organisational identity change and focuses upon how such change threatens the legitimacy of PSOs, as perceived by external stakeholders. By doing this, it also extends the tax administration and tax policy literatures.

Empirically, our study examines organisational identity change in a government regulatory agency, the UK tax agency, Her Majesty's Revenue and Customs (HMRC). Driven by policy exhortation to do so, senior management in HMRC has sought to move away from its traditional regulatory role towards enabling its 'customer', the corporate taxpayer, to 'shelter' tax.

Theoretically, we show change in organisational identity does not prove a straightforward matter. Any attempted change in organisational identity impacts the legitimacy ascribed to PSOs by external stakeholders (Brunsson and Sahlin-Andersson, 2000; Rondeaux, 2006; Skalen, 2004). In theorising how organisational identity might be viewed by external stakeholders, we focus upon the need for a PSO to maintain a 'virtuous' identity in order to retain legitimacy (Moore, 2005, 2012). This is important for policy makers and senior managers to understand. Should a PSO fail to sustain its identity as one imbued with moral purpose to external stakeholders, then it risks undermining its legitimacy and its survival may be threatened (Cheney and Vibbert, 1987; Dutton and Dukerich, 1991; Waeraas, 2010). This is particularly important in the case of tax collection. There is a social contract between citizens and the state such that 'taxes are what we pay for civilized society' (Oliver Wendell Holmes, Jr, United States Supreme Court Justice). If the state is discredited then taxpayers may not be so willing to pay their taxes to fund public goods.

This paper is structured as follows. First, we synthesise and critique the literature around organisational identity, discussing what might constitute a 'moral' or 'virtuous' organisation, and how this might apply to PSOs driven towards a greater customer-orientated identity. We then outline our case context and research design, following which data analysis is presented along three related themes: (i) Senior managers: 'Looking in the mirror'?; (ii) Corporate taxpayer: 'Tax avoidance (sheltering) isn't immoral, but we aren't customers'; and (iii) Public and media: 'Tax avoidance (sheltering) is immoral'. We conclude with a summary of our empirical case, where we highlight our theoretical contribution and policy implications, before calling for further research.

LITERATURE REVIEW

Organisational Identity

Organisational identity represents the interaction of internal social identity of managers and employees, and the external image of an organisation held by others, such as customers and the public (Ashforth and Mael, 1996; Hatch and Schultz, 2002). The concept of organisational identity was first developed by Albert and Whetten (1985) and subsequently the definition of the concept has become dynamic, in flux and often contested, as it responds to change (Gioia, Schultz and Corley, 2000; Scott and Lane, 2000a, 2000b). There are four major approaches to organisational identity: functionalist, social constructionist, psychodynamic and postmodern (He and

Brown, 2013). In this study we take a social constructionist approach as the political influences create a less stable and less rigid organisational identity. We focus upon the response of external audiences to policy-driven managerial attempts to manipulate organisational identity, and so focus upon organisational image (Hatch and Schultz, 2002). This represents an important matter, since a PSO must 'keep an eye on the mirror' as it engages in identity change, in order to retain legitimacy (Dutton and Dukerich, 1991).

Commencing with Weber, there is an important sociological tradition centred on the concept of legitimacy. Legitimacy in this sense follows Weber's theory, which is one that stresses the importance of followers' beliefs (Weber, 1964). Legitimacy is also a major concept in organisation and management studies (see Suchman, 1995) as well as being critical to public policy debates. Organisations must achieve legitimate status in their environments in order to guarantee resources and avoid claims that they are negligent, irrational or unnecessary (Meyer and Rowan, 1977). The literature highlights that the external audience value accountability and reliability in organisations, and has documented risk associated with deviation from an established external identity (Hannan, Baron, Hsu and Kocak, 2006). Previous research on the link between organisational identity and legitimacy has shown that multiple organisational identities help to establish moral claims to legitimacy (Sillince and Brown, 2009); the construction of a legitimate sense of organisational identity is a combination of the performance of a stable identity over time together with distinguishing a different identity from other firms (Barney and Stewart, 2000) and is a function of level, locus, mechanism and approach (He and Baruch, 2010). In short, 'organizations need to adopt or possibly merely project identities that elicit legitimacy attributions' (Brown, 2001, p. 117). The importance of organisational image is reinforced by the media, which renders organisational identity more visible, as it exposes divergence between corporate images and organisational actions (Hatch and Schultz, 2002). As a consequence of its 'adaptive instability' (Gioia et al., 2000), senior managers' efforts to deliberately alter organisational identity are prone to challenge (Humphreys and Brown, 2002). Challenge to organisational identity from external stakeholders has been highlighted in cases where organisations invest in the culture of the customer (Du Gay, 2000) and in morally ambiguous contexts (Teram, 2010), such as public services settings.

A Virtuous Organisational Identity

In operationalising how organisational identity might be viewed by external stakeholders, we focus upon the need for a PSO to maintain a 'virtuous' identity in order to retain legitimacy. This is a concept grounded in MacIntyre's work (1984), *After Virtue*. To quote an introduction to a special issue about organisational virtue in *Organization Studies* (Nielsen, 2006, p. 317):

> [MacIntyre] critically observed that, under the severe pressures of narrowly focused, systems driven, utilitarian financial and bureaucratic calculation, it can be very difficult both for organizations and individuals in their organizational lives to realize and express moral agency and virtue.

This seems particularly relevant within PSOs, where delivery of service is increasingly utilitarian and coheres around the notion of customers and their sovereignty (Du Gay, 2000; Rosenthal and Peccei, 2007).

Moore has applied MacIntyre's work to contemporary organisations (Moore, 2005, 2012), in a way that particularly resonates with our concerns about attempts to manipulate identity. Policy makers or senior managers within PSOs pursue external goods of effectiveness (MacIntyre, 1984), orientated towards the customer, such as enhancing customer satisfaction. However, this represents a fundamental challenge to the development of a virtuous organisation since the pursuit of external goods can corrupt the practice at the core of the organisation, i.e. could potentially 'kill' the organisation from the inside. In the case of HMRC, there exists a social and psychological contract so that citizens can expect to receive public services in return for paying taxation. Citizens can expect HMRC to collect the taxation due from taxpayers. Instead, the 'virtuous' organisation needs to preserve the practice at its core. This seems the essence of the attempted manipulation of organisational identity of HMRC towards customer orientation and enablement (representing external goods), which is not supported by the long-standing core practice of HMRC focused upon regulation. HMRC could then become a customer service provider (Tuck, 2013). Instead, developing an organisational identity for the common good requires a power-balanced structure that ensures the views and desires of particular constituencies are not privileged over others (Moore, 2005, 2012). This is particularly relevant in the case of PSOs, which are inherently more complex than private sector counterparts, with continuous contestation of their public purpose. Linked to this, PSOs should not see themselves as compartmentalised from other institutions in society, but part of a larger system, which delivers public goods. We detail this further in the next section of our paper.

Organisational Identity of PSOs

Questions of values and policies pervade PSOs, particularly at the point of delivery (Hoggett, 2006). Associated with New Public Management, a particular concept pervading policy is the idea of the 'sovereign' customer, as a figure of agency, enterprise and self-reliance, who is given choice in the public sphere and the means to exercise it (Hood, 1991). Even regulative organisations, such as tax agencies, which we would normally assume need legitimacy for their authoritative role and coercive powers, attempt to become identified with customer-orientated values. They put customers first (Aberbach and Christensen, 2007) and enact a more lenient identity, distancing themselves from the more 'traditional' authoritative and bureaucratic identity (Waeraas, 2010). However, the notion of the customer for public services delivery is one likely to be contested inside and outside PSOs (Berg, 2006; Bockel and Nooredegraff, 2006; Caron and Giauque, 2006; Horton, 2006; Korczynski and Ott, 2004; Needham, 2006; Thomas and Davis, 2005). With respect to tax agencies, being too customer-orientated is likely to challenge their core practice of regulation, on the basis the organisation is no longer 'virtuous' (Moore, 2005). Compliant taxpayers might question HMRC's approach if in their view HMRC was being too lenient to other taxpayers.

HMRC

In this paper we specifically examine the dynamics of organisation identity in HMRC. A regulatory agency, such as HMRC, is likely to engage in strategic self-presentation around its rule-enforcing function, its neutrality and its legitimate exercise of authority (Waeraas, 2010). However, HMRC has been subject to policy development to take on the role of 'enabler' of tax revenue collection, with associated emphasis upon users of its services as a customer (Her Majesty's Revenue and Customs, 2005, 2006, 2007, 2009). HMRC introduced the customer concept for internal purposes in the beginning of the 1990s (Tuck, 2013). Subsequently a change programme was introduced in 1992; one of its main themes was customer service (National Audit Office, 1996). The customer concept was further reinforced with the launch of the document 'The Whole Customer Vision, Practice and Design Principles (Her Majesty's Revenue and Customs, 2005). Associated with this, we suggest that HMRC is no longer the same organisation if its regulative activity is supplanted (Albert and Whetten, 1985; Waeraas, 2010). This represents an exemplary arena to examine our research concern, since there is a perpetual tension between regulation and enablement, which impacts organisational identity and legitimacy.

The corporate tax compliance process for large corporations is carried out by experts on both sides of the fence. The analogy of a game is frequently used to describe the interaction between tax inspectors in HMRC and their customers (Picciotto, 2007). In detail, under regulation, the tax agency would relate at arm's length with its corporate customers through a series of formal letters, which set out queries and calculations for the corporation's tax liabilities, to which the corporate customer would respond, with a final meeting at the end of the process to confirm liabilities. This tended to set the tax agency and corporate taxpayer against each other, as the latter sought to reduce the calculated tax liability. Further, should the corporate taxpayer fail to agree the calculation, then HMRC would start litigation proceedings and the matter would end up in the law courts.

In comparison, enablement requires HMRC to negotiate with the corporate taxpayer from the outset in a more proactive and relational manner. Reinforcing this more enabling approach, the role of 'client relationship manager' (commonly, former tax inspectors (tax agents) occupy this role) was introduced, responsible for interaction between HMRC and large corporate taxpayers (Her Majesty's Revenue and Customs, 2006). This reflects the changing relationship between HMRC and the corporate taxpayer, with the latter positioned as the 'customer', and performance agreements and targets for 'customer service' framing tax collection activity. The move from regulation to enablement represents a response to the ability of the corporate taxpayer to negotiate tax settlements where the law is unclear, or omits to foresee the tax implications of specific circumstances. The broader rationale for moving towards enablement was the reduction of regulation and the development of a more conducive national climate for business to flourish, i.e. where corporations are viewed primarily as creators of wealth, rather than taxpayers. If the UK is not viewed as a conducive tax regime to do business, then the corporate taxpayer, particularly multinational corporations (MNCs), may move their activity elsewhere, i.e. the government wants to avoid adversarial relationships with the corporate taxpayer (Duncan, 2006).

RESEARCH DESIGN

Our study is a single empirical case, which can be theoretically generalised to aid transferability of analysis (Eisenhardt, 1989; Yin, 2004). Our case is set in the UK, which is subject to neo-liberal policy reforms that are evident globally, but for which the UK has been described as a 'fast mover' (Martin, Currie and Finn, 2009). Global neo-liberal policy forces have exacerbated the flux and tension around the identity of PSOs, particularly those in the regulatory sphere (Hoggett, 2006; Waeraas, 2010). This is particularly so in contexts such as the police and prisons where users would not normally have been referred to as customers (Clarke, Newman, Smith, Vidler and Westmarland, 2007; Needham, 2006).

Consistent with an interpretive perspective on organisational identity (Brown, 2001), our data set focuses on the views of external organisational stakeholders towards identity change. Our data set comprises 55 semi-structured interviews; 25 of these were carried out with HMRC senior managers, purposively sampled as those managing the change towards enablement, including the chairman. Apart from the chairman, all senior management respondents had trained and worked as tax inspectors, a role, until recently, focused upon technical skills and arm's length regulation. They were thus well-placed to comment upon the change from regulation to enablement, including how external stakeholders perceive such changes. These are complemented by interviews with twelve partners of a 'Big 4' accountancy firm (who gave specialist tax advice to the tax and financial directors of MNCs), and eighteen tax directors of MNCs. Interviews lasted 60–120 minutes, and all except two were recorded and fully transcribed (in the latter, notes were taken during the interview and elaborated following the interview). We further elaborated upon the societal or public image of HMRC, through systematically collating documentation from parliamentary committees and media reports (high quality press, television news items, web searches) covering the ten years (2002–2012) over which interviewees reported change towards enablement had occurred. This constitutes an archive running to thousands of pages, which was themed by stakeholder group, further broken down to specific issues, including organisational identity change. In Gephart's (1993, p. 1469) terms, we were able to collate 'a substantial archival residue' from the different published sources.

Analysis of data was framed by themes from the organisational identity literature, but allowed for induction through emergence of novel insights (e.g. that HMRC senior managers raised concerns about enablement and subsequent organisational legitimacy), as the authors coded the interview transcripts and the documentary archive. Our emerging theoretical arguments were based on the interplay between theory and data (Eisenhardt, 1989). During this process, we enhanced the internal validity of our research through the construction of thematic narratives around organisational identity. External validity was created through systematically comparing HMRC senior managers', external stakeholders' and political/media perceptions of changing organisational identity (Miles and Huberman, 1994). We moved from raw data to the themes presented in our manuscript through successive rounds of coding (Pratt, 2009). As a means of supporting our analysis, findings were presented to internal and external stakeholders at professional network events. This elaborated findings in some instances (e.g. variation in senior managers' support for enablement), but more importantly allowed a check on the authenticity of our analysis (Yin, 2004).

FINDINGS

We derived three inter-linked themes around the response of external stakeholders to organisational identity change: (i) Senior managers: 'Looking in the mirror'?; (ii) Corporate taxpayer: 'Tax avoidance (sheltering) isn't immoral, but we aren't customers'; and (iii) Public and media: 'Tax avoidance (sheltering) is immoral'. Our interview quotes below illustrate that the moral purpose of HMRC is contested as senior management attempt to reconstruct organisational identity in a way only partially supported by corporate taxpayers, and with increasing outrage by the public and media.

Senior Managers: 'Looking in the Mirror'?

It is useful to set out the stance of HMRC senior management towards organisational identity change since it is not as straightforward as one might expect. Even the policy makers, who sought to drive change in organisational identity, appear caught between the desire to support the creation of wealth through enablement, and to ensure, through tax collection, that wealth is re-distributed via a more regulatory role. They hold on to the core practice that informs HMRC's traditional organisational identity of regulation, as succinctly captured in the following statement by one of its senior civil servants in HM Treasury:

> We are committed to creating the *right* [emphasis added by authors] tax environment for business and individuals, which encourages enterprise and minimises red tape. In return, we expect everyone to pay their fair share. And where we see tax avoidance, we will crack down on it. That's particularly important at a time when the Government has had to make tough choices elsewhere (Her Majesty's Treasury and Her Majesty's Revenue and Customs, 2011, p. 3).

A senior manager in HMRC, who highlighted that his own identity remained aligned with technical expertise in applying tax legislation at arm's length, also questioned the relevance of the customer concept that accompanies enabling. He suggested, 'we have to call them customers even though they might not want to be' (Senior Manager #13). It seems that some senior managers in HMRC were looking in the mirror (Dutton and Dukerich, 1991) and exhibiting concern about organisational legitimacy in the eyes of external stakeholders. Another senior manager, with significant technical experience as a tax inspector, also reported similar concern about organisational identity change:

> It's not recognised that calling taxpayers 'customers' over-emphasises the enabling side of things at the cost of the regulating. Quite clearly we are here to regulate. We are not paid to enable. I think the enabling is significant, but it's a minor part of what we ought to be doing (Senior Manager #3).

Ambivalence about the enabling approach is increasingly evident from HMRC managers in the wake of the global financial crisis, with one senior manager further commenting, 'a £300 million provision saving £100 million tax may be a drop in the ocean as far as the corporate is concerned, but it would still buy a lot of hospital beds in the UK' (Senior Manager #19). Further, PricewaterhouseCoopers tax advisors report that HMRC managers have significantly changed their approach towards tax collection, and, even in the face of a move towards enabling, have firmed up more regulatory intervention in cases of what they consider excessive (abusive) tax avoidance (PricewaterhouseCoopers, 2013).

However, we note some other senior managers were much less aware of the legitimacy concerns associated with policy exhortation to move towards enablement: 'it is our job to facilitate normal commercial business' (Senior Manager #8). They were not 'looking in the mirror' to assess how others see them, even in financially austere times.

In summary, we see that even policy makers and senior managers in HMRC do not necessarily 'buy' into the organisational identity change towards enablement they are meant to implement. This foreshadows resistance towards organisational identity change of HMRC from those external stakeholders, corporate taxpayers and the public, whom HMRC were meant to serve.

Corporate Taxpayer: 'Tax Avoidance (Sheltering) Isn't Immoral, But We Aren't Customers'

When confronted with the argument that there exists a moral imperative to pay tax, corporate taxpayers are resistant in three ways. We might expect them to support organisational identity change toward enablement that allows them to 'avoid' tax. However, we emphasise their support for tax avoidance is not predicated on their view of themselves as the 'customer' who should be 'enabled', but more on an economic and legal justification.

First, corporate taxpayers argue that the creation of wealth itself is important and beneficial for the UK, since tax revenues will increase, even as corporate taxpayers follow 'acceptable' tax avoidance policies. Conversely, a more confrontational approach from HMRC may result in reduction or even cessation of tax revenue, as corporate taxpayers move to more 'tax friendly' countries:

> I think that the tax environment has changed quite dramatically for the worse. In order to stay competitive, it [the UK's tax regime] needs to change for the better because other systems are becoming more favourable. If companies don't want to engage with the UK's tax system, they don't need to (FTSE 100 Company Tax Director #17).

Second, even if the creation of wealth itself is not held in high regard, corporate taxpayers argue that their 'moral' responsibility, as enshrined in law, is towards their shareholders, rather than more broadly towards UK citizens. That corporate taxpayers had a 'moral imperative' to pay taxes as demanded by law but would seek to morally minimise these on the basis they served shareholders as their main responsibility is central to statements made by company tax directors and their tax advisors about tax avoidance:

> [What] I find rather irritating is they are trying to introduce a fairly moralistic tone into tax payments. … Clearly it is our duty to pay taxes as levied by the law but we are not in the business of paying tax any more than we have to and it is often overlooked by Revenue officials that the directors of these companies have fiduciary duties to their shareholders and paying excessive amounts of tax isn't the way you discharge your fiduciary duties (FTSE Company Tax Director #13).

Indeed, they held the view that HMRC should remain an arm's length body that regulates and advises policy makers, but not one that enables:

> I think that's an immoral point of view to take because I don't think there is any moral imperative to pay a particular amount of taxes, it seems the moral imperative comes from abiding within the laws that are there. But I think you need a clear set of laws which the government is responsible for putting in place and the Revenue is responsible for administering. I don't actually think the Revenue ought to have a view on how much tax is or isn't raised. I think the Revenue should have a view on whether there is unfairness or anomalies, which need removing but they shouldn't have a view on whether that's levied up or down. At the government level clearly there is a policy requirement to collect an amount of tax and there is a moral imperative on taxpayers to pay the amount of tax they ought to under law. There is no moral imperative for them to pay any tax at all if the law doesn't say they should, or any particular amount of tax and I think that's where the confusion comes from, particularly in the evasion, avoidance debates (Big 4 Tax Advisor #2).

Third, there is some concern from corporate taxpayers regarding how they might be implicated in any debate about the morality of tax compliance. They argue this confuses wealthy individuals who seek to avoid tax with corporate taxpayers who seek to comply with the law. Responding to media coverage of tax avoidance:

> I'm not entirely certain what audience they're speaking to when they say this [the morality argument]; I mean if they're talking to the general public, it doesn't do them much good in terms of outcomes, but I suppose they then bask in the sort of reflected glory that our [HMRC] is after these horrid people, but as a practical matter I'm left uncertain where it gets them. They may be speaking to government, but they don't need to write articles in the tax journals to speak to government; or they're speaking to people like me and I don't care what they say. What I want to know [is], is what I'm doing legal? Don't tell me about morality; is it legal? The law is there. If they write the law in a certain way, then they've written the law in a certain way and so therefore this attempt to compare me to the man who evades tax by hiding his income or puts his company into bankruptcy and avoids his tax really doesn't do anything for the relationship. To try to cast me in a miasma of all these horrid people who are legally but illegally legally avoiding tax really doesn't help at all (FTSE 100 Company Tax Director #8).

To emphasise their stance, corporate taxpayers were keen to distance themselves from any characterisation as 'villains' who abusively avoid tax. Thus, they might be expected to support the changing identity of HMRC towards enablement, since this, we might expect, provides tax avoidance with regulatory legitimacy. Yet this did not prove the case. Corporate taxpayers are supportive of acceptable tax avoidance on the basis that they are the wealth creators, and they have a legal requirement to serve their shareholders. They are not necessarily supportive of their re-positioning as a 'customer', which accompanies changing HMRC organisational identity towards enablement. We note that corporate taxpayers, as represented by their tax directors and advisors, perceived inconsistency and tension in the role and identity of HMRC, with some concern about the customer-focused discourse that HMRC promotes:

> I told a previous director [of HMRC] quite vociferously that we aren't customers. In my view the customer of the HMRC is the Treasury. We are not customers, we are taxpayers. But I think what they are trying to say is, 'Yes, you are taxpayers, but in terms of service we provide you, we are acting not just as regulators, but also as facilitators, so to that extent you are customers' (FTSE 100 Company Tax Director #12).

Indeed in the quote below, we see some cynicism from the corporate taxpayer regarding HMRC's identity change towards an enabling organisation in which its customer orientation was central. Corporate taxpayers did not buy into the 'enchanting myth' of the sovereign customer (Korczynski and Ott, 2004, p. 577), instead wishing that HMRC continue enacting its traditional, more authoritative role (Waeraas, 2010):

> I think they [HMRC] are trying to show that HMRC isn't an ogre, a miserable organisation, which drags money out of people. They are trying to show that their role is essential to society, using the customer concept. I suppose they are trying to create a new image for what they're doing. However, the customer concept is the wrong route for this (FTSE 100 Company Tax Director #16).

In summary, corporate taxpayers present a distinctive view of what constitutes 'moral' tax compliance. Some corporate taxpayers even question if the issue of morality should be invoked at all when considering tax compliance. At the same time, corporate taxpayers resist HMRC's organisational identity change towards a greater customer orientation to which they are subject. Thus, policy-driven organisational identity change is no straightforward matter. As evident in our next empirical section, the issue of morality is central to public and media concerns about tax avoidance, and continues to inform the dynamics of organisational identity for HMRC.

Public and Media: 'Tax Avoidance (Sheltering) Is Immoral'

Whilst policy makers and HMRC senior management may try to blend enablement with the longstanding core practice of regulation, the quote below, from a BBC news item, highlights the fact that the wider public hold a very pejorative view of HMRC's identity change. They regard legal obligation and moral obligation as decoupled in the process of HMRC enacting its identity change. In essence, the wider public still perceives large corporate taxpayers as avoiding tax. They particularly focus upon the tax practices of those visible MNCs, more so in times of global financial downturn and the disproportionate effect of this upon poorer citizens:

> Although tax avoidance, as practised by News Corp, is well within the law, the general public struggle to sympathise (BBC News, 1999).

Reflecting this, the UK telecommunications company Vodafone has been particularly singled out by public demonstrations for its abusive avoidance of tax. As part of this abusive tax avoidance, Vodafone had been in dispute with HMRC for ten years over a tax avoidance scheme relating to the acquisition of a German company, which was settled within the UK Court of Appeal in 2010 (Houlder, 2010). A report from the Treasury Committee (2011) concerned with the administration and effectiveness of HMRC starkly presents public concern about tax avoidance:

> 159. A particular source of controversy has been HMRC's settlement of large tax cases involving corporations. Allegations have been made in the press that cases have been settled inappropriately for a lower yield than might otherwise have been achieved. …
> 163. The public needs to be assured that cases involving large sums of money are being settled correctly. Equally it is unfair on HMRC staff and damaging to public confidence that the Department can be the subject of repeated allegations it cannot refute, even if they are groundless (Treasury Committee, 2011).

In the quote above, we see that the Treasury Committee invokes diminished public confidence in HMRC as it moves towards an enabling role. Buttressed by negative media commentary, this constitutes a threat to the latter's organisational legitimacy.

Picking up on such concerns, the UK's more left-leaning broadsheet newspaper, *The Guardian*, has been running a high-profile campaign to highlight tax avoidance by MNCs. The media reflects the public view that HMRC acts as a regulator to the tax affairs of large corporations and is thus beholden to the public to make visible, in a transparent way, their tax dealings with large corporations. As another dimension of being virtuous, HMRC is also expected to behave equitably with taxpayers, whether powerful MNCs or 'the man [*sic*] on the street'. For example, on 13 May 2011, Phillip Inman reported:

> HM Revenue & Customs has failed to provide details of a deal that allowed Goldman Sachs to avoid millions of unpaid tax after other firms settled similar disputes, according to a prominent member of a powerful parliamentary committee. The lack of disclosure in the long-running dispute with the US investment bank meant there was a danger the public would think there was 'one rule for some companies, and another for individual taxpayers', said Labour MP Chuka Umunna. Without directly attacking the appearance of preferential treatment for the US investment bank, Umunna said he was concerned that the case echoed the tax deal with Vodafone that led to demonstrations and protests by the campaigners UK Uncut. Vodafone was accused of saving £6bn in tax after it agreed a deal with HMRC (Inman, 2011).

Meanwhile, high-profile charities also reinforce concerns that the public have about tax avoidance, elevating the problem to one of global significance. They highlight that a virtuous regulatory organisation is not one that encourages inequity between the rich corporate and poor individuals, as the former are allowed to manage their tax affairs in a self-interested way:

> [Our] report seeks to expose the scandal of a global taxation system that allows the world's richest to duck their responsibilities while condemning the poorest to stunted development, even premature death …. It is mostly about the world's transnational

> corporations wielding their enormous power to avoid the attentions of the tax man – with devastating results (Christian Aid, 2008, p. 1).

Reflecting public pressure and media attention, the transcripts of oral evidence given to the Parliamentary Public Accounts Committee (House of Commons Committee of Public Accounts, 2008) are revealing of political and wider public concern about the role of HMRC:

> *Q4 Chairman:* You see what surprises me is that many people will be as astonished by this as I was. If we look at 1.12, what we see there is a third of large businesses pay no corporation tax at all. That is extraordinary. Do you think that members of the public, if they were watching this, would find that very strange.
>
> *Mr. Hartnett (Chairman, HMRC):* I think members of the public would be interested to know why that is (House of Commons Committee of Public Accounts, 2008, p. 21).

So, despite promotion of organisational identity change towards enablement, even the chairman of HMRC is forced to admit that the public may be angry that a significant proportion of corporate taxpayers are able to avoid tax payment completely. Further, it seemed that he did not anticipate such a response from the public. The most senior management in HMRC did not keep an eye on the mirror to assess its image from the perspective of those outside the organisation as it engaged in identity change (Dutton and Dukerich, 1991). That the most senior manager in HMRC did not hold his ground around the virtue of enablement highlights how HMRC's core practice of regulation is decoupled from its new organisational identity as customer-focused and enabling corporate tax avoidance.

In summary, on the basis that an enabling role is necessary to support wealth creating activity, we might anticipate societal concerns about tax avoidance of corporate taxpayers are reduced. However, we note ongoing concerns expressed in the media and some very public (and often hostile) citizen reaction to those corporate taxpayers deemed to engage in tax avoidance. Given the current financial deficit faced by the UK and other governments, and subsequent reduction in public spending, the collection of tax becomes a more important moral matter for society, which has implications for organisational identity orientated towards the customer.

DISCUSSION AND CONCLUSION

Our study reveals that different external stakeholders have different views of the organisational identity change from 'regulator' to enabler' that HMRC engages in. External stakeholders contest changing organisational identity, most significantly focusing upon the moral purpose of HMRC, and whether the latter remains a 'virtuous organisation' (Moore, 2005). Even the corporate taxpayers that HMRC seek to serve exhibit distaste for the customer concept (Alford, 2002; Du Gay, 2000; Clarke et al., 2007; Needham, 2006; Rosenthal and Peccei, 2007). In short, the increasing customer orientation of HMRC impacts how external stakeholders perceive it is discharging its moral purpose, and so threatens the legitimacy of HMRC.

In Moore's (2005) terms, pursuit of external goods – customer satisfaction – has driven out the regulatory practice at the core of HMRC. Society holds HMRC to its traditional role as regulator of the large corporate taxpayer, whom the public regard as 'villains'. The 'damaged' moral identity of HMRC impacts negatively upon the social and psychological contracts between taxpayers and the government regarding tax payments. Taxpayers are more compliant when they agree with tax laws being imposed (Vihanto, 2003) and when the political process is recognised to be fair and legitimate (Feld and Frey, 2007). Citizens expect the government to provide services as a quid pro quo for paying their taxes. However, this social and psychological contract may break down if organisational identity is compromised. The House of Commons Committee of Public Accounts, in its report in November 2012, when discussing the small payments of tax by multinationals and the associated lack of detail of HMRC's approach, noted that 'this undermines public confidence in the tax system and in HMRC which could have a negative impact for wider tax compliance' (House of Commons Committee of Public Accounts, 2012, p. 3). Specifically, we suggest that HMRC, as a regulative organisation, runs the risk of undermining its legitimacy as it seeks to distance itself from its traditional authoritative and bureaucratic organisational identity, and orientates too much towards the customer (Waeraas, 2010).

Extending analysis beyond our specific empirical case, we emphasise that the moral purpose of PSOs is a significant contemporary discourse (Sveningsson and Larsson, 2006). Moral purpose is particularly important within PSOs, given associated vague and oft contradictory sets of values held by various stakeholders, around which are required difficult trade-offs, and which may prove challenging to manage (Cheney and Vibbert, 1987; Christensen and Legreid, 2007; Waeraas, 2010). In their eagerness to please customers, we argue that policy makers, and senior managers within PSOs, may think they can credibly project any impression they like to the customer, no matter what their past heritage holds. However, government regulatory organisations have legitimacy around their authoritative role and coercive powers, which is underpinned by a certain moral view of their function held by society. This coheres around the rule of law, justice, democracy, objectivity, accountability and the common good that constitutes the basis of the virtuous organisation (Moore, 2005). Should moral claims go unheeded, PSOs run the risk of losing the support of external constituents in a way that may threaten their search for legitimacy and survival (Hatch and Schultz, 2002; Teram, 2010), in which case policy makers and senior managers, when engaging in organisational identity change, might pay more attention to managing the mirror so that their image aligns with the expectations of external stakeholders (Dutton and Dukerich, 1991). In this light, we note that the media is taking more interest in the private lives of organisations, including PSOs, and is keen to expose any divergence between corporate images and organisational actions. Thus, PSOs have increased exposure to critical voices, which means creating and maintaining identity is even more problematic (Albert and Whetten, 1985).

Regarding further research, our analysis is based upon a single empirical case. The furore from the public and the media around tax avoidance may render organisational identity change from regulator to enabler particularly challenging. However, we suggest many PSOs have increased societal expectations regarding their moral purpose, and there is a need for more research into changing organisational identity in such contexts. Such research is required to fuel open public debate about organisational identity reconstruction that follows policy reform, more so when characterised by moral ambiguity (Hatch and Schulz, 2002; Teram, 2010). Finally, noting some senior managers looked in the mirror (Dutton and Dukerich, 1991) and raised concerns about their organisation's legitimacy as a regulatory agency, we encourage more research to examine the changing organisational identity of HMRC from an internal perspective.

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THE CLAIM TO THE TAX DOMAIN: EXAMINING THE ACTIVITIES OF ACCOUNTANTS IN THE LATE NINETEENTH AND EARLY TWENTIETH CENTURIES

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ABSTRACT

This paper examines the activities of UK accountants in the late nineteenth and early twentieth centuries. Its aim is to determine the nature of their work in relation to taxation, by looking chiefly at the contemporary evidence provided by The Accountant*, the accountants' professional journal. First published in 1874, this journal provides information on tax and other activities at a time when accountants were establishing their credentials as a new profession. The paper considers issues surrounding income tax in this period, as the complexities associated with it provide the wider context and backdrop for accountants' activities. It then specifically considers why and how accountants met the increasing need for tax advice and claimed this work domain as part of their professional jurisdiction. The paper then goes on to consider the role of lawyers in taxation during the same period.*

INTRODUCTION

To determine the nature of their work in relation to taxation, this paper examines the activities of UK accountants in the late nineteenth and early twentieth centuries by looking chiefly at the contemporary evidence provided by *The Accountant*, the accountants' professional journal. This journal was first published in 1874 and is a very useful source of information on tax and other activities at a time when accountants were establishing their credentials as a new profession. During much of the period covered by this paper (up to 1922), Ireland was part of the United Kingdom (UK) as a result of the Acts of Union 1800 (sometimes referred to as the

Acts of Union 1801, as 1 January 1801 was the date they came into force). Both countries thus had the same fiscal code for this period in terms of income tax (the latter being extended to Ireland in 1853 after its reintroduction in England in 1842), and professionals dealing with this tax throughout the UK would be beset by the same issues. It is acknowledged that the use of *The Accountant* does privilege to a degree the views and perspectives of accounting professionals, but this 'insider's view' nonetheless provides valuable insights. The paper develops in depth ideas briefly mentioned in earlier papers (see, for example, Frecknall-Hughes, 2012; Frecknall-Hughes and McKerchar, 2013a, 2013b).

This paper first looks at the issues surrounding income tax in this period, as the complexities associated with it provide the wider context and backdrop for accountants' activities. It then specifically considers why and how accountants met the increasing need for tax advice and claimed this work domain as part of their professional jurisdiction. The paper then goes on to consider the role of lawyers in taxation during the same period, with conclusions set out in the final section.

RELEVANT TAX ISSUES

The background to the development and establishment of a profession may often be driven by various social, economic, political and legal events (Stacey, 1954; Wilmott, 1986; Walker, 1995; Maltby, 1999). Indeed, it is difficult to provide a definition of a profession which is capable of universal agreement. Furthermore, there is no one theory that can explain the development of professions (West, 1996). Willmott (1986) discusses three perspectives on professional development: critical, functional and interactionist. The critical perspective sees the 'emergence of professional bodies … as a means of achieving collective social mobility by securing control over a niche within the market for skilled labour', and is a 'strategy for controlling an occupation, involving solidarity and closure, which regulates the supply of professional workers to the market', also allowing a basis for domination of other bodies and associations operating in the same or a similar work domain (Willmott, 1986, p. 558). Willmott (1986, p. 557) suggests that 'before the early 1970s "functionalist" and "interactionist" perspectives were dominant', but since then a '"more critical approach" has developed which draws heavily upon the work of Weber and Marx'. The functionalist perspective 'attends to professions as integrated communities whose members undertake highly skilled tasks that are crucial for the integration and smooth operation of society' (Willmott, 1986, p. 557), which is very much the approach taken in the seminal work of Carr-Saunders and Wilson (1933), whereas interactionism studies professions 'as interest groups that strive to convince others of the legitimacy of their claim to professional recognition' (Willmott, 1986, p. 557). It is, however, quite possible to see these perspectives as successive phases in professional development. For example, striving to claim professional status and recognition (interactionism) might be followed by a critical and then a functional phase or, indeed, they might be synchronous.

In terms of taxation, for example, the growth in the complexity, volume and importance of taxation legislation, especially income tax legislation in the latter half of the nineteenth and early part of the twentieth centuries, was extremely significant and resulted in a requirement for tax specialists. This was a domain which accountants were claiming as legitimate work, at a time when there were also attempts to control who should do work that was deemed legitimate and to exclude the *soi-disant* accountants who were regarded as disreputable (see, for example, Edwards, Anderson and Chandler, 2005, 2007; Anderson, Edwards and Chandler, 2005, 2007).

A key issue, arguably, was when it was realised that income tax, though still bearing the trappings of a temporary imposition, had become permanent, and people needed help to either cope with it or find a legitimate way of not paying it. Income tax had been regarded initially as a temporary tax, which was indicated by it having to be imposed annually, but it seemed apparent after the Crimean War that it would never be abolished, although Gladstone's government had intended that it should expire in 1860 – an intention indicated in the 1853 Budget. Gladstone retained it (with a schedule of reduced rates), with the awareness that such a reversal of policy would need considerable justification, which he provided by abolishing the vast majority of remaining import tariffs and the excise on paper (Stebbings, 2009, p. 62; St John, 2010, p. 96). It was the price paid for tax reform in these other areas (Sabine, 1966, p. 90; Daunton, 2001, p. 167). Over the next few years, despite the fiction of annual imposition being maintained (which is still retained to this day in the UK), the permanency of income tax became more generally accepted, although Gladstone again proposed its abolition as late as 1874 (Sabine, 1966, p. 116). Increasing numbers of companies and persons were affected by it, the latter now including 'skilled workers and senior clerks who would be earning over the exemption limit' (Sabine, 1966, p. 96). It was not always easy to administer or collect, as the income tax rules were full of anomalies, loopholes and opportunities for avoidance, as the 1851 Hume Committee[1] had revealed. Also, the rules were not always consistently applied. It may well be the case that over a period of years people had become conditioned to the idea that income tax was a temporary measure, and as it would (they thought) be abolished, there was no need to do anything much about it – an attitude which changed with the realisation that it was effectively permanent. Gladstone was explicit in 1860 about retaining it indefinitely (although he did subsequently call for its abolition), which is likely to have created a shift in the way society at large viewed the tax and reacted to it. Thus the years immediately following 1860 are the crucial context for this paper, with 1874 being particularly significant as it was in this year that it became obvious the tax would become permanent (Stebbings, 2009, p. 213), as that was Gladstone's last call for its abolition. He was also defeated in the general election on that year and retired as the Liberal party leader, which may also have resulted in less prominence being given to the idea of abolition.

THE NEED FOR TAX ADVICE – THE ACCOUNTANTS

The founders of the Institute of Taxation in the UK, established in 1930,[2] were lawyers, accountants and ex-Inland Revenue men (see Jeffrey-Cook, 1990, 1991a, 1991b), so it is reasonable to examine the accounting and legal professions in preceding years as being the likely providers of the first tax specialists. The question is how far to go back, as law is a much older professional group than accounting, which in the late nineteenth century was only about 100 years old.[3] Arguably, lawyers had been involved in taxation matters for centuries, as tax was enshrined in law, but the newer professionals were not slow to colonise this area and appeared to be at the forefront of meeting the need for tax expertise, as demanded by 'the magnitude and complication … necessary to meet the growing wants of the age' (*The Accountant*, 1874, No. 1, p. 5) in the period after 1860. Contemporary professional material provides considerable evidence for this.

The earliest issues of *The Accountant* (1874) are very useful in providing this evidence.[4] A comment in the journal in 1875 (No. 38, p. 14[5]) remarks on the parliamentary return for 1873 in terms of income tax raised: nearly one half of the total collected in England was paid by trades and professions, with more than half of the total collected in Scotland being paid by trades and professions. One of the earliest references to taxation in the journal is in 1878 (No. 185, p. 3), in the matter of the Crown's prior claim to payment of income tax in a liquidation – *Re Henley & Co.* – with this being disputed, as the Income Tax Act of 1842 prescribed treatment of claims on an equal footing, which a prior claim by the Crown would violate. The key question here was which had priority where two different statutes appeared to be in conflict, causing considerable debate, although in due course the Crown would come to have priority in such instances.

A recurrent theme in numerous issues of *The Accountant* proved to be the correct deductions of income tax from dividends or interest (the treatment differed). Letters to the journal reveal uncertainties about whether interest should be taxed on an accrual basis or a paid basis, and whether dividends should be taxed when paid or payable, the latter case being further complicated by uncertainty as to the tax rate to apply if there had been a change of rate between the date of a dividend being declared payable and the date it was actually paid. Difficulties surfaced very early on in 1878 (No. 189, p. 5), in an article reporting on apparent discrepancies between how English railway companies, as opposed to Indian railway companies, dealt with a difference in the applicable tax rate where two different fiscal years were involved. A letter in the London press from Fred B. Garnett, Secretary of the Board of the Inland Revenue, was quoted in confirmation of the correct treatment.[6]

In 1880, a letter was printed (No. 279, pp. 5–6), under the title of 'Income Tax', which summarised a wealth of bitter sentiment against income tax and the way it was collected, which is worth citing in full. The writer puts forward the view:

1. That this is a tax on labour, and that no distinction is made in the rate charged to the man who does not work at all, and to him who has to work.
2. That it is an inquisitorial tax.
3. That it is assessed on a most unfair principle, and is not a correct way of ascertaining a man's real profit.
4. That the conditions imposed, whereby a mortgagor or borrower is deemed to act as agent for the collector, are unjust.
5. That it is unjust to assess on an average of 3 years.

The writer, an auditor of various companies and firms (who at that time did not need to be a qualified accountant), cites examples from his clients and his own personal experience as well as hypothetical examples in support of his complaints. The chief issues are that no distinction is drawn between unearned and earned income; that if there is a difference of opinion between the taxpayer and the authorities, the taxpayer is compelled to open his books up to Revenue inspection, which was resented as an intrusion of the grossest kind; a perception that the tax does not take account of legitimate expenses which should be deducted to arrive at net profits; that the collection of income tax on interest paid is done by an unfair means; and that assessment, in the case of (5) above, which refers to persons commencing trade after being employed, should be on an annual basis.

This type of complaint is made similarly by the National Traders' League (*The Accountant*, 1883, No. 470, pp. 4–5), particularly emphasising point (2) above:

1. Surveyors of taxes[7] regularly increase sole traders' assessments without cause and aggrieved parties cannot appeal without closing their shops.
2. Victims submit rather than expose books to district commissioners.
3. District commissioners habitually ignore accounts submitted to them.

The traders complained that district commissioners did not allow deductions from profit and were generally high-handed in their dealings, 'cutting about' the profit and loss account so that the true profit was unrecognisable (1883, No. 466, pp. 6–7; No. 467, p. 6; No. 468, pp. 5–6). The traders wanted accounts certified by a chartered accountant to be conclusive evidence in respect of assessment. This suggests that accounts were being regarded as reliable and should thus be deemed valid by parties other than those for whom they were prepared – and further, that they had been prepared by reputable professionals. This occasioned a response from one W.H. Cousins on behalf of the commissioners (1883, No. 470, p. 12), which stated that the charge of increased assessment was too general, but that the commissioners would investigate if particulars of specific cases could be provided; that Schedule D traders need not be assessed by district commissioners, they could elect to be assessed by Commissioners for Special Purposes appointed by the Crown; and that the charge of ignoring accounts was too general for them to provide a response. In regard to the idea that certified accounts should be conclusive evidence of liability, Mr Cousins comments that the district commissioners are gentlemen selected by the Land Tax Commissioners to administer income tax in an 'independent and unbiased manner' and are not under the control of the Board of the Inland Revenue or any other government department. Moreover, he says the district commissioners do accept accounts. Robinson (1964, p. 219; 1984, p. 219), however, makes the point that, in Ireland at least, taxpayers had resisted tax authorities' requests for certified accounts in support of profit calculations, but acceded as such accounts most easily refuted the assessments the authorities issued that were so high that taxpayers were forced to appeal and incur additional costs (implicit also in the citation above from *The Accountant*, 1883, No. 470, pp. 4–5). If then tax authorities were not accepting figures in accounts that they themselves had requested, the grievance underlying the complaint in *The Accountant* is more easily understood.

Different kinds of material included in *The Accountant* confirm that the calculation of taxable income was of considerable professional concern. An issue in 1880 (No. 306, p. 8) reported on a paper read by David Chadwick (the first president of the Institute of Chartered Accountants in England and Wales (ICAEW)) at the Social Science Congress in Edinburgh, entitled 'For Purposes of Taxation What Is the Most Scientific and Practical Definition of the Word "Income"?' Income should be a:

> … clear annual amount after deducting all necessary outgoings received from any property or investment of capital, or from any trade, profession or occupation, or from any annuity or other source leaving at the end of each year the capital of source intact.

In 1882 (No. 412, p. 8), there is a request to the editor, as follows.

> Sir, – As Accountants are frequently consulted by their clients on questions of income-tax returns, perhaps some of your readers can inform me if there is any work published serving as a guide or reference, and, if so, where such can be cheaply procured.
>
> Yours, &c.
>
> D.E.L.
>
> October 19th, 1882

This produced several recommendations, for example, of works by Dowell and Senior respectively (1882, No. 413, p. 6), but also included a stern rejoinder (1882, No. 416, p. 7) from 'S.D.N.' to 'study carefully the various Acts of Parliament authorising the imposition of the tax' as there is no reliable guide.

Various letters and articles in early issues of *The Accountant* indicate a great deal of uncertainty as to what was permitted by law and what exact role the Revenue Commissioners was supposed to play in administering and applying the law, particularly in the context of trade. An article entitled 'Income Tax' in 1884 (No. 480, pp. 8–9) stated that the commissioners 'overstep the bounds between duty and tyranny' (p. 8) and that by their refusal to accept estimates of income, which then led to examination of a person's private affairs, people were made to appear dishonest. The same article cites the case of *Knowles and Sons v McAdam*, in which the commissioners disallowed 'depreciation' charged in respect of extracting coal from the ground, which had been calculated as the difference between the value of the relevant asset at the beginning and end of the company's financial year. The company appealed and won, with the court allowing a reference to McCulloch's *Principles of Political Economy* fourth edition, p. 530. The article goes on to comment (*The Accountant*, 1884, No. 480, p. 9) that:

> … even so powerful a body as the Income Tax Commissioners are not permitted to make their own law, but their duty is simply to administer it, and to do so in the interest, and not to the detriment, of Her Majesty's subjects.

The Income Tax Commissioners did not let this matter rest.[8] In the same year, there was a further article (1884, No. 482, pp. 6–7) reporting on their attempt to reverse the decision in the *Knowles and Sons* case in the (Scottish) Court of Session case, *Coltness Iron Company v Black*, which ultimately went before the House of Lords. The point at issue was whether the costs of sinking/boring new pits to replace worn-out ones were permissible deductions from profits. The House of Lords gave judgment for the Commissioners, finding that the cases were not analogous, so the later one did not overrule the earlier one. The costs of working a mine (as in *Knowles*) could be deducted, but not the cost of making it (*Coltness Iron*), though doubts were cast over the decision on the *Knowles* case, especially in terms of depreciation and what it actually meant. These cases are early examples of attempts to distinguish revenue expenditure from capital, thus helping to define what constitutes income, and are significant in the development of both accounting and taxation principles, but they derive at root from accounting issues (see especially Lamb, 2002, on the issue of depreciation). The same article (1884, No. 482, p. 7) also takes the opportunity to express considerable dissatisfaction with income tax in general.

> It is at once a tax upon honesty, industry, and perseverance, and being originally imposed for the purpose of carrying on the scourge of war, has since continued to be a scourge on those who employed it for that purpose.

The letters in *The Accountant* and the court cases indicate that the practical experience of accountants with the day-to-day affairs of companies and businesses helped them to become experts in the technicalities of translating the word of law into specific numbers, thus having an effect on taxable amounts. They were involved in business processes and possessed the specialist knowledge that allowed them validly and credibly to challenge tax officials. Such involvement would put them on a different footing from legal professionals, which the following discussion makes clear.

The journal frequently printed queries and/or letters on other tax topics, giving an indication of the types of issues accountants encountered, such as areas of legal uncertainty or ambiguity and other problematic issues, for example, whether income tax is payable on capital borrowed from bankers as distinct from private lenders (1884, No. 481, p. 6), on the apparent different treatments of depreciation (1884, No. 482, p. 8), on how tax should be levied on agents of foreign 'houses' (1885, No. 556, p. 9), and how building societies should deal with income tax in respect of interest on mortgages (1884, No. 523, pp. 13–14). This last matter was raised in the House of Commons, with the Chancellor of the Exchequer replying that the Board of the Inland Revenue was looking into the matter, concluding that (1884, No. 523, p. 14) 'the question is one of a highly technical character and surrounded with practical difficulties'. It might be inferred from this that the authorities likewise were unclear how to deal with it, a view that is reinforced by the result in another case, *Last v The London Assurance Corporation*, being queried in the House of Commons in its application of the law (whether income tax was assessable on profits returned to members of the aforementioned company (1885, No. 555, pp. 4–5)) to the Financial Secretary of the Treasury, Sir H. Holland, who replied that he could not say anything until he had considered the 'shorthand writer's notes' (1885, No. 555, p. 9). Even the judiciary had problems in applying income tax rules, the current difficulties being so great that '… judges in the highest judicial tribunal in the realm hold and express the most diametrically opposite views', undoubtedly because of '[t]he inquisitorial nature of the Income Tax, the unfairness with which it is levied, the numberless ways in which it may be, and is, evaded [which] furnish strong argument to those who advocate its abolition' (1885, No. 555, pp. 4–5).

Attempts to dispel at least some of the cloud of uncertainty were provided by lectures on income tax to accounting students, such as that by Mr A. Murray, Fellow Chartered Accountant (FCA), to the Manchester Accountants' Students' Society (1885, No. 474, pp. 8–11); by Mr. W.L. Gough, Surveyor of Taxes, to the Nottingham and Midland Counties Accountants' Students' Association (1885, No. 537, pp. 10–11 and No. 538, pp. 8–10); and by Mr R.R. Daly, Associate Chartered Accountant (ACA), to the Liverpool Chartered Accountants Students' Society (1894, No. 999, pp. 93–98), who admits that, in regard to the importance of income tax, 'we ought to be more fully masters of it than, I may as well confess, I for one was' (p. 93).

The issues referred to above are typical of the tax content in early issues of *The Accountant* – and this continued with a similar degree of frequency in subsequent years. Hence it is not surprising that one of the very early specialist tax firms was the Income Tax Adjustment Agency, which began to offer its services in 1890, shortly followed by the Income Tax Repayment Agency in 1901. By 1914 'there were fourteen rivals' offering similar types of advice (Jeffrey-Cook, 2002).

The material already cited from *The Accountant* suggests that there were considerable technical difficulties posed by taxation. These continued into World War I and beyond. Stopforth (1990, p. 238) cites the comments of Sir Josiah Stamp (considered to be the leading tax authority of his day), writing in 1919, after income tax rates had risen significantly in the war:

> 'Taxation is now rapidly developing from a merely unpleasant incident into a dominating feature of daily life, and those features which hitherto have been of little interest, because they have been too small to matter, now become of great importance; the blemishes which were insignificant may now be intolerable because in the magnitude of the burden they have become sufficiently magnified or intensified to be within the range of ordinary human feeling.'

The situation was exacerbated by the introduction of the Excess Profits Tax (see also Plehn, 1920), and the greater demand by authorities for accurate figures to ensure that liabilities were calculated correctly (see Farmar, 2013, pp. 62–63) – all providing work for accountants. Stopforth (1990) also comments on the growth of professional expertise in respect of avoidance schemes, from about 1910, which clearly gave domain to accountants. This had also been increased by the Finance Act 1903, which allowed accountants (as well as solicitors and barristers) to appear before the Income Tax Commissioners, something which was resented by the legal profession (see also Walker, 2011). *The Accountant* established a regular advice column, because of the increasing importance of income tax, as taxpayers needed '"the advantages of professional assistance in a subject of such intricacy"' (Stopforth, 1990, p. 243, citing *The Accountant*, 6 June 1914). In 1922, the journal increased its fees as a consequence of the increased cost of providing its readers with such advice.

Another indication of the increased need for tax advice to meet the requirements of an increasingly complex environment is seen in the establishment in 1927 of the professional journal *Taxation* (Jeffrey-Cook, 2002). Significantly, it was begun by Ronald Staples, who was one of the founder members of the Institute of Taxation. In 1931, *Taxation* carried an article on the formation of the Institute:

> 'Before the war [World War I] there was little to learn about taxation law and practice but as the burden has increased with its ever-growing "ill-digested mass of legislation", it has become a highly specialised subject and every accountant and solicitor in the country realises the importance of studying it.
>
> Learned judges and eminent lawyers are constantly admitting that the subject is one of the most intricate in their experiences, and as the years go by the Finance Act provisions relating to taxation seem to become more obscure and official publications more exacting.
>
> The recent announcement of the formation of the Institute of Taxation, therefore, came as no surprise to our readers who will realise that the need for such a body has long been felt' (Anon. (1931), reproduced in *Taxation*, October 1987, p. 34).

Although the above article must be read in the light of justifying the establishment of a professional body, it clearly indicates that tax difficulties continued.

The material in *The Accountant* shows that accountants had quickly become involved in income tax issues. That they had done this so swiftly may be a result of their engagement in commercial accounting and financial statements, as income tax on company profits, dividends, interest, etc., is a natural corollary to that engagement. They were already involved and prepared to acquire the technical knowledge as an extension to what they were already doing. This expansion of their 'cognitive dominion by using abstract knowledge to annex new areas, to define them as their own proper work' (Abbott, 1988, p. 102) is one of the defining traits of a profession. Accountants were claiming the tax domain as part of their activities to help to establish professional validity by defining what was the 'proper' work of an accountant, contemporaneously with the issues surrounding the establishment of the various accounting professional bodies in the late nineteenth century (see, for example, Edwards et al., 2005, 2007; Anderson et al., 2005, 2007). Tax was part of that 'proper' work, and while accountants were not allowed to advertise their services, the fact that they could provide a tax service as an 'add on' to what they did would make their services overall more attractive to clients. Anderson et al. (2005, p. 43) note the 1894 case of 'Mr ACW Rogers, who enquired [of the ICAEW] whether he could add the words "Income Tax Adjustment Agency" to his sign' as a chartered accountant. The ICAEW denied his request, the concept of agency being one of many work areas it felt was not fitting for an accountant. It did not, however, comment on the unsuitability of taxation when it had a clear opportunity to do so.

This swift colonisation of an emerging or unclaimed area appears to be a recurrent feature of the accountancy profession and its willingness to develop, which continues in more modern times. For example, Dezalay (1991, p. 795) comments, in relation to tax law consultancy in Europe, that this was an area 'left fallow' by lawyers, although an area which theoretically fell into the legal domain, because it 'was disdained by top European lawyers, and … as a consequence, was progressively appropriated by accountancy firms'. The reason for this was that this type of work was seen as not respectable, as it was on the fringes of what the higher levels of the continental legal profession deemed acceptable. Accounting, to which this area was seen as connected, had been viewed as a craft allied with trade, conferring no social status on the accounting practitioner, whereas the practice of law conferred considerable social prestige – what Dezalay (1991, pp. 792–793) inherently attributes to the superiority of 'the republic of letters' over 'the empire of numbers'.

An important characteristic historically associated with professions, as opposed to engagement in trade and commerce, has been the enhanced social standing that their members have enjoyed. From early times, professions were deemed fitting occupations for the well-educated 'spare' sons of the aristocracy and gentlefolk, who were unlikely to inherit family titles or land to provide them with an income. These 'spare' sons often became clergymen, army/navy officers, medical men or lawyers without any noticeable diminution in their social standing. Engagement in trade (and 'getting one's hands dirty'), involving profits and money, was regarded as degrading, unless immensely successful in financial terms. Rutterford and Maltby (2006, p. 175) make clear that the system of primogeniture, designed to ensure the intact transmission of landed estates from one generation to the next, often by means of an entail, 'penalized younger sons' (Rutterford and Maltby, 2006, p. 178). If a younger son failed to inherit money from another relative or to make an advantageous marriage:

> In order to maintain their status as gentlemen, they were restricted to employment in respectable professions such as the civil service, the law, the Church, and the armed forces (Rutterford and Maltby, 2006, p. 178).

This solution to the 'younger son problem' (Rutterford and Maltby, 2006, p. 178) had long been recognised but by the 1870s was no longer as widely available, owing to open competition (Rutterford and Maltby, 2006, p. 178, citing Brodrick, 1872).[9]

The emergence of the need for financial experts who could understand trade helped establish the various accounting institutes, but their members' social standing was regarded as tarnished because of the association with trade. The need to deal with the tax arising as a consequence of profit, giving rise to a need also for tax experts, meant that tax and tax activities were similarly regarded and thus taken up by accountants and not lawyers.

Similarly, albeit somewhat later in time, audit specialists in the 1960s took the offensive by appropriating greater responsibilities in the tax area, claiming a good knowledge of taxation practice which was supported by a 'long-standing familiarity with fiscal bureaucracies' (Dezalay, 1991, p. 797). Through:

> … their ability to construct tax devices, which make it possible to minimise tax demands by exploiting loopholes in the law, accountants have gradually succeeded in occupying the position of consultants to economic leaders. Their presence at the inception of a transaction, which they helped to structure, ensures that they are well-placed to sell other services (Dezalay, 1991, p. 797).

THE NEED FOR TAX ADVICE – THE LAWYERS

Given that taxation is imposed by law, there is a disputed 'border territory' between the professions of law and accountancy (Freedman and Power, 1992, p. 1) into which tax undoubtedly falls. The material cited from *The Accountant* suggests that accountants colonised the income tax area very thoroughly. What were the lawyers doing while this was happening? The research which examines the legal profession considers mostly its development (see, for example, Baker, 1981; Baker, 2002, pp. 155–172; Brooks, 1981; Duman, 1981; Levack, 1981; and Prest, 1981, 1987), but work which considers the particular type of work that lawyers actually did is distinguished by extreme scarcity.

One of the issues that affected the newer accountancy profession was an attempt, as has been discussed earlier, to define what Abbott (1988) refers to as the 'proper work' or jurisdiction of the profession in terms of what its members could and could not do, in a definite attempt to raise its status, professionally, socially and economically. By and large, there was never any debate in law as to what the work domain was, as this was automatically defined by the word 'law', though there might have been consideration as to which type of practitioner might deal with an issue at different stages, a process which was developed and refined over many years. In early times (see Baker, 1981; Baker, 2002, pp. 155–172; O'Day, 2000), distinctions between lawyers in terms of who carried out particular functions was much less clear. However:

> By the mid-sixteenth century there were two branches of the legal profession – barristers, and attorneys and solicitors. Traditionally solicitors dealt with landed estates and attorneys advised parties in lawsuits. Gradually, these two roles combined and the name 'solicitors' was adopted (Law Society, 2015).

Although there were many solicitors of impeccable reputation, the profession also had 'pettifoggers and vipers' (a term used by Brooks in the title of his 1986 book), which damaged its reputation. In 1825 'to raise the reputation of the profession by setting standards and ensuring good practice' (Law Society, 2015), the Law Society[10] was formally founded (obtaining its first royal charter in 1831, with a new charter in 1845). It is not often remarked that the formal organisation of the modern legal profession, in terms of its professional bodies, is so close in time to that of the accountants, and the ICAEW in particular. The Bar Council, as the regulatory body for barristers, was an even later development, in 1894 (Bar Council, 2011). However, it seems more the case that the setting up at these dates of professional bodies did not *per se* drive the establishment of the profession itself or determine its legitimacy, in the same way as establishing professional bodies validated the accounting profession. The law bodies were more a recognition of a status quo.

Although it was commented above that research into the type of work done by lawyers is scarce, in many ways it might be viewed as self-evident, as the tax cases referred to above (e.g. *Re Henley & Co.*) would require the appropriate involvement of lawyers. There is no doubt of that involvement, even in tax matters pre-dating income tax. For example, Ferrier (1981, pp. 303–304) reports on a 1783 scheme to 'get round' the payment of a two-pence scot duty payable in Glasgow on each pint of ale or beer brewed, brought in or sold in the city and suburbs, in the case of *Magistrates and Town Council of the City of Glasgow v Messrs Murdoch, Warren & Co*. The brewers, based at Anderston, then far enough away to be considered as not in the city or suburbs, announced that they would cease to supply the city, and made a contract with a Mr Munro, who bought the beer and supplied it to customers from the Anderston premises. The case was taken to the House of Lords. Lord Mansfield was the foremost judge, and had no qualms about judging this a tax avoidance scheme which should not be allowed, and ignoring the 'device of the intermediate contract with Munro' (Ferrier, 1981, p. 306). In general, however, there is still no academic insight into the 'behind the scenes' work of either solicitors or barristers.

Lawyers had been involved in tax work for many years, especially in terms of dealing with tax on death and so on (for example, probate duty had been introduced in 1694, with succession duty and estate duty appearing in the mid- to late 1880s). This was usually and clearly linked to the need for a solicitor when a will was made. The full extent to which the legal profession colonised the newer areas offered by income tax remains to be investigated.[11] Logically, lawyers might be expected to be less proactive than accountants, as their role is typically played at the end of a process, for example, when dealing with a person's estate or when a matter is referred to court, as already mentioned, and thus they absorbed the additional work as something akin to their existing role as advocates, 'strict defenders of their client's interests' (Dezaley, 1991, p. 794). Clients would thus seek them out, whereas accountants would seek out clients. It may be that income tax work offered sufficient scope for both accountants and lawyers to co-exist without rivalry, as both thus had different roles to play. Certainly, a brief look at the *Solicitors' Journal & Reporter*, one of the main professional journals for solicitors, would seem to confirm this. For example, Volume 6, 1861–1862, for 22 March (p. 381), carries a letter about 'Deed Stamps in the Colonies' and for 7 December (p. 89) a query from 'TYRO' about succession duty receipts. Early comments about income tax appear to relate to how it affects solicitors themselves as professionals, rather than how it affects their clients. In the *Solicitors' Journal & Reporter*, Volume 5, 1860–1861, for 18 May (p. 501) there is an untitled piece about a petition signed by 700 solicitors complaining about how they suffer 'grievous hardship', like many other professional men, because of the 'precarious' nature of the incomes. At this time, such rivalry as did exist between accountants and lawyers seems confined to insolvency and bankruptcy work (see Walker, 2004) and there is frequent sniping by one profession at the other in their professional journals. For example, *The Accountant* (1875, No. 20, pp. 3–4) refers to lawyers regarding accountants as 'poachers'. It may also be the case that lawyers in general considered the work derived from arenas such as company accounts as *infra dignitatem* – as tainted by an association with trade – which carried a certain social stigma, and therefore only became involved at a stage beyond this or when their services were deemed essential (i.e. when matters went to court). While this is speculation, given the comments of Dezalay (1991) referred to earlier and solicitors' history of dealing with the landed gentry, it is not wholly without foundation. It is, however, given some support by legal resentment over accountants (as well as solicitors and barristers) being allowed by the

Finance Act 1903 to appear before the Income Tax Commissioners, as mentioned previously.

CONCLUSION

This paper has put forward the case for accountants being very proactive in claiming tax work as 'proper' work falling into their domain, at a time when they were establishing themselves as credible and valid professionals and setting boundaries for their work in terms of what was and was not deemed suitable. It is argued that their association with trade made them well placed to follow up on the tax issues associated with expenses to be deducted in computing profits, dividends, interest, etc., for companies, and, indeed, for individuals associated with companies, such as directors (not to mention exploiting opportunities for avoidance – see Stopforth, 1990). This is supported by a wealth of contemporary material from *The Accountant*. However, while the evidence from this journal more than supports the case made here, it would be helpful also to look also at other contemporary, professional accounting journals to expand on this, as there were several published in this period, such as the *Incorporated Accountants' Journal* (first published as a quarterly journal in 1889, becoming a monthly publication in 1895) and *The Circular*, launched in 1905, which became the *Certified Accountants' Journal* in 1909. Similarly, it would be useful to look in greater details at the *Solicitors' Journal & Reporter* and other professional law journals, but these are projects for further research.

ENDNOTES

1 The Select Committee on Income and Property Tax was its official title.

2 This became the Chartered Institute of Taxation in 1994, when a royal charter was granted.

3 *The Accountant*, 1882, Vol. 8, No. 400, pp. 4–5, refers to the profession at this date as not going back 'more than a century'.

4 Robinson (1964, pp. 217–218 and 1984, pp. 217–218) comments that *The Accountant* did not devote 'any space to tax affairs prior to 1900'. However, as this paper proves, issues relating to income tax are evident in terms of the problems it created.

5 References from here onwards in the form of year, issue number and page reference(s) relate to issues of *The Accountant*. The majority of items are not attributed to any named author, and many do not have specific titles.

6 See also 1880, No. 292, pp. 4–5; 1880, No. 314, p. 12; 1884, No. 523, p. 13.

7 These were the forerunners of inspectors of taxes.

8 It may be that this is the result of a higher quality of surveyor now becoming involved in tax cases. Open, competitive examinations for the post of surveyor were introduced in 1881 (Sabine, 1966, p. 122).

9 See further Frecknall-Hughes and McKerchar (forthcoming 2015/2016).

10 It was originally called the London Law Society at its more informal inception in 1823, but 'the term "London" was dropped from the title to reflect the Institution's national aspirations' (Law Society, 2015). The first formal title was 'The Society of Attorneys, Solicitors, Proctors and Others Not Being Barristers, practising in the Courts of Law and Equity of the United Kingdom'. In 1903 the official name was changed to 'The Law Society' (Law Society, 2015).

11 This will require extensive study of, for example, case law reports and the legal professional journals during this period.

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IRELAND'S INTRODUCTION OF TRANSFER PRICING: A NEW INSTITUTIONAL THEORY PERSPECTIVE

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ABSTRACT

This article explores the rationale for Ireland's introduction of transfer pricing legislation in 2010. For most multinational corporations, tax planning involves structuring the business in a way that justifies the location of profits in low-tax jurisdictions, underpinned by transfer pricing methodologies/legislation. This may involve the use of tax haven locations or the use of hybrid structures to reduce a group's effective tax rate. The continuing facilitation of such structures by tax authorities may impact on Ireland's legitimacy internationally. Such an appeasement may bring into question the State's 'organizational identity' (Dhalla and Oliver, 2013, p. 1804).

Drawing on new institutional sociology (NIS), a theoretical framework is established of the context and processes connected with designing, endorsing and diffusing transfer pricing policies. It draws on the work of Dillard, Rigsby and Goodman (2004) and Mulligan (2008, 2012) in developing the framework. NIS is 'primarily concerned with an organization's interaction with the institutional environment, the effects of social expectations on the organization, and the incorporation of these expectations as reflected in organizational practices and characteristics' (Dillard et al., 2004, p. 508).

The evidence in this study was collected using semi-structured in-depth personal interviews with thirteen senior tax advisors. The recurring evidence emerging from the research was that Ireland's need to achieve and protect its international legitimacy as a mature fiscal jurisdiction underpinned the rationale for the introduction of transfer pricing. Both coercive and normative isomorphism forces were also at play in the introduction of the rules, emanating from

mounting institutional pressure from various parties including the Organisation for Economic Co-Operation and Development (OECD),[1] Group of Twenty (G20), International Monetary Fund (IMF) and other governments.

INTRODUCTION

This paper addresses the research question, 'What was the rationale for Ireland introducing transfer pricing in 2010?' The manner in which such a fundamental and normative component of tax policy was introduced and subsequently monitored is arguably sacrosanct in ensuring Ireland's reputation and legitimacy is upheld. The paper should assist tax policy makers and other observers in Ireland and elsewhere in gaining a greater understanding of the process and practice of transfer pricing, which in turn may contribute towards a more successful implementation of Irish tax policy in an ever-changing global economic climate. Transfer pricing challenges from overseas tax jurisdictions could have serious multimillion Euro implications for the Irish Exchequer, presenting the government with significant challenges in the advance planning of tax revenue.

The term 'transfer pricing' literally means the pricing of business transactions between associated persons (Li, 2002, p. 824). In an international tax context, transfer pricing often refers to the artificial arrangement of internal pricing within a multinational corporation (MNC), with the intention of creating a tax advantage sometimes referred to as mispricing, which some commentators consider 'crosses the line from tax avoidance into outright tax evasion' (Morais, 2009). Transfer pricing has become an important international tax concern for three main reasons: globalisation, the opportunity this provides to taxpayers to manipulate their transfer pricing and the need for revenue authorities to protect their revenue base (Eden, Dacin and Wan, 2001).

Transfer pricing practices matter to the state as they affect the taxes it can impose on corporations' profits to finance the provision of public goods and services and thereby secure legitimacy (Sikka and Willmott, 2010). Accordingly, transfer pricing is central to both the debate about the legitimacy of the state and the social responsibility and accountability of corporations. The ability for MNCs to undertake transnational income shifting has significant repercussions for international fiscal policy makers (Li, 2002).

One of the consequences of the recent global economic downturn is an increase in the level of complex and prescriptive worldwide regulation. The effectiveness of the larger nations and indeed the OECD in driving the tax agenda was in evidence through the efforts of the G20 in increasing the level of exchange of tax information and the focus on tax transparency. Within this economic, political and social environment, the introduction of a formal new transfer pricing regime in Ireland in 2010 was not unexpected.

Globalisation creates 'integrated businesses with enormous cross border transfers while corporate income tax systems remain nationally based' (Eden et al., 2001, p. 1). They highlight that governments contend globalisation enables MNCs to beguile transfer prices and curtail their tax exposures, thereby requiring 'tighter regulation' (Eden et al., 2001, p. 1).

TRANSFER PRICING – IRISH CONTEXT

MNCs operating in Ireland have benefited from a favourable corporate tax regime over many years with a range of tax rates from 0 per cent (export sales relief (ESR)/ Shannon relief) to 10 per cent (manufacturing and financial services) and finally to the more recent 12.5 per cent rate (which is now available to *all* trading companies). This array of low taxation rates has provided an attractive fiscal environment for foreign direct investment (FDI) and the potential to shift profits into Ireland (PricewaterhouseCoopers, 2009). A number of commentators have highlighted the extent to which MNCs have been using transfer pricing to shift profits into Ireland (Stewart, 1989; Honohan and Walsh, 2002; Sullivan, 2004; Conefrey and Fitzgerald, 2009).

Recent United States (US) Internal Revenue Service (IRS) challenges have also illustrated the extent to which the Irish state has been used by MNCs to shift profits into Ireland, to avail of its low corporate tax rate of 12.5 per cent. This is particularly prevalent in the high technology and pharmaceutical sectors, as highlighted by Sikka and Willmott (2010). Up until recent taxation changes regarding intellectual property in 2009, transfer pricing provisions in Irish tax legislation were only of limited application, and few resources had been devoted to the area by the Irish Revenue Commissioners (PricewaterhouseCoopers, 2009). Eden et al. (2001) note that small capital importing countries (like Ireland) historically tended to pay little regard to transfer pricing. Yet transfer pricing was a significant issue both for MNCs operating in Ireland and for Irish companies investing abroad, due to the interventions of foreign tax authorities.

The introduction of transfer pricing must be considered in the context of the evolution of Irish tax policy over the last 60 years from the early days of ESR[2]/Shannon exemption,[3] to the transition from the 10 per cent rate to the 12.5 per cent rate of corporation tax in 2003, to the eventual introduction of transfer pricing in the Finance Act 2010. This was discussed at length during the interviews and provided a rich contextual backdrop to the research question. The contrasting perspective when Ireland was at a stage of industrial infancy (1950s to mid-1990s) compared to the era of the so-called 'Celtic Tiger' (1995–2007) is demonstrative of the political nature of institutional change both incremental and radical (Dillard et al., 2004; Greenwood, Raynard, Kodeih, Micelotta and Lounsbury, 2011).

The Irish government introduced transfer pricing law in the Finance Act 2010, which applies to accounting periods commencing in 2011. The provisions provide that 'income' can be adjusted upwards or 'expenditures' downwards (section 835C(2), Taxes Consolidation Act 1997) so these provisions may not give rise to any fiscal deterioration for the Irish Exchequer. The fact that the new laws only provide that income can be adjusted upwards may not prevent the age-old conundrum of profit shifting.[4] This approach is consistent with the views of Sikka and Willmott (2010, p. 353), who highlight that '… low or no tax jurisdictions have little direct interest in monitoring transfer pricing practices to ensure that they comply with the arm's length principle'. A double tax agreement using the mutual agreement procedure (MAP) must be used if an Irish company seeks a downward adjustment to its income for tax reporting purposes, resulting from an overseas transfer pricing adjustment that increases income in the overseas counterparty company.

The new regime[5] includes many features expected of a jurisdiction introducing transfer pricing rules for the first time, but interestingly the legislation contains two unique characteristics. First, the new regime is confined to related party dealings that are taxable at Ireland's corporate tax rate of 12.5 per cent (i.e. trading transactions[6]); and second, a 'grandfather' clause whereby arrangements entered into between related parties prior to 1 July 2010 are excluded from the new transfer pricing rules. The exclusion of non-trading income from the new transfer pricing provisions preserves an important tax arbitrage opportunity for the FDI community in Ireland (this is typically achieved by lending the after-tax Irish-sourced profits on an interest-free basis to a related company in Luxembourg which secures a deduction for 'notional interest' deemed payable to the Irish lender. Typically the Luxembourg company then lends on the monies (at an arm's length interest rate) to another affiliate in another jurisdiction which secures tax relief on the interest it pays the Luxembourg company, sometimes referred to as a deduction/no inclusion outcome (D/NI).) The consensus amongst interviewees was that this 'carve out' was as a result of a compelling lobby from the FDI community in Ireland (Heij, 2012; Roberts and Bobek, 2004; Suchman and Edelman, 1991), in so doing recognising the conflicting institutional demands (Pache and Santos, 2010).

Having provided a contextual background for this research, we now present the theoretical lens through which the research was undertaken. We then outline in turn our theoretical model, the research methodology adopted and our findings from our fieldwork and in our concluding remarks identify future research possibilities in this important field.

NEW INSTITUTIONAL SOCIOLOGY

There are three strands of institutional theory identified in the literature, namely old institutional economics, new institutional economics and new institutional sociology (NIS). The research addressed in this paper focuses on NIS as this facilitates the consideration of the 'social, political and economic aspects that make up the context within which an organisation functions' (Dillard et al., 2004, p. 511). These assist in constructing a theoretical framework of the context and the processes associated with creating and adopting transfer pricing policies.

NIS is primarily concerned with an organisation's interaction with the institutional environment, the effects of social expectations on the organisation and the incorporation of these expectations as reflected in organisational practices and characteristics (Martinez and Dacin, 1999). The goals of NIS are to develop potent explanations of the ways in which institutions assimilate historical experiences into their rules and organising logics (DiMaggio and Powell, 1991a). It focuses on the 'importance of the social context within which organizations operate' (Scott, 2008, p. 211). Institutional theorists recognise the interplay of both top-down and bottom-up processes in shaping, constraining and empowering actors within the organisational field (Scott, 2008).

So what is an institution? Peters (1999, p. 29) describes it as a compilation of values and rules, mainly normative rather than cognitive in the way in which they impact institutional members, as well as the routines that are established to implement and enforce those values. North (1990, p. 4) notes that 'an essential part of the functioning of institutions is the costliness of ascertaining violations and the severity of punishment'.

Hussain and Hoque (2002, p. 164) advocate that institutional theory 'adopts a broader, multi-dimensional approach for focusing on issues of external (macro) and internal (micro) organizational contexts'. They also posit that this perspective 'has contributed significantly to the understanding of the relationship between organizational structures and the wider social environment in which organizations are situated'. North (1990, p. 64) notes that 'a theory of institutions also inevitably involves an analysis of the political structure of a society and the degree to which that political structure provides a framework of effective enforcement'.

Dillard et al. (2004, p. 507) recognise the limitations of extant institutional research and criticise the lack of consideration given to the 'dynamics associated with change or the role of human agency' and to the role played by power, special interest and the political dimensions of organisations. Indeed Tuttle and Dillard (2007, p. 390) recognise the political process as one in which 'interested actors organize and mobilize their power to influence the field'. In their theoretical model, Dillard et al. (2004) emphasise the continuous recursive nature of their model, noting that the organisation field practices and criteria will also affect the economic and political level criteria, by either accepting the norms and practices articulated by the powerful interest groups, modifying them, or eliminating them and thereby affecting the resource allocation process within a society and the recognised social order (Dillard et al., 2004, p. 514).[7] Dillard et al. (2004, p. 518) specify three constructs, namely representation, rationality and power, to analyse and understand organisational actions within a larger institutional and societal context. They believe the advantage of the NIS-based approach is that it enables consideration of the social, political and economic aspects of the organisational field in which the MNC operates (Dillard et al., 2004, p. 511).

An organisation and its environment are located in a larger organisational field (DiMaggio and Powell, 1991b, p. 65), which they define as being composed of the organisations that produce the same good or service, supply the resources they require and consume their products, and also the regulatory agencies and various occupational associations that govern them. It includes within its purview parties that are meaningfully involved in some 'collective enterprise' (Scott, 2008, p. 208). DiMaggio and Powell (1991b, p. 65) emphasise that the conception is not confined to competing firms or networks and note the significance within their definition of including the 'totality of relevant actors'. In so doing, the concept comprehends the importance of both connectedness and structural equivalence (Mulligan, 2008). Scott (2008, p. 186) notes the uniqueness of each field, which is 'composed of some combination of regulatory and normative controls over activities and actors within the field'.

DiMaggio and Powell (1991b) note that highly structured fields provide a context in which tax issues of a mutual concern (e.g. transfer pricing) amongst governments can be viewed. Notably in the context of attempts by a state to take a unilateral approach to transfer pricing, DiMaggio and Powell (1991b, p. 64) advocate the homogeneity of institutional practice, noting that 'highly structured fields provide a context in which individual efforts to deal rationally with uncertainty and constraint often lead, in the aggregate, to homogeneity in structure, culture, and output'.

Three common themes permeate through NIS – namely legitimacy, isomorphism and decoupling – and are discussed in turn.

Legitimacy

This concerns legitimacy-seeking behaviour, which refers to what is considered appropriate behaviour by actors in the environment within which organisations must interact (Mulligan, 2008, 2012). This theme directs that organisations need to be socially acceptable and credible in order to survive in their social environment (Scott, 2001). Scott (2001, p. 59) posits that legitimacy is 'a symbolic value to be displayed in a manner such that it is visible to outsiders'. He positions the source of legitimacy beyond the boundaries of an individual organisation in super-organisational beliefs about social reality that are widely accepted by powerful actors.

How an organisation (in this case a government) is perceived by the array of external constituents present in the tax arena (in this case other governments and corporations), which have many and sometimes conflicting views or 'competing sovereigns' (Scott, 2001, p. 60) on what constitutes legitimate behaviour, represents a rich case study in the management of legitimacy. One might, for example, regard the introduction of transfer pricing legislation in Ireland as being a symbolic attempt to gain legitimacy. The requirement to determine procedural legitimacy may be greater among organisations whose processes have a high degree of arbitrariness, which makes them more prone to challenges on their work arrangements and procedures according to Scott (1987).

Isomorphism

Organisations adapt to what they believe society expects of them, which leads to institutional isomorphism; this is a useful platform for comprehending the politics and ceremony that permeates modern economies (DiMaggio and Powell, 1991b). Isomorphism is a 'constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions' (DiMaggio and Powell, 1991b, p. 66). Dillard et al. (2004, p. 509) describe isomorphism as the 'adoption of an institutional practice by an organization'. Scott (2001) identifies the three pillars of new institutional theory as regulative, normative and cultural cognitive. Each is associated with a particular institutional isomorphism, namely coercive, normative and mimetic, upon which DiMaggio and Powell (1991b) expound. Coercive isomorphism 'stems from political influence and the problem of legitimacy' (DiMaggio and Powell, 1991b, p. 67); this manifests when 'powerful bodies' in an organisation's field, through both formal and informal pressures, exercise authority or power to adopt specific structures or practices or else face sanctions (Hopper and Major, 2007). Normative isomorphism occurs when demands from institutions with moral legitimacy are perceived as binding. It represents the ingredient that 'promotes the success and survival of organizations' (Meyer and Rowan, 1991, p. 49). Mimetic isomorphism often results from standard responses to uncertainty, i.e. under pressures of uncertainty organisations often imitate peers that are perceived to be successful or influential (Haveman, 1993).

Decoupling

Due to conflicting tension between institutional pressures and internal efficiency requirements, organisations claim to adapt institutional practices, whereas in reality they may not have done so in order to safeguard organisational efficiency (Mulligan, 2008).[8] Decoupling refers to circumstances where the formal organisational structure or practice (Ireland's light touch transfer pricing policies) is separate or distinct from actual organisational practice (in this study's context the OECD transfer pricing policies) (Dillard et al., 2004). Meyer and Rowan (1991, p. 58) posit that 'decoupling enables organizations to maintain standardized, legitimating, formal structures while their activities vary in response to practical considerations'. A classic example of this applying in this study was the exclusion of non-trading income from the transfer pricing rules. From the primary research it was evident that the practical considerations which were taken into account were the impact that such an extension would have had on the powerful FDI community, which led to strong coercive pressure to implement a 'light touch' transfer pricing regime (Seidman, 1983).

Research undertaken by Westphal and Zajac (1994, 1997) indicate that decoupling is most likely among reluctant (later) adopters that respond to normative pressure (Eden et al., 2001). A later study by Fiss and Zajac (2006) suggests that organisations that actively declare their conformity to demands for strategic change are less likely to be the ones that implement structural changes. These views were in evidence in our research findings.

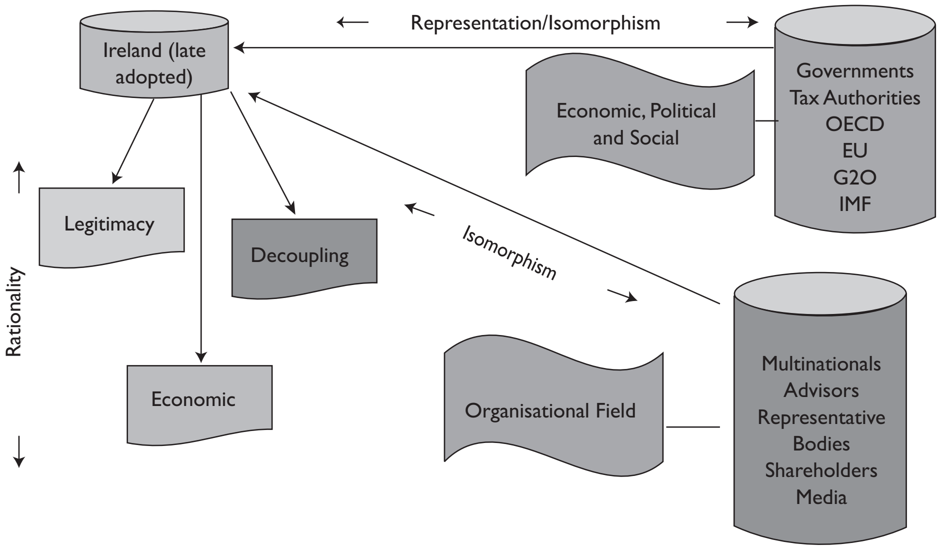
Further support of the rationale for introducing a modified version of the OECD regulations can be seen from the views of George, Chattopadhyay and Sitkin (2006), who posit that decision makers resort to decoupling when they encounter ambiguity in their reading of the environment. In response to institutional pressure for conformity, the organisation may selectively conform to institutional pressures. This is consistent with the views of Oliver (1991), who found that the propensity to decouple was strongest when an organisation was dependent on key influencers (e.g. the FDI community in Ireland). It also resonates with the views of Quirke (2013, p. 1677), who posits that 'the notion that institutional environments impose structural uniformity upon passive organizations has given way to the recognition that fields may be fragmented.'

Decoupling carries a significant health warning, which Meyer and Rowan (1977, p. 357) refer to as the 'logic of confidence and good faith', i.e. that people trust that the organisation does what it says it will. Organisations that decouple must avoid close inspection or else they are exposed as frauds. Ireland's continuing facilitation of certain hybrid structures and the manner in which its transfer pricing legislation is framed will be influenced by the outcomes of the base erosion and profit-shifting (BEPS)[9] initiative (Dutton and Dukerich, 1991; Fiss and Zajac, 2006).

THEORETICAL MODEL

The research uniquely draws on aspects of NIS in establishing a theoretical framework (illustrated in Figure 1) of the context and processes connected with designing, endorsing and diffusing transfer pricing policies. It draws on the work of Dillard et al. (2004) and Mulligan (2008, 2012) in developing the framework.

FIGURE 1: THEORETICAL MODEL



Representation refers to the way reality is framed or symbolically described. Rationality provides the legitimating conditions for evaluating criteria and practices. The theoretical model uses a number of theoretical constructs which emanate from NIS, namely legitimacy, decoupling and isomorphism. All three strands of isomorphism (coercive, normative and mimetic) were in evidence from the field research. In the model the powerful influence of other governments, tax authorities, the OECD, G20 and the IMF are included in the set of influencers at the economic, political and social level – the 'institutional demands' (Pache and Santos, 2010, p. 457). This group creates coercive isomorphism, which 'stems from political influence and the problem of legitimacy' (DiMaggio and Powell, 1991b, p. 67). This construct manifests when powerful bodies in an organisation's field, through both formal and informal pressures, exercise authority or power to adopt specific structures or practices or else face sanctions. Within the model, actors and lobbyists at each level are operating in different contexts and have different interests, different sources of power and different audiences to whom their claims for legitimacy must be presented (Perrow, 1985). Consequently, there will be an abundance of tension and controversy between the different levels around the framing and timing of legislation.

RESEARCH METHODOLOGY AND METHODS

The research question 'What was the rationale for Ireland introducing transfer pricing in 2010?' was considered in the context of a number of discrete objectives, which were arrived at after a detailed consideration of the research question itself, findings from a pilot interview and the literature informing the theoretical framework. The pilot interview was conducted with a tax director with one of the Big 4 firms specialising in transfer pricing. The interviewee previously worked as a transfer pricing specialist outside of Ireland (within the same firm), which provided an interesting perspective on the topic and helped to refine the line of enquiry in the final interview process and to refine the theoretical framework.

Having refined the questionnaire and theoretical model, semi-structured in-depth personal interviews were conducted with thirteen senior tax consultants who have held senior tax positions within their organisations for ten years or more. The personal interview schedule was developed from research questions arising from reviewing the prior literature on NIS. The primary objective of these interviews was to obtain detailed insights into transfer pricing. The interviews were guided by a number of broad open-ended questions and were conducted on the interviewees' firms' premises. The philosophical approach taken is an anti-positivism or interpretation perspective, recognising the 'need to get inside the worlds of those involved in meaning construction, which is viewed as context dependent and also time dependent' (Oats, 2012, p. 11).

There were three primary reasons for selecting senior tax consultants for interview. First, all interviewees have significant years of experience in international tax and transfer pricing. Second, individuals at a senior level could be expected to have a broad perspective on their firms' and clients' operations and may thus be viewed as being able to address questions investigating views on transfer pricing. Third, the interviewees' vast experience of dealing with tax authorities (both domestic and foreign) provides a richness of content in evaluating the role played by the respective authorities. Prior to conducting the interviews, ethics approval was sought and received from the relevant institution.

The list of potential interviewees was researched by examining all of the Big 4 firms (plus two other mid-tier firms, both of which are international firms) and the leading legal firms' websites to establish their designated specialists in international tax consultancy/transfer pricing. The interviewees were selected using 'purposeful sampling' to provide 'a great deal about issues of central importance to the purpose of the research' (Patton, 1990, p. 169). The justification for this approach was to choose information-rich cases whose study would enlighten the question under investigation.

In the interviews, it was agreed that the individuals' names and firms' names would remain anonymous. The interview schedule is shown in Table 1.

All thirteen interviews were recorded by tape and subsequently professionally transcribed. Each transcription was sent to the interviewee for confirmation of accuracy. The interview analysis constituted a pervasive activity throughout the life of the study. For example, throughout the interview collection phase, ongoing analysis was aided by extensive notes taken during and immediately after interviews, listening to interview tapes while travelling and dog walking, and the taking of additional notes and use of mind maps. This, in effect, provided a provisional running record of analysis and interpretation. Initial readings of early transcripts throughout the interview collection phase also meant that in subsequent interviews (the total interview schedule spanned a three-week period) certain issues

TABLE 1: INTERVIEW SCHEDULE

Title	Designation	Firm Type (all Irish-based unless stated otherwise)	Specialism	Duration of Interview
Partner	IT2	Mid-tier firm (based in Canada)	Transfer pricing	1 hour
Partner	IT3	Legal firm	International tax	1.5 hours
Partner	IT4	Legal firm	International tax	1.25 hours
Consultant	IT5	Legal firm	International tax	2.5 hours
Partner	IT6	Legal firm	International tax	2 hours
Director	IT7	Big 4	International tax	1 hour
Partner	IT8	Big 4	International tax/ transfer pricing	2 hours
Consultant	IT9	Legal firm	International tax	1.25 hours
Partner	IT10	Big 4	Transfer pricing	1.25 hours
Partner	IT11	Big 4	International tax	1.5 hours
Partner	IT12	Big 4	Transfer pricing	1.25 hours
Partner	IT13	Big 4	International tax	1.25 hours
Partner	IT14	Big 4	International tax	1.25 hours

Note: The designation IT1 was not used, to avoid any possible confusion with the commonly used acronym for the Institute of Taxation in Ireland (ITI).

that appeared to be arising from these readings could be probed more deeply. In conducting the post-interview analysis, the broad areas addressed in the interview guide provided a framework/template from which a more detailed analysis of transcripts could proceed.

In total, the transcripts were read on seven separate occasions after data collection had ceased. The first and second in-depth reading of each transcript was undertaken with the tape of the interview running 'as emphasis, mood, intonation and so on can crucially elaborate meaning' (Jones, 1985, p. 58). Each transcript was subsequently re-read and any themes emerging at this stage within this framework were recorded beside the relevant 'chunks' of the interview transcript intuitively coloured-coded for each apparent theme (Miles and Huberman, 1994, p. 56).

A detailed summary of all of the interviews was also prepared after the third reading highlighting emerging themes and providing general observations on the conduct of each interview. The process of coding facilitated the reduction of the transcript evidence, and also provided a means of interacting with and thinking about the evidence, thereby encouraging processes of reflection.

Simple mind (cognitive) maps were also prepared for each interview in order to support or, in some cases, challenge the themes identified. These also helped in the search for any apparent contradictions in the initial themes derived from the transcript evidence. Detailed matrices summarising the themes/codes identified in each transcript (Miles and Huberman, 1994) were then developed in order to visually display the themes emerging when the initial codes were developed. These displays aided in identifying patterns in the interview evidence as a whole (Huberman and Miles, 1994; Miles and Huberman, 1994) with the predominant codes/themes becoming evident partially by mapping the relative incidence of different codes.

Examining the matrices enabled the recognition of regularities, patterns and explanations in the evidence collected. It is important to recognise that while the most common recurring themes in the data were easily determined using the matrices, the authors were careful to avoid presenting a 'smoothed set of generalizations that may not apply to a single interview' (Huberman and Miles, 1994, p. 435) and made strenuous efforts to preserve the uniqueness of certain individual interviews. With their permission, the next section of this article includes quotes from some of these individuals, since their own words often best describes specific features or problems of this research area.

The theoretical approaches addressed in this article primarily draw on insights from NIS. These insights were subsequently used to interpret the empirical evidence, which enabled the writers to encapsulate the core issues emanating from the analysis in a coherent narrative.

Limitations

The qualitative approach adopted in this study, involving interviews with tax consultants from ten professional firms, means the findings are not statistically generalisable. To achieve the latter however was not the researchers' objective. Rather, it was to explain and enhance the understanding of transfer pricing in practice and to form the basis for theoretical development, which it does.

For the most part, this study sought the perspective of tax professionals and as such provides only one perspective. It could be argued, for example, that obtaining the perspective of tax/finance personnel working in industry or the perspective of the government/tax legislators on tax policy/lobbying aspects would provide further information and enhance our understanding of transfer pricing in practice even more. This broader perspective could form the basis for further research (see below).

FINDINGS AND DISCUSSIONS

The key findings and implications are presented here, drawing on the major themes which emerged in the course of addressing the research question and associated objectives. The interviews were undertaken during a period (the first three months of 2011) in which there was blanket political focus on Ireland's tax competition, which added an 'extra bite' to the richness of the conversations held. In the lead up to the German by-elections, Chancellor Angela Merkel's debate with the new Irish government concerning Ireland's 12.5 per cent corporation tax rate was being played out in the media, highlighting her dilemma of trying, as suggested by IT6 'to convince the German people that it's okay to bail Ireland out while Ireland has a 12.5 per cent rate of corporation tax.'

The findings are presented in line with the different stages of Irish tax policy for the FDI sector discussed earlier, as the evidence suggested a direct linkage between the introduction of transfer pricing and the maturity of tax legislation. Indeed this evolution was a constant theme referred to by the interviewees. The interviewees' views on the overall evaluation of the Irish regime are then presented.

Early Days of FDI to 2003

The levels of profits reported in Ireland during the early days of FDI in the late 1950s and 1960s in Ireland was highlighted by IT11, noting that Ireland did not experience the 'multiplicity of profits that we've had in the past 15 years in terms of being reported here'. IT3 alluded to the fact that the level of FDI in Ireland was 'comparatively insignificant in terms of global economy'. At a micro level, reflecting on the state of the Irish economy during this period, IT4 believes that Ireland was considered 'almost a developing country,[10] and if you look at a lot of developing countries, people give them tax breaks' – the tax break in this instance being the toleration of the absence of transfer pricing. In contrast on the international stage, transfer pricing as a strategy, as an 'anti-avoidance tax measure, was only really getting up and running during the period of the ESR', as noted by IT5.

IT6 referred to the global transparency aspects, noting that 'in the 1950s and 1960s communications weren't as instant, financial reporting standards were not harmonised and I think a lot of the activities that went on throughout the world just weren't identified.' The evolution of transfer pricing as a discipline was referred to by many of the interviewees, IT9 noting that 'everyone has come up the knowledge curve … I guess all the tax administrations have more muscle now in terms of ability to look at issues more closely.' Noting the increased level of reported profits in Ireland as a result of the growth of the information and communications technology (ICT) sector, IT9 surmised that it took the 'Microsofts, Googles and Intels' to prompt both international and domestic attention on the level of reported profits in Ireland and the lack of transfer pricing legislation.

Introduction of 12.5 per cent Rate in 2003

The consensus amongst the interviewees was that 2003 was a game changer; IT11 attributes the increased focus and pressure on Ireland to introduce transfer pricing to the greater range of activities that qualified for the 12.5 per cent rate compared to the narrower scope of the previous low-tax rates/exemptions, which had been largely confined to manufacturing activities. IT12 noted the extent of transfer pricing legislation in place across the globe when it was first being considered by his firm in 2003, highlighting that there were numerous countries in Europe and worldwide which did not have transfer pricing legislation. He recalled that pre-1990[11] only the OECD top 10 countries had transfer pricing and Ireland was 'nowhere even near that'. At the time that the 12.5 per cent rate of corporation tax was introduced in Ireland in 2003, the possibility of transfer pricing being introduced was very much on the agenda. The rationale for the proposed introduction at the time was, as described by IT5, that '… every Tom, Dick and Harry would set up an operation here and seek to drop profits in [to] Ireland.'

IT6 understood at the time there was 'pressure in the Counsel of Finance Ministers for Ireland to do a number of things, one of which was transfer pricing' (Hopper and Major, 2007). The draft legislation/regulations were kept 'under the radar' but were seen by a number of relevant stakeholders. However, IT6 believes that a number of negative responses came back advocating that the introduction of such detailed rules would be 'just disastrous for Ireland'. Specifically, as noted by IT13, the introduction would have had an 'adverse impact on the future investment plans' – inter alia the extension of the rules to interest-free loans at the time was particularly sensitive. Coincidentally, the same sensitivity was evident when the rules were eventually introduced in 2010. IT11 recalls that the 'business sector lobbied heavily against it in terms of costs and compliance' and was of the opinion that the priority of Revenue in terms of their resources swung to the then current dilemma of the 'various DIRT[12] tribunals and enquiries'.

In lieu of transfer pricing provisions in 2003, IT5 noted that Revenue took an alternative approach with the FDI community, by adopting a rigorous approach in examining applications for rulings as to the application of the 12.5 per cent rate, alluding to the fact that 'they started giving some rulings … trying to restrict the application of the 12.5 per cent.' It was concerning to note the observations of some of the interviewees (IT10 and IT11) who believed that this initial rigor may have been diminished in later years.

Introduction of Transfer Pricing – 2010

Post-2003 increasing pressure (all three strands of isomorphism in evidence) from a number of sources resulted in the introduction of transfer pricing in 2010. IT6 referred to the combined pressures of the 'OECD, the black list, our treaty partners and the G20 summits as being important in influencing their decision to succumb to the pressure' to introduce the new rules (DiMaggio and Powell, 1991b; Scott, 2001). Furthermore, IT3 argues that the absence of transfer pricing 'became less acceptable when Ireland became a more economically viable jurisdiction and a real source of investment from the USA' (Martinez and Dacin, 1999). IT13 agrees, attributing this focus in the main to the increasing prevalence of aggressive tax reduction policies by MNCs: '… there was a greater chance now than there was in 2003 of Ireland's reputation being impacted by the absence of transfer pricing' (see Carpenter and Feroz, 2001). IT5 describes the global fiscal context, noting that whilst companies have expanded their overseas operations, 'the domestic tax base has shrunk while at the same time the demand for government expenditure in all sorts of areas has gone up.'

By the end of 2009 the international tax environment was changing such that pressures emanating from various sources led to the introduction of transfer pricing. The changing environment is consistent with institutional theorists who argue that the power and potency of the various institutional pressures for change may vary over time (DiMaggio and Powell, 1991b). As noted by IT13, in 2010 'it was much more inevitable that transfer pricing rules would come in now, than any time previously.'

Against a backdrop of global tax reduction strategies by MNCs and tax base erosion caused by these phenomena and the emerging global recession, IT13 believes that Ireland was 'keen not to be seen in the same light as some of the offshore locations and wanted to be seen as a mature economy and mature in relation to its tax approach' (Dillard's rationality construct, Dillard et al., 2004). A similar view was expounded by IT8, who emphasised that the new rules were introduced to 'underpin the integrity of the Irish tax system' (Meyer and Rowan, 1977; Carpenter and Feroz, 2001) and in a manner perceived as acceptable to the actors in that field (Dillard et al., 2004). Homogeneity often fosters legitimacy, helping to support Ireland's cause (Scott, 2001).

There was a broad consensus that Ireland's tax system required an injection of legitimacy to make Ireland 'look more respectable or more aligned with other members of those groupings' (IT3) (Dillard's rationality construct, Dillard et al., 2004). The importance of legitimacy in the international tax arena was alluded to by IT3, emphasising that Ireland Inc. 'needs to be very careful that it remains on the right side of the rather vague line as to what is internationally acceptable and what is not acceptable'. IT13 concurred, arguing that the rules' introduction were motivated by Ireland's desire to demonstrate to the international community that Ireland had a 'mature tax environment and that we weren't a predatory tax nation'.

IT8 referred to the institutional pressures, noting that OECD countries (which belong to the economic and political level in the theoretical model) are expected to have transfer pricing regimes which are embedded within the terms of double taxation treaties. This was also commented upon by IT10, who opined that Ireland had to be 'seen to align ourselves with international best practice'.

IT5 considered that the introduction of transfer pricing would help in defending against an accusation of Ireland being labelled a tax haven. Whilst IT8 dismissed this possibility, he cautioned that Ireland cannot 'be overly careful as our multinational base is so important and we need just to keep our tax regime as robust as possible'. This appears to address the need to establish procedural legitimacy as Ireland may have been perceived as a jurisdiction whose tax policies had a high degree of arbitrariness, which may make it more vulnerable to attacks on its policies (Scott, 1987). IT6 alluded to the post IMF bailout era as one where there will be 'even heightened concern over how Ireland's tax policies are seen on the world's stage in a bigger picture'.

IT10 argues that not having transfer pricing was 'perceived as a blot on our copybook' and that Ireland needed to align itself with international best practice, illustrating normative isomorphism at play (DiMaggio and Powell, 1991b). IT4 alluded to the need to make Ireland an 'acceptable jurisdiction that can take a seat with the big boys', albeit recognising that the exercise was 'more cosmetics' from an Irish Revenue/Department of Finance perspective insofar as being able to say to their counterparts at various multilateral and bilateral negotiations that 'yes Ireland also has a transfer pricing regime' (Dillard's representation construct, Dillard et al., 2004). Does this rationale satisfy Suchman's view that 'legitimacy is possessed objectively, yet created subjectively'? (Suchman, 1995, p. 574). IT3 supported this view, advocating that Ireland had to be perceived as being 'members of the club' (evidence of mimetic isomorphism in action, whereby the club's members have become homogenous). The desire for conformity resonates with what Fligstein (1990) describes as the stability funcion of organisational fields.

IT13 noted that Ireland was preoccupied with defending the 12.5 per cent tax rate, a key attribute of Irish tax policy which IT13 referred to as the 'holy grail'. From this perspective, the absence of transfer pricing was described by IT10 as 'the big elephant in the room'. From a timing perspective, IT12 noted that in the context of the various tax agendas, it was the 'thing to do to introduce it at that point in time'. In the context of trying to defend the 12.5 per cent rate, IT13 alluded to the dilemma which Ireland is facing in trying to defend the low rate of corporate tax and concurrently being regarded as 'not mature in relation to other aspects of the tax regime'. IT5 reinforces this view, advocating that when Irish Revenue/Department of Finance officials attend international tax fora and engage in discussions defending the 12.5 per cent rate, they have one more 'weapon in their armoury' (see also Suchman, 1995).

IT2 spoke of the need for a country like Ireland to have a transfer pricing system in place to negotiate double tax treaties, a process which IT11 described as being 'tough, very political and point scoring'. IT2 also alluded to similar difficulties in the processing of MAPs. IT6 accepts this critique, highlighting that Irish Revenue would have found it difficult to 'come to the negotiation table and fight your case for Ireland's profit share'. IT7 concurs, advocating that Irish Revenue 'didn't really have a leg to stand on because they didn't have transfer pricing legislation'. IT11 similarly believes that the defence of the existing tax base was relevant, noting a concerning increase in the level of tax refunds[13] to Irish corporates arising from foreign tax authority challenges – 'the fear level was increased when the claims were increased'. IT2 agreed, noting that a transfer pricing regime was necessary to 'protect the tax base' and referred to the international pressure to have a system and an administrative apparatus to 'counter some of the actions of the Treaty partners' (see also North, 1990).

Evaluation of the Irish Transfer Pricing Rules

There were a number of insightful observations made by the interviewees. IT3 opined that the introduction of transfer pricing was 'a defensive measure rather than anything that would raise any significant revenue'. IT4 highlighted that 'any reasonable commentator will look at what was being brought in as being mainly cosmetic' to make Ireland a more legitimate place for locating business. He surmised that the international community expectation was not exclaiming 'my God, Ireland want to seriously say to US multinationals "you're not paying half enough in terms of royalty fees to the US or you're not paying back enough of the profits that are coming into Ireland for products" or whatever'. This aspect was affirmed by IT5, who spoke of the 'devil in the detail' insofar as 'in reality the Irish transfer pricing rules only kick in if you seek to shift profit out of Ireland, so we're not necessarily objecting if you shift a lot of profit into Ireland.' In this regard, IT10 notes that in reality an MNC in preparing their global transfer pricing strategy would have 'set it up to optimise the 12.5 per cent tax rate' whilst minimising the risk on the counterparty side of the transaction.

Ireland's transfer pricing rules do not extend to non-trading transactions, which has preserved a number of widely used hybrid financing structures using a non-resident related party intermediary, typically resident in Luxembourg (as described earlier). IT3 noted that such structures are used on a 'large-scale basis'. IT10 alluded to the attractiveness of both the low corporate tax rate and the ability to lend the post-tax income on a tax-efficient basis. Indeed, IT6 highlights that such hybrid structures are under examination by the OECD and the European Union (EU), suggesting that Ireland's facilitation of such structures will come under the microscope.

He graphically illustrates his view by stating that 'no matter how much fake tan you put on, the pimples will show through under the microscope' (IT6). IT8 would be less concerned, noting that in other jurisdictions such as Luxembourg, there are 'a lot of more objectionable areas which would be further up the food chain'. Indeed, IT14 conceded that any change to the Irish rules would be as part of a broader European drive, which would involve the targeting of other hybrid mechanisms facilitated under the fiscal regimes in countries such as Malta and Luxembourg.

According to IT13, this carve out (non-application to non-trading transactions) is illustrative of the 'under the radar FDI lobby' who, through a range of lobbyists (citing the Big 4 and American Chamber of Commerce as examples), lobby for a tax regime that is 'friendly to FDI' (see Tuttle and Dillard, 2007). In this context, IT13 argues that Revenue/Department of Finance had 'to balance two things, trying to balance the reputational issue that Ireland is seen as being responsible in terms of its tax regime, that it has good relationships with the tax treaty neighbours as well as with the EU, but at the same time facilitating the FDI community and further FDI investment'.

Extensive discussions centred on the perceived capability of Irish Revenue, their approach to transfer pricing in the past, and their fire power (Markham, 2012) in dealing with foreign tax authorities, etc. IT2 highlights the importance of Irish Revenue administering and enforcing the new legislation in a responsible and even-handed way. Indeed, IT8 advocates it will be necessary for Revenue to have a large transfer pricing team in light of the 'expediential growth' or 'tsunami' of transfer pricing disputes in the future. He acknowledges that existing personnel are proactive and helpful and that 'Ireland's competent authority is superb' but bemoans the limited amount of capacity. The capacity issue was concurred with by IT9, who expressed concern as to whether Revenue has the 'breadth of resources here to adequately defend our tax base'. Notwithstanding the capacity concern, IT9 has been 'incredibly impressed' with the manner in which Revenue has dealt with the IRS and would not regard Revenue as a 'soft touch by any stretch of the imagination' (see Li, 2002). The predicament in dealing with a well-established transfer pricing tax authority such as the IRS was succinctly described by IT3 as not so much intimidation but that Revenue are 'aware of their power and strength and their resources, so yes, there is a sort of Samson and Goliath feel about it' (see Dillard's power construct, Dillard et al., 2004).

Most of the interviewees emphasised that there has been an evident change in approach by Revenue following a realisation that there was a knowledge deficit. IT11 noted that this became axiomatic when Revenue became enthralled in very detailed and complex transfer pricing MAPs and competent authority claims. During this learning curve, IT14 conceded that there was generally a 'more sophisticated tax regime on the other side of the transaction'. IT11 noted in the past Revenue were acting more as the 'good guys' but 'I think less so now.' He attributed this to financial and political pressure within Revenue.

CONCLUSIONS

This paper has addressed the question as to the rationale for Ireland introducing transfer pricing in 2010. The introduction of the transfer pricing rules in Ireland were primarily underpinned by the legitimacy construct; the factors that would have been of concern included the need to demonstrate that Ireland has a mature fiscal framework. The primary research elucidated a number of economic issues including protecting the tax base, defending the 12.5 per cent corporate tax rate and giving Irish Revenue additional armoury in dealing with transfer pricing disputes. Based on the evidence gathered, there was a concern expressed that had Ireland not introduced transfer pricing, it may have resulted in it appearing on a 'black list', which could discourage foreign direct investment into Ireland. Coercive isomorphism was evidenced by the powerful role of (sometimes competing) stakeholders at the economic, political and social levels. The whole field of international tax is changing and, in an era of uncertainty, having normative tax provisions in the tax legislation infrastructure can be regarded as an example of mimetic isomorphism at play.

Ireland was a late adopter of transfer pricing in 2010, at which stage it was very much in the minority of developed countries which did not have transfer pricing on its statute books. This contrasts with the original proposed (but mothballed) introduction in 2003 when Ireland was one of many developed countries which did not have transfer pricing legislation.

It was clear that the 'carve out' (or decoupling) of non-trading income from the transfer pricing regime reflects the powerful role of the FDI community in Ireland. Revenue's indication of adopting a 'light touch' approach to monitoring transfer pricing may also be considered under the decoupling construct. As a late adopter of transfer pricing, such approaches are not unexpected (Westphal and Zajac, 1994, 1997; Eden et al., 2001; Fiss and Zajac, 2006).

Ireland faces many challenges as it grapples with the introduction of transfer pricing. A notable finding which emerged during the interview process was that, at an operational level, Revenue faces the challenge of upskilling its staff on the intricacies and nuances of transfer pricing, and then retaining these staff members, i.e. possibly losing them to Big 4 firms that face similar human resources issues. Markham (2012) highlights the challenges the IRS faces in staff retention with transfer pricing specialism. The requirement for specialist training, particularly in the valuation of intellectual property transactions, will need to be addressed, as it is in this area where disputes are likely to be most prevalent. This may require the recruitment of transfer pricing specialists from overseas professional practices and the IRS or Her Majesty's Revenue and Customs (HMRC). The absence of personnel to administer and police the system may bring into question – by those at the economic, political and social level – the legitimacy of the actions undertaken and perhaps the authority itself.

The ability and the need to successfully defend potential transfer pricing adjustments are sacrosanct, not alone from a tax policy legitimisation perspective but equally importantly in defending Ireland's tax base at a time when Ireland's sovereignty has been exposed. There are upsides to rigorously enforcing the new rules, against the backdrop of sea changes in the international tax arena. If Ireland can continue to demonstrate to the international tax spectators that it upholds internationally acceptable tax policies, then the opportunities to attract FDI may be enhanced.

Future research in this area could draw on alternative theoretical perspectives to enhance our understanding further, such as corporate social responsibility theory (Gray, Kouhy and Lavers, 1995), legitimacy theory (Deegan, Michaela and Tobin, 2002; Dowling and Pfeffer, 1975; Johnson, 2004; Lindblom, 1994) or political economy theory (Armstrong, 1998; Benson, 1975; Wamsley and Zald, 1973; Zald, 1970).

ENDNOTES

1 Christians (2014, p. 43) describes the OECD as a 'transnational network, and its tax division is a tightly knit epistemic community whose main purpose is to create spaces for government officials to collaborate with business and industry leaders to frame issues of international tax policy, formulate norms, and syndicate these norms globally through domestic law making procedures'.

2 To encourage exports and generate jobs in manufacturing, export sales relief (ESR) was introduced in 1956. This provided relief from income tax and corporation profits tax on the profits from the export of certain manufactured goods.

3 The Customs Free Airport (Amendment) Act 1958 allowed special tax and duty concessions to industries and services operating within the Shannon Free Airport. These included exemptions from income tax and corporation profits tax for profits derived from trading operations within the area. Under customs control, raw materials could be imported, without payment of duty and taxes, manufactured and then exported. Duty became payable only if the goods entered home consumption. Shannon was the first free zone in the world in which manufacturing operations were carried out.

4 For a fuller discussion on profit shifting see Scholes, Wolfson, Erickson, Maydew and Shevlin (2005).

5 As part of the 2010 Finance Act, enacted in April 2010, Ireland introduced broad-based transfer pricing legislation. The legislation endorses the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and adopts the arm's length principle. There are, of course, institutional transfer pricing regulations in play such as the United Nations regulations – see www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf. Other tax regimes which do not conform necessarily to the arm's length principle, such as Argentina, Brazil and Mexico, also exist. Such regimes are of course relevant in the context of Irish resident companies dealing with these jurisdictions; however this paper does not address these issues due to scoping constraints.

6 Passive income for the purposes of the new regime may include interest, royalties, dividends and rents from property where the income arising is not derived from an active trade. In practice, each transaction must be examined in the context of the company and its business to determine if it will constitute trading or passive income.

7 The role that the corporate lobby played in mummifying the Stop the Tax Haven legislation in the US and reducing the scope of Ireland's transfer pricing rules are evidential of this applying in practice.

8 This is consistent with international law theorists who suggest that a state may 'act out of self-interest' (Goldsmith and Posner, 2005, p. 3).

9 The OECD's Action Plan on BEPS was published in July 2013 with a view to addressing perceived flaws in international tax rules. The 40-page action plan, which was negotiated and drafted with the active participation of its member states, contains 15 separate action points or work streams, some of which are further split into specific actions or outputs. The plan is squarely focused on addressing these issues in a coordinated, comprehensive manner, and was endorsed by G20 leaders and finance ministers at their summit in St Petersburg in September 2013.

10 Supported by the Marshall Aid Plan, Western Europe was experiencing a significant degree of post-war prosperity. The economy of Ireland was stagnating with living standards increasing at much lower rates than those in continental Europe. Ireland was primarily an agricultural country with about half of those employed working in that sector and exports mostly consisted of live cattle for the British market.

11 Both ESR and Shannon relief exemptions expired in April 1990.

12 Investigation into widespread tax evasion which occurred during the 1990s through the use of non-resident accounts from which deposit interest retention tax (DIRT) was not deducted.

13 Pre-1990 refunds to multinationals was a non-event, simply as they paid no corporation tax in Ireland due to ESR and Shannon reliefs. Any transfer pricing adjustments only gave rise to additional tax liabilities in the home country. Post-1990 this all changed.

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SAFE HARBOUR TO ARMS LENGTH: UK EVIDENCE OF DEBT SHIFTING AND THIN CAPITALISATION

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ABSTRACT

Intercompany debt financing has been used as a mechanism through which multinational corporations can minimise their corporate tax bill. This has prompted governments to implement preventative measures, known as thin capitalisation rules, to limit the tax deductibility of debt interest and prevent corporations from shifting taxable profits to other jurisdictions. In response to the lack of existing research as to the effectiveness of these preventative measures, particularly the transfer pricing form of legislation, this paper considered whether a 2004 change to the United Kingdom (UK) regulations on thin capitalisation affected the capital structure decisions of foreign-owned UK companies. Specifically, the study examined the effect of the amendment on debt–equity ratios in those firms by conducting a quantitative longitudinal study of the debt–equity ratios of a sample of 432 UK incorporated subsidiary companies of multinational groups during the period 2001–2010. The findings revealed that sample companies appeared to have modified their debt–equity ratios post the 2004 amendment. Highly geared companies reduced their debt–equity ratios following the change to the thin capitalisation rules, while the changes to the rules enabled low-geared companies to increase their gearing levels. Company size impacted the decisions to change capital structure following the amendment of the thin capitalisation rules while the residence of parent companies did not seem to have an influence. Overall, thin capitalisation rules were factored into the capital structure decisions of foreign-owned UK companies post 2004.

INTRODUCTION

The question of how companies determine capital structure has puzzled academics for several decades. A substantial amount of research effort has been devoted to searching for an understanding of the determinants of a firm's capital structure, but despite this level of intensive research Myers (2001) observed that there is still a limited understanding of firms' financing decisions.

Despite a lack of consensus as to the determinants of company capital structures, one particular area where understanding financing behaviour is becoming increasingly important is that of multinational corporations that can shift profits from high- to low-tax jurisdictions through the utilisation of intercompany debt financing. For example, in 2007 Alliance Boots was the subject of a heavily geared takeover and relocation to Switzerland, resulting in a virtual elimination of the group's British tax liability (*The Guardian*, 2009). Plender (2004) observed that in 2003 eight of the top twenty largest foreign-owned United Kingdom (UK) companies were paying negligible amounts of UK corporation tax.

In response to earnings shifting practices, governments have implemented preventative measures, known as thin capitalisation rules, which limit the amount of interest deducible in the computation of profits for corporate tax. This paper seeks to build on previous research by attempting to understand the effects of these preventative measures on companies' financing decisions in the relatively under-researched UK jurisdiction.

The objective of this study is to explore the effects of taxation regulations on the financing decisions of multinational corporations. The study aims to determine whether thin capitalisation rules affect the financing decisions of foreign-owned UK companies. Specifically, the effect of a 2004 amendment to the UK thin capitalisation rules was examined to test variations in the proportions of debt held in response to the changed legislation.

While very little is known about how thin capitalisation rules affect the financing decisions of multinational firms, in recent years a number of studies have been undertaken which have typically focused on ratio-based thin capitalisation rules. Indeed, a recent study by Ruff and Schindler (2012), in a review of German thin capitalisation rules, concluded that the current German rules appear ineffective and that a potential better alternative may be to rely on controlled foreign corporation rules. The UK thin capitalisation regulations, post 2004, are unique in that they exclusively apply transfer pricing rules to govern thin capitalisation. In light of suggestions for a consolidated set of European thin capitalisation rules based on an arm's length approach (Dourado and de la Feria, 2008), this study will contribute to the ongoing debate amongst policy makers on capitalisation regulations, base erosion and profit shifting.

The remainder of the paper is divided into four main sections. The first section provides a brief outline of the foundations of capital structure theory. Specifically, the relationship between taxation and financing decisions along with consideration of the competing theories of capital structure are outlined. The second section focuses on the operation of thin capitalisation rules and discusses the operation of thin capitalisation rules in the UK both before and after the 2004 amendment. The third section describes the data and methodology used and discusses the findings of this study. Finally, the study concludes by providing a summary of the study's principal findings, the limitations of the study and identifies possible areas for further research.

CAPITAL STRUCTURE

The seminal papers within the capital structure field are those by Modigliani and Miller (1958, 1963). These papers formed modern thinking on capital structure. Modigliani and Miller's Proposition I with taxes showed that there are advantages for firms to have debt in their capital structure due to the tax deductibility of interest payments and the non-deductibility of dividend payments. By taking on debt instead of equity, firms can shelter profits due to interest payments being subtracted from profits before tax is calculated. Therefore, the value of the leveraged firm is equal to the value of the unleveraged firm plus the tax shield. Similarly, Modigliani and Miller's Proposition II with taxes shows that as equity is replaced by cheaper debt, the cost of capital decreases, allowing an optimal capital structure to be achieved at the point where the firm is 100 per cent debt financed.

However, in reality to achieve an optimal capital structure, the potential threat of financial distress needs to be considered. Sarkar and Zapatero (2003) noted that to incorporate the threat of financial distress, the theoretical literature has identified two major competing models of capital structure theory, the traditional 'trade-off theory' and the more recent 'pecking order hypothesis'. Kraus and Litzenberger (1973) describe trade-off theory as firms setting an optimal leverage ratio by balancing the tax benefits of debt against bankruptcy costs. Pecking order theory suggests that there is a strict ordering or hierarchy of sources of finance. Myers and Majluf (1984) noted that such a hierarchy results from adverse selection issues which arise when the firm has more information about its value than the firm's providers of funds. The result is that a firm will have a preference for internal sources of funds, followed by debt and then, when such sources are exhausted, external equity finance will be used. Furthermore, when external funds are required, a firm prefers debt financing to equity financing. Sarkar and Zapatero (2003) observed that in a head-to-head comparison between the two theories, the pecking order model seems to be more favourably viewed than the trade-off theory. The authors cite the major drawback of the trade-off theory as its contradiction of asserting a positive earnings-leverage relationship, which has in fact been found to be negative. Shyam-Sunder and Myers (1999) noted that pecking order theory is well supported in the literature but Hovakimian, Opler and Titman (2001) noted that pecking order theory may be useful in the short run and trade-off theory may be useful in the long run.

A salient omission from the above literature is how the capital structure decisions of multinational corporations may differ from individual firms. While the asymmetric taxation treatment of debt and equity financing offers firms an incentive to utilise debt finance, trade-off theory predicts that the usage of debt is limited given the associated costs of financial distress. However, the costs of financial distress are absent when the debt is provided from a parent to a subsidiary as the funds extended remain within the corporate group (Chowdhry and Coval, 1998). Accordingly, multinational companies can use internal debt as a means of moving taxable profits from high-tax jurisdictions to low-tax jurisdictions (Haufler and Runkel, 2012). To this end, the utilisation of internal debt in multinational firms is widely viewed as a tax-saving mechanism (Fuest and Hemmelgarn, 2005).

The operation of this tax-saving mechanism can be illustrated by the way a foreign-owned subsidiary company can be capitalised and how that decision can impact the amount of income it declares for tax purposes. In most countries general tax rules allow a deduction for interest expenses in arriving at the taxable income so that the higher the level of debt in a company (and consequently the interest expenses it incurs), the lower its taxable income. In a cross-border setting, multinational firms can structure financing arrangements so that they can put in place a tax-efficient debt level in borrowing subsidiaries while ensuring that the interest income of the lending parent (or affiliate) is received in a jurisdiction that either does not tax the interest income or charges a lower tax rate on that income than applies in the borrowing subsidiary's jurisdiction. In addition, bilateral tax treaties may remove the requirement to withhold tax on interest paid to a non-resident recipient. Consequently, a parent company operating in a low-tax jurisdiction that establishes a subsidiary in a high-tax jurisdiction will typically use internal debt to finance that subsidiary's operations. In the absence of any preventative measures, the result is that the overall tax liability of the group is reduced through the shifting of earnings from a high- to low-tax jurisdiction.

The term 'thin capitalisation' is used to refer to a firm which has been financed principally with debt (Richardson, Hanlon and Nethercott, 1998). Weichenrieder (1996) noted that managers of multinationals are well aware of the circumstances where thin capitalisation is beneficial to the group and observed that these managers actively consider the tax implications associated with debt financing in setting capital structures.

Panteghini (2009) provided theoretical evidence to illustrate the use of debt for earnings shifting. The author's model illustrates that the corporate group's ability to shift earnings increases the tax benefit of debt financing, making it a more valuable tool for groups than for standalone companies. Empirical evidence on multinational companies funding their foreign subsidiaries with debt has been presented by a number of researchers. Egger, Eggert, Keuschnigg and Winner (2010) observed that foreign-owned companies maintain a 2 per cent higher gearing level than their domestic counterparts, while Desai, Foley and Hines (2004) found that a 10 per cent increase in the tax rate of the jurisdiction of the foreign subsidiary is associated with a 2.8 per cent higher debt–asset ratio. Alshuler and Grubert (2002) observed that the ability to repatriate profits contributes to firms utilising debt. Huizinga, Laeven and Nicodeme (2008) observed that a multinational's use of debt financing for its affiliates depends partly on national tax rates, indicating the occurrence of international earnings shifting. Further empirical evidence as to the occurrence of earnings shifting was provided by Hines and Rice (1994), Buettner and Wamser (2007) and Overesch (2009), with the latter noting that multinational corporations gain a significant taxation advantage when the parent company is located in a low-tax jurisdiction. Mintz and Smart (2004) noted that earnings shifting through debt financing is not limited to cross-border transactions and illustrated the occurrence of sub-national earnings shifting in Canada from high-tax provinces to lower-tax provinces.

In summary, although academics have sought to explain why a high proportion of multinational firms choose to finance subsidiaries with debt, the research published to date provides only a partial view, as the impact of government anti-tax avoidance measures has not been addressed systematically in the literature. The next section explains one of those anti-tax avoidance measures, i.e. the thin capitalisation rules.

THIN CAPITALISATION RULES

As noted, it is advantageous from a tax perspective for a multinational parent company to provide additional capital to its subsidiaries by way of debt. Overesch and Wamser (2010) observed that this is a serious concern for national governments that wish to protect corporate tax revenues from multinational tax planning arrangements, while Green (2004) noted that:

> Governments and tax authorities are concerned about this because they consider that there is nothing to stop groups of companies from abusing this situation by capitalising subsidiaries with excessive levels of debt (Green, 2004, p. 3).

Consequently, governments have enacted legislation to prevent abusive financing structures where debt levels are deemed too high (Buettner, Overesch, Schreiber and Wamser, 2008). For example, Dimac (2013) noted that the Australian tax authorities have rules in place since 2001 to make the tax system there more equitable and prevent excessive debt levels, while Blouin, Huizinga, Laeven and Nicodeme (2014) noted that to counteract the negative consequences of debt finance, many countries have established rules that restrict the deductibility of interest expenses above certain debt levels. These rules are commonly known as thin capitalisation rules, the effect of which limit the tax deductibility of interest paid to lenders (Maβbaum and Sureth, 2009).

The Organisation for Economic Co-Operation and Development (OECD) (2012) has recommended two possible approaches to setting tax anti-avoidance thin capitalisation rules: the pre-determined ratio approach and the arm's length approach. The pre-determined ratio approach suggests that tax authorities set a statutory debt–equity ratio, commonly known as a safe harbour (Richardson et al., 1998). Dourado and de la Feria (2008) noted that at that time all EU states, other than the UK, applied a pre-determined ratio ranging from 1:1 to 6:1. If that ratio was exceeded, the interest on the excess debt would not be deductible when computing corporate tax (Hazak, 2009). While this approach promotes greater certainty for the participants, it can be circumvented by adjusting the level of equity to keep within the defined ratio (von Brocke and Perez, 2009). In addition, if a single threshold is to be utilised, tax authorities may experience difficulty in setting an appropriate ratio. If set too high, companies that operate with abusive but low ratios go undetected, and if set too low, companies that depend on bona fide debt financing will suffer unjustly (Mintz, 2004).

The arm's length approach involves making an assessment of the loan in order to determine if an advantage is being obtained due to the relationship between connected parties. Accordingly, the financing arrangements of a group of companies will fall within the rules if one party is carrying more interest-bearing debt than it could sustain on its own or if the loan terms are not on an arm's length basis. Flexibility is an advantage of the arm's length approach as authorities can look into the nature of the financing arrangements that would otherwise satisfy specified limits. However, this approach does not offer certainty to taxpayers. Additionally, the cost to governments of operating an arm's length approach will be greater than the predetermined ratio approach, given the need to investigate the circumstances around particular connected party transactions. Typically, the arm's length approach is enforced through transfer pricing legislation. The aim of a transfer pricing regime is to counter tax losses arising out of non-arm's length pricing transactions (Her Majesty's Revenue and Customs, 2010a). The operation of transfer pricing rules will substitute the arm's length provision – that is, the interest rate or loan amount which would have arisen between unrelated parties for the actual provision in respect of dealings involving related parties when a tax advantage would otherwise be conferred on one party (VanderWolk, 2004a).

UK Thin Capitalisation Rules – Pre 2004

Prior to 2004, the UK thin capitalisation rules operated in two layers. The first layer consisted of the provisions of section 209 of the Income and Corporation Taxes Act (ICTA) 1988. The second layer took the form of the transfer pricing rules of Schedule 28AA of the ICTA 1988 (Green, 2004). VanderWolk (2004a) noted that the thin capitalisation rules in force prior to 2004 and as outlined in Her Majesty's Revenue and Customs (HMRC) *Tax Bulletin 17* (1995) provided that interest payments on securities issued by a company to a related holder are treated for corporation tax purposes as non-deductible distributions to the extent that the amount paid exceeds a reasonable commercial return. Furthermore, the rules only applied to funding provided to a company by a 75 per cent parent company (or by another 75 per cent subsidiary of the recipient's parent company) and that an informal 1:1 rule of thumb ratio was acceptable (Mac, 2001).

Prompt for Change

The changes to the UK's thin capitalisation legislation in 2004 were prompted by a European Court of Justice (ECJ) decision in *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002]. The case involved the granting of a loan from a Dutch parent company to its German subsidiary. The German thin capitalisation rules provided that an interest payment to a parent company by a subsidiary, which was not entitled to a German corporate tax credit, was to be treated as a dividend unless the borrower could have obtained the loan from an unrelated party on similar terms (Airs, 2003). Given that no corporate tax credit was available to non-resident shareholders, the loan fell within the scope of the German thin capitalisation rules and the German tax authorities denied the deduction of interest payments in both 1997 and 1998.

The German tax authorities argued that because of the excessive level of indebtedness of the German subsidiary, a third party would not have granted the loan in the circumstances (von Brocke and Perez, 2009).

Lankhorst-Hohorst Gmbh claimed that the reclassification of the interest as a deemed distribution was discriminatory and in contravention of the right to freedom of establishment contained in Article 43 of the European Community (EC) Treaty (Airs, 2003). The ECJ noted that the taxation of interest on loan capital paid by German-resident subsidiaries to their parents differed depending on the tax residence of the parent, and that in light of the differing treatment for resident and non-resident parent companies, there was a barrier to the freedom of establishment, noting that:

> Such a difference in treatment between resident subsidiary companies according to the seat of their parent company constitutes an obstacle to the freedom of establishment which is, in principle, prohibited by Article 43 EC. The tax measure … makes it less attractive for companies established in other Member States to exercise freedom of establishment (*Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*, 2002, p. 32).

The effect of the obstacle is that should the German legislation be effectively implemented:

> A non-resident parent company can no longer usefully opt to finance its subsidiary by using loan capital. Its freedom of financing is therefore, in practice, more limited than that of a resident parent company
> (*Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*, 2002, p. 56).

It is interesting to note that the ECJ made specific reference to the fact that just because 'rules are consistent with the provisions of the OECD model convention does not also mean that they comply with Article 43 EC' (*Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*, 2002, p. 80). Therefore, compliance with the OECD convention will not satisfy as a defence for thin capitalisation rules found to be contrary to European law.

UK Thin Capitalisation Rules – Post 2004

The *Lankhorst-Hohorst* decision prompted fears that the UK thin capitalisation regulations were non-compliant with the EC Treaty. Consequently, the UK government took the opportunity to overhaul its thin capitalisation regulations to provide protection from any challenge under European law and preserve the UK revenue base (VanderWolk, 2004b). The provisions contained in section 209 of the ICTA 1988 were repealed, by section 34 of the Finance Act 2004, and incorporated within the general transfer pricing rules of Schedule 28AA with effect from 1 April 2004 (Nendick, 2004). This was the most significant revision of the transfer pricing and thin capitalisation rules for six years (Green, 2004). The amendments went further than simply removing the discriminatory UK to UK company exemptions and as a consequence foreign-owned UK subsidiaries which are part of multinational groups were the most likely entities to have to comply with the transfer pricing regulations (VanderWolk, 2004b). In order to allow companies to develop an understanding of the requirements prescribed by the transfer pricing legislation, section 33(3) of the

Finance Act 2004 provided for an adjustment period of two years, to April 2006, during which the UK tax authorities would not impose penalties for failures to keep appropriate records of all arm's length pricing (Green, 2005). Table 1 summarises the pre- and post-2004 positions.

TABLE 1: SUMMARY OF AMENDMENTS

Pre-2004	Post-2004
Generally accepted safe harbour debt–equity ratio of 1:1	No reliance to be placed on debt–equity ratio alone
Unenforced transfer pricing regulations	Sole focus on transfer pricing
Borrowing capacity considered on group basis	Borrowing capacity determined without reference to credit rating of parent company
Little transfer pricing documentation	Greater emphasis on transfer pricing documentation

Since the April 2004 modifications, the UK tax authorities have challenged a number of group funding structures as being thinly capitalised despite the ratios previously outlined in *Tax Bulletin 17* (Her Majesty's Revenue and Customs, 1995) being adhered to (Mahalingham, 2007). In order to avoid a transfer pricing audit, companies may take steps to reduce their reliance on debt financing below the previously accepted 1:1 ratio. The shift to transfer pricing regulation requires the debt capacity of the borrower to be determined in isolation from its parent group. As such, certain companies may be deemed thinly capitalised based on their stand-alone debt capacity, as previously they may have relied on their parent's borrowing capacity.

Alternatively, Mahalingham (2007) also argues that the UK tax authorities' shift in focus may present opportunities for certain companies to increase their utilisation of debt. Capital structures with debt usage in excess of the 1:1 debt-to-equity ratio can be justified in circumstances which represent arm's length funding. Allen's (2000) study of spare debt capacity showed that 88 per cent of UK firms operated a policy of holding spare debt capacity, with the ability to borrow up to 20 per cent more. Accordingly, the lack of reliance on informal ratios may present the opportunity for increased interest deductions to be obtained on inter-company funding structures which are supported by appropriate documentation.

DATA AND FINDINGS

To examine the effect of the 2004 thin capitalisation rules change, all foreign-owned UK companies within the scope of the legislation before and after the 2004 amendment were considered. However, UK companies with a parent based in an OECD country with a lower corporate tax rate than the UK – which either do not tax interest received or subject the interest received to a lower tax rate than the UK – are more likely to engage in earnings shifting. Hence, it was decided to restrict the sample to those UK companies which had a parent in an OECD country with a lower corporate tax rate than the UK rate.

The data were obtained from the Forecasting Analysis and Modeling Environment (FAME) database, which provides firm-level panel data for over seven million companies in the UK and Ireland (Bureau van Dijk, 2012). The database facilitated the identification of foreign-owned companies operating in the UK within the timeframe of the study. Only companies that provided full individual accounts were selected, as consolidated financial statements do not reflect the extent of intercompany debt. As recommended by Miller, Morris and Scanlon (1994), companies from all industries were included to counter potentially confounding effects of industry-specific practices. Finally, as suggested by Weichenrieder and Windischbauer (2008), companies which exhibited negative equity in any year or which had extreme levels of debt were excluded from the sample as it would not be appropriate to compare negative, positive or extreme ratios. This produced a sample of 432 companies. The sample was further analysed by country of ownership, size and original gearing levels. Analysing the data in these categories facilitated the identification of differing effects of the thin capitalisation rules and potential trends.

Debt–equity ratios provide a suitable means of evaluating the impact of the legislation as they measure the degree to which the funds of a company have been provided by lenders (Melville, 2008, p. 359). Accordingly, debt–equity ratios were calculated each year for all companies for the period 2001–2010, with periods of 2001–2004 and 2006–2010 used as comparatives. This cut-off period provided similar levels of observations both before and after the 2004 amendment. 2005 was excluded as the post-2004 rules were not fully applied that year. The debt–equity ratios were calculated in accordance with HMRC guidelines. Therefore, the debt–equity ratio used was the ratio of total interest-bearing debt to shareholders' funds (Her Majesty's Revenue and Customs, 2010b), i.e.:

Debt–Equity Ratio = Debt/Shareholders' Funds

HMRC defines debt, for thin capitalisation purposes, as money or money's worth which is owed by one party to another (Her Majesty's Revenue and Customs, 2010c). Interest-free debt is excluded from this definition. Therefore for thin capitalisation purposes, debt comprises short- and long-term group loans, overdrafts and other short- and long-term loans, while equity is treated as the shareholders' funds, which includes issued share capital, share premium, retained earnings and other substantiated reserves (Her Majesty's Revenue and Customs, 2010c). Revaluation reserves are regarded as equity if there is evidence of the substance of the revaluation, such as a report from a qualified expert or the accounts being audited (Her Majesty's Revenue and Customs, 2010c). Table 2 summarises the components of the debt–equity ratio.

TABLE 2: COMPONENTS OF DEBT AND EQUITY

Debt	Equity (Shareholders' Funds)
Overdrafts	Issued share capital
Short- and long-term group loans	Share premium
Other short- and long-term loans	Retained profits/losses
Loans from directors	Substantiated revaluation reserves

Table 3 displays for the whole sample the number of companies whose mean debt–equity ratio increased, decreased or remained constant over the two periods, while Table 4 displays maximum and minimum values of debt–equity ratios, the mean values, the standard deviation around the mean and the *p*-value to test for significant difference in the means.

TABLE 3: MOVEMENT IN MEAN DEBT–EQUITY RATIOS

Movement	Number of Companies	Share
Decrease	207	47.9%
Increase	194	44.9%
No change	31	7.2%
Total	432	100.0%

TABLE 4: WHOLE SAMPLE

	2001–2004				2006–2010				
	Mean	SD	Max	Min	Mean	SD	Max	Min	*p*-value
Debt–equity ratio	2.29	16.70	550	0	1.42	6.44	147.62	0	0.050
Debt (£000s)	9,926	93,473	2,734,802	0	6,494	53,665	2,029,461	0	0.261
Equity (£000s)	12,400	67,580	1,051,686	0	12,568	65,804	1,158,762	0	0.862

The main finding that emerges from Tables 3 and 4 is that the UK changes to thin capitalisation rules have influenced companies' capital structure decisions. The reduction in the average debt–equity ratio from 2.29 to 1.42 is significant at the 5 per cent level and implies that the amendment to the legislation resulted in companies taking active steps to reduce the proportion of debt held so as to not be deemed thinly capitalised by the UK tax authorities. Table 4 also illustrates that the main cause of the change in debt–equity ratios was a reduction in the level of debt employed, with the mean level of debt falling from £9,926,000 to £6,494,000. These findings concur with Mahalingham's (2007) claim that, in the wake of the 2004 changes to the legislation, companies would likely reduce their gearing levels to avoid an HMRC audit. Accordingly, it appears the new method of determining the company's borrowing capacity restricted the debt capacity of these companies. However, while the mean debt–equity ratio of the sample decreased, Table 3 shows that 194 firms actually increased their gearing levels.

To investigate further, the sample was analysed by the country of ownership of the parent firms. As noted previously, it was decided to restrict the sample to those UK companies which had a parent in an OECD country with a lower corporate tax rate than the UK rate. Table 5 displays the number of companies by country that exhibited mean debt–equity ratio increases or decreases, or whose mean debt–equity ratio remained constant over the two periods, while Tables 6, 7 and 8 highlight the maximum and minimum values, the mean values, the standard deviation around the mean and the *p*-value in respect of Switzerland, Ireland and Denmark respectively. The category of 'Others', which included all remaining countries whose tax rate was lower than the UK, will not be discussed further as the sample size is too small.

TABLE 5: MOVEMENT IN THE MEAN DEBT–EQUITY RATIOS BY COUNTRY OF OWNERSHIP

Parent Country	N	Share	Decrease	Increase	Constant
Switzerland	198	45.8%	106	82	10
Ireland	163	37.7%	71	74	18
Denmark	55	12.7%	22	30	3
Others	16	3.7%	8	8	0
Total	*432*	*100.0%*	*207*	*194*	*31*

TABLE 6: MOVEMENT IN THE MEAN DEBT–EQUITY RATIOS – SWITZERLAND

	2001–2004				2006–2010				
	Mean	**SD**	**Max**	**Min**	**Mean**	**SD**	**Max**	**Min**	***p*-value**
Debt–equity ratio	2.86	21.14	550	0	1.64	8.08	147.62	0	0.132
Debt (£000s)	17,525	136,543	2,734,802	0	9,177	77,916	2,029,461	0	0.204
Equity (£000s)	16,706	76,945	888,107	0	14,489	64,989	864,574	0	0.234

TABLE 7: MOVEMENT IN THE MEAN DEBT–EQUITY RATIOS – IRELAND

	2001–2004				2006–2010				
	Mean	**SD**	**Max**	**Min**	**Mean**	**SD**	**Max**	**Min**	***p*-value**
Debt–equity ratio	2.06	13.71	312.82	0	1.14	4.51	88.6	0	0.140
Debt (£000s)	2,162	11,012	258,196	0	3,157	8,241	64,303	0	0.137
Equity (£000s)	5,417	23,128	300,000	0	6,578	19,785	300,000	0	0.107

TABLE 8: MOVEMENT IN THE MEAN DEBT–EQUITY RATIOS – DENMARK

	2001–2004				2006–2010				
	Mean	**SD**	**Max**	**Min**	**Mean**	**SD**	**Max**	**Min**	***p*-value**
Debt–equity ratio	1.32	4.41	53.58	0	1.53	5.31	63.47	0	0.654
Debt (£000s)	7,724	27,876	239,823	0	7,568	22,265	182,098	0	0.964
Equity (£000s)	19,654	112,687	1,051,686	0	23,947	131,549	1,158,762	0	0.114

Given its general classification as a tax haven (Rixen, 2011; Dharmapala, 2008), Switzerland appears an attractive jurisdiction for earnings shifting. However, the extent of this practice seems to have diminished as Table 6 illustrates that the new form of assessing the borrower's debt capacity appears to have put considerable pressure on Swiss-owned companies to reduce the level of debt they carry. From the table, UK subsidiary companies with a Swiss owner appear to show a large reduction in the mean debt–equity ratio from 2.86 to 1.64 between the pre- and post-2004 periods, caused by the reduction in the level of debt employed, with the mean level of debt falling 47.6 per cent from £17,525,000 to £9,177,000. However, none of these findings are significant at the 5 per cent level.

The corporation tax rate in Ireland was lower than the rates which applied in other OECD countries. Table 7 reports an overall decrease in the mean debt–equity ratio from 2.06 to 1.14 for UK companies with an Irish parent. While this observation is not statistically significant at the 5 per cent level, 45.4 per cent of such companies actually showed an increase in debt–equity ratios between both periods. This finding may demonstrate the flexibility of transfer pricing legislation identified by Richardson et al. (1998). Specifically, in the case of UK subsidiary companies with an Irish parent, although the principal effect of the legislation appears to have prompted an overall reduction in the average debt–equity, a large number of UK firms with Irish parents may have used the transfer pricing provisions to justify carrying higher amounts of debt finance.

In relation to Danish-owned companies, the findings show an increase in the average debt–equity ratio employed but this finding is not significant at the 5 per cent level. The lack of any significant movement after the current thin capitalisation legislation became effective could in part be explained by the fact that prior to 2004 the corporate tax rates for both Denmark and the UK were 30 per cent. This may indicate that there was no incentive for Danish companies to shift profits through debt financing. The reduction in Danish corporate tax rates to 25 per cent will have created some scope for Danish parents to make tax savings.

In summary, segregating the companies by the residence of their owner facilitated the identification of foreign-owned UK subsidiary companies where the thin capitalisation rules could have had the most impact. The findings suggest that it is Swiss- and Irish-owned firms that the legislation has most affected. Given the favourable corporate tax regimes in Switzerland and Ireland, these jurisdictions would have long been viewed as prime jurisdictions to facilitate debt shifting and the findings suggest that the thin capitalisation rules may have contributed to lower levels of debt used by many such companies. The results are consistent with the findings of Huizinga et al. (2008) in relation to how debt financing may be related to national tax differences.

A similar picture emerges when sample companies are segregated by size. Tables 9, 10, 11, 12 and 13 show statistics for the two comparative time periods of sample companies segregated by size. Companies are classified into four groups: large, medium, small and micro, according to European Commission classifications. Large companies are those whose 2010 revenue was in excess of £50 million, medium companies are those with a turnover of between £50 million and £10 million, small companies are those with a turnover of between £10 million and £2 million and micro companies are those with a turnover of less than £2 million (European Commission, 2003).

Tables 10–13 show that for each size category, the mean debt-to-equity ratio decreased. Table 10 reports that for large companies, while the average debt–equity ratio reduced from 4.06 to 1.92, this was not significant. Of these companies 54.3 per cent actually increased their gearing level over the two periods, which is reflected in the finding that average debt levels increased by 56.3 per cent. This finding implies that the modifications made to the legislation resulted in some large companies

TABLE 9: MOVEMENT IN THE MEAN DEBT–EQUITY RATIOS BY SIZE

Company Size	N	Share	Decrease	Increase	Constant
Large	35	8.1%	15	19	1
Medium	85	19.7%	38	45	2
Small	106	24.5%	52	52	2
Micro	206	47.7%	102	78	26
Total	*432*	*100.0%*	*207*	*194*	*31*

TABLE 10: MOVEMENT IN THE MEAN DEBT–EQUITY RATIOS – LARGE COMPANIES

	2001–2004				2006–2010				
	Mean	SD	Max	Min	Mean	SD	Max	Min	*p*-value
Debt–equity ratio	4.06	12.51	99.82	0	1.92	3.43	34.7	0	0.164
Debt (£000s)	14,904	30,882	189,549	0	23,293	33,977	198,203	0	0.141
Equity (£000s)	25,119	67,029	355,595	43	29,423	62,998	384,023	45	0.353

TABLE 11: MOVEMENT IN THE MEAN DEBT–EQUITY RATIOS – MEDIUM COMPANIES

	2001–2004				2006–2010				
	Mean	SD	Max	Min	Mean	SD	Max	Min	*p*-value
Debt–equity ratio	3.56	30.57	550	0	1.54	5.10	88.43	0	0.241
Debt (£000s)	2,786	6,484	70,875	0	4,426	10,041	118,836	0	0.018
Equity (£000s)	4,547	7,220	52,384	0	6,283	7,851	67,223	0	0.000

TABLE 12: MOVEMENT IN THE MEAN DEBT–EQUITY RATIOS – SMALL COMPANIES

	2001–2004				2006–2010				
	Mean	SD	Max	Min	Mean	SD	Max	Min	*p*-value
Debt–equity ratio	1.72	15.32	312.82	0	1.25	5.19	68.12	0	0.552
Debt (£000s)	2,286	10,374	113,749	0	2,421	11,432	136,171	0	0.518
Equity (£000s)	2,305	3,898	26,083	0	3,539	6,328	49,295	2	0.002

TABLE 13: MOVEMENT IN THE MEAN DEBT–EQUITY RATIOS – MICRO COMPANIES

	2001–2004				2006–2010				
	Mean	SD	Max	Min	Mean	SD	Max	Min	*p*-value
Debt–equity ratio	1.75	7.13	117.96	0	1.37	7.77	147.62	0	0.302
Debt (£000s)	15,959	134,197	2,734,802	0	6,590	75,367	2,029,461	0	0.139
Equity (£000s)	18,674	93,009	1,051,686	0	16,944	90,787	1,158,762	0	0.350

taking active steps to change the proportion of debt held in their capital structures. For medium-sized companies the reduction in the debt–equity ratio from 3.56 to 1.54 is not significant, but the mean increases in both debt and equity were highly significant. For small companies there was a highly significant increase in the level of equity held in their capital structures. This finding may indicate that these companies were not in a position to alter their debt levels, but instead adjusted the level of equity on their balance sheets. Table 13 illustrates that micro companies were the only group of companies which reduced the mean amount of debt held after 2004, but that finding was not significant at the 5 per cent level. Given that micro companies may have less collateral, they may have relied on their parent when justifying their debt capacity in the 2001–2004 period. Therefore, the observed reduction in debt financing may be attributed to these companies now being assessed on a stand-alone basis. Conversely, all other size categories showed an increase in the overall debt levels. It may be that the ability to carry out the level of economic analysis suggested by Mahalingham (2007) was more suited towards larger and medium-sized companies. The 31 companies which displayed a constant debt–equity ratio appear to maintain a policy of not using debt finance. Of these companies, 83.9 per cent were micro-sized, which appears consistent with Norton's (1990) finding that smaller-sized companies are more likely to maintain a no debt policy.

Finally, the data were analysed by reference to initial gearing level in the two groups: companies which had a mean debt–equity ratio greater than or equal to 1:1 over the 2001–2004 time period and companies whose debt–equity ratio was less than 1:1 over the same period. As noted previously, the pre-2004 thin capitalisation regime contained the informal 1:1 rule of thumb ratio. That split facilitated a judgement to be made as to how well the thin capitalisation rules targeted abusive capital structures. Table 14 summarises the number of companies in each category while Table 15 illustrates the differences between companies based on their original indebtedness, showing the mean debt–equity ratio, mean debt and mean equity levels for both time periods together with their significance.

TABLE 14: SEGREGATION BY ORIGINAL GEARING

Debt–Equity Ratio	N	Share	Decrease	Increase	Constant
≥1:1	121	28%	93	28	0
<1:1	311	72%	114	166	31
Total	*432*	*100%*	*207*	*194*	*31*

TABLE 15: SEGREGATION BY ORIGINAL GEARING

	2001–2004				2006–2010				
	Mean	**SD**	**Max**	**Min**	**Mean**	**SD**	**Max**	**Min**	***p*-value**
Debt–Equity Ratio ≥1:1									
Debt–equity ratio	7.54	30.95	137.5	1	3.48	8.91	60.29	0	0.009
Debt (£000s)	28,196	173,209	2,734,802	0	15,551	98,418	2,029,461	0	0.235
Equity (£000s)	8,561	42,292	807,587	0	10,022	22,622	213,804	0	0.499

(*Continued*)

TABLE 15: (*CONTINUED*)

	2001–2004				2006–2010				
	Mean	**SD**	**Max**	**Min**	**Mean**	**SD**	**Max**	**Min**	***p*-value**
Debt–Equity Ratio <1:1									
Debt–equity ratio	0.24	0.39	0.99	0	0.62	2.27	13.64	0	0.000
Debt (£000s)	2,818	17,350	239,823	0	2,977	13,856	302,000	0	0.876
Equity (£000s)	13,894	75,116	1,051,686	0	13,559	76,246	1,158,762	0	0.750

The statistics reported in Table 15 indicate that the thin capitalisation rules have been effective in reducing gearing levels for companies that were operating higher gearing levels in the pre-2004 period. This is reflected by a highly significant fall in the mean debt–equity ratio for companies which had a ratio of greater than 1:1 in period 2001–2004 from 7.54 to 3.48. Accordingly, the thin capitalisation rules appear to be fulfilling their objective of preserving the UK revenue base (Vander-Wolk, 2004b) by reducing the number of companies holding excessive amounts of debt. Conversely, those companies which had a low level of gearing appear to have taken the opportunity to increase it post-2004 with a highly significant increase in the mean debt–equity ratio from 0.24 to 0.62.

The overall observation of a decline in the mean debt–equity ratio (Table 4) is consistent with the findings of Overesch and Wamser's (2010) examination of German thin capitalisation rules after an amendment to the legislation in Germany in 2001. They observed a reduction of approximately one-third in the mean of the debt–equity ratio due to a 2001 thin capitalisation reform. The results in Table 15 are consistent with the findings of Weichenrieder and Windischbauer (2008), who observed significantly more reductions in those companies which were highly geared prior to that amendment.

CONCLUSIONS

The objective of this study was to explore the effects of taxation regulations on the financing decisions of foreign-controlled UK companies. Specifically, the study aimed to determine whether thin capitalisation rules affect the financing decisions of such companies by considering the effect of a 2004 amendment to the UK thin capitalisation legislation by examining variations in the proportions of debt levels.

The findings indicate a degree of effectiveness of the 2004 amendment to the thin capitalisation rules. Specifically in the first instance, taking the sample as a whole, the change in the thin capitalisation rules influenced companies' capital structure decisions with the average debt–equity ratios falling from 2.29 to 1.42. Second, the amendment was most effective in reducing gearing levels for companies that operated what may be deemed excessive gearing levels prior to the 2004 amendment.

Third, companies which had lower levels of gearing, below 1:1, prior to the change in legislation exhibited increases in the proportion of debt held, indicating that a number of companies have utilised the amendment to the rules to increase their debt holdings to levels thought unallowable during the pre-2004 regime.

Consequently, it appears that the transfer pricing form of thin capitalisation rules has had a two-dimensional effect in reducing highly geared capital structures and facilitating an opportunity for a number of companies to increase gearing levels above previously acceptable limits. Fourth, the extent of the impact of the thin capitalisation rules varied depending on the size of the company. Finally, the residence of the parent company did not cause significant changes to the debt or equity levels. In summary, the amended UK thin capitalisation rules appear to have had a contrasting effect as they have been effective in targeting highly geared and potentially abusive capital structures, while providing the opportunity for a number of companies to utilise more debt than they would have under the pre-2004 regime.

There are a number of limitations. First, the study focused only on thin capitalisation rules but there may be other factors which could have influenced the capital structures of the sample companies. For example, factors such as non-debt tax shields (MacKie-Mason, 1990; Downs, 1993), size (Ang, Chua and McConnell, 1982), level of operating risk (Gaud, Jani, Hoesli and Bender, 2005) and growth opportunities (Titman and Wessels, 1988) have been found to play a role in capital structure decisions and may have influenced the sample companies' decisions on whether or not to hold debt. Second, any differences in the accounting principles applied by the sample companies may distort results (Rajan and Zingales, 1995) and the data do not allow for the identification of parent companies which have provided interest-free loans to subsidiary companies or confirmation as to whether revaluation reserves were verified. Third, the sample may contain companies whose ownership has changed over the 2001–2010 period. The database does not provide a means of examining changes in ownership for sample companies.

Despite the limitations this study has made a contribution to understanding an under-researched area by providing empirical evidence as to the effect transfer pricing thin capitalisation rules have on capital structure decisions and serves as an impetus for further research. Given the lack of certainty associated with transfer pricing legislation, a more effective analysis might entail conducting a survey and additional primary research in the form of interviews. Such an approach would enable the determination of the full extent of the legislation's effect on the companies' financing decisions.

APPENDIX 1: CORPORATE TAX RATES

Jurisdiction	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Czech Republic	31.0	31.0	31.0	28.0	26.0	24.0	24.0	21.0	20.0	19.0
Denmark	30.0	30.0	30.0	30.0	28.0	28.0	25.0	25.0	25.0	25.0
Iceland	30.0	18.0	18.0	18.0	18.0	18.0	18.0	15.0	15.0	18.0
Ireland	20.0	16.0	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
Poland	28.0	28.0	27.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Switzerland	24.7	24.4	24.1	24.1	22.3	21.3	21.3	22.2	21.2	21.2
United Kingdom	30.0	30.0	30.0	30.0	30.0	30.0	30.0	28.0	28.0	28.0

Source: Organisation for Economic Co-Operation and Development (2011)

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PAPERS PRESENTED AT THE TWENTY-SEVENTH ANNUAL CONFERENCE

The titles of papers presented at the twenty-seventh Annual Conference of the Irish Accounting and Finance Association (29–30 May 2014), Queen's University, Belfast, were as follows:

Author(s)	Papers Presented
Lakshman Alles & Louis Murray *Curtin University of Technology; University College Dublin*	Investment Horizons, Time Diversification and Sustainable Withdrawal Rates During Retirement Investing in UK Markets
Darinka Asenova & Matthias Beck *Glasgow Caledonian University; Queen's University, Belfast*	Social Risk of Public Spending Cuts in Scotland: Local Authority Experiences
Sandra Brosnan *University College Cork*	Accounting and HR Dynamic Tensions in the Recognition and Management of Intellectual Capital
Domenico Campa & Ray Donnelly *Trinity College Dublin; University College Cork*	Non-Audit Services Provided to Audit Clients, Independence of Mind and Independence of Appearance: Latest Evidence from Largest UK Listed Companies
Mary Canning & Brendan O'Dwyer *University College Dublin; University of Amsterdam*	Tensions and Struggles with Identity Formation: Insights from an Irish Regulatory Oversight Body
Tongyu Cao, Hasnah Shaari & Ray Donnelly *University College Cork; Universiti Utara Malaysia*	Is Fair Value Accounting Used for Unbiased Reporting or for Earnings Management? Evidence from Malaysia
John Casey & John Kehoe *Waterford Institute of Technology*	The Impact of Voluntary Auditor Rotation on Audit Quality: An Empirical Study of the FTSE 350 Companies
Peter Clarke *University College Dublin*	Let Them Pay for Their Starvation: The Introduction of Income Tax in Ireland (1853)
Frank Conaty *NUI Galway*	Research Approaches to the Study of Performance Management in Collaborative NPO/Public Sector Settings
Ciaran Connolly & Noel Hyndman *Queen's University, Belfast*	The Discharge of Accountability by UK Charities: Reflecting on Mixed Organisational and Stakeholder Motivations

Author(s)	**Papers Presented**
Ciaran Connolly & Tony Wall *Queen's University, Belfast; University of Ulster*	The Consequences of Implementing IFRSs in the Devolved Administrations
Peter Deeney, Mark Cummins, Michael Dowling & Adam Bermingham *Dublin City University*	Energy Sentiment and Emission Allowance Prices
John Doran, Margaret Healy & Maeve McCutcheon *University College Cork*	Collaboration or Conflict: The Diversity of Accounting Students' Experiences of Group Work
Elaine Doyle & Patrick Buckley *University of Limerick*	Qualitative Research and Research Ethics Review: The Development of a Workable Model
Gerardine Doyle, Rosemarie Kelly & Sheila O'Donohoe *University College Dublin; Waterford Institute of Technology*	The Mater Misericordiae Hospital: From Religious Origins to Incorporation – Have the Founders Come Full Circle?
Joanna Dyczkowska & Tomasz Dyczkowski *Worclaw University of Economics*	Linkages Between Goal-Setting Methods and Effectiveness of Internal Communication in Polish Enterprises
Eoin Foley, Patrick Mulcahy & Thomas McCluskey, *PwC; Dublin City University*	Do Thin Capitalisation Rules Effect Capital Structure Decisions? Evidence from the UK
John Forker & Ann-Marie Ward *University of Sussex; University of Ulster*	Gender Leadership and Performance in Non-Profit Financial Institutions
Desmond Gibney *National College of Ireland*	Capital Budgeting Process in the Irish Public Sector: A Case Study of the Metro North PPP Megaproject
Luis Gomes, Vasco Soares, Silvio Gama & Jose Matos *Polytechnic of Porto; Universidade Portucalense; Universidade do Porto*	Long-Term Dependence in Financial Prices: Evidence from the Belgian Stock Market Returns
Peter Green & David McAree *University of Ulster*	Intertemporal Dividend Models: Additional Empirical Analysis Using Announcement Data from Irish Quoted Companies
Noel Hyndman et al. *Queen's University, Belfast*	Making Sense of Public Sector Accounting Reforms: A Comparison of the UK, Italy and Austria
Martin Kelly & Ciaran Connolly *Queen's University, Belfast*	The Discharge of Accountability by Social Enterprise Organisations: Do as We Say, Not as We Do
Sheila Killian *University of Limerick*	'For Lack of Accounting': Social Silence and Ireland's Magdalen Laundries
John Maher & Tony Quinlan *Waterford Institute of Technology*	Culture, Management and Accounting: Reflections on Urban Celebrations involving a Tale of Three Cities
Victoria Maier & Matthias Beck *Queen's University, Belfast*	The UK PFI Policymaking Process: A Case of Punctuated Equilibria
Ruth Mattimoe & Caroline McMullan *Dublin City University*	Dynamic or Dying: A Review of the Irish Hotel Industry 2000–2010

Author(s)	Papers Presented
Danielle McConville & Noel Hyndman *Queen's University, Belfast*	Reporting of Performance in UK Charities: A Focus on Effectiveness
Francis McGeough *Institute of Technology, Blanchardstown*	Performance Management in Ireland: The Failure of SMI
Celine McInerney *University College Cork*	Carbon Exposure and the Cost of Capital
Andrea McNamara & Sheila O'Donohoe *Waterford Institute of Technology*	The Availability of SME Bank Credit in Europe: The Role of Country Characteristics
Maurice O'Brien & Sylvia Dempsey *Cork Institute of Technology*	Enterprise Resource Planning (ERP) Education in Accounting Degree Programmes
Dominic Peltier-Rivest *Concordia University, Montreal*	A Model For Preventing Corruption Worldwide
Geraldine Robbins, Gerard Turley & Stephen McNena *NUI Galway*	From Boom to Bust? The Financial Performance of City and County Councils in Ireland
Waymond Rodgers, Grace Mubako & Graeme Reid *University of Hull; University of Texas*	Knowledge Influencing Scepticism in Engagement Planning
Jo-Anna Russon *Queen's University, Belfast*	Corporate Social Responsibility vs Tax Efficiency: The Case of GlaxoSmithKline in Nigeria
Paul Ryan, Clare Branigan & Cal Muckley *University College Dublin*	The Winner's Curse, Price Anchors and Bidder Characteristics: Evidence from Successful Residential Real Estate Auctions
Corina Sheerin *National College of Ireland*	The (She) Wolf of Wall Street: Myth or Reality?
Aisling Tuite, Sean Byrne & Ray Griffin *Waterford Institute of Technology*	Towards an Understanding of Change and Organisational Culture in a Major Irish Bank
Mohi Uddin *Queen's University, Belfast*	Strategic Responses to External Pressures for Accountability: A Case Study on a Large Development NGO
Plenary Session Professor Christine Cooper *University of Strathclyde*	A Critical Reflection on Shareholder Value Maximisation
Roundtable Discussion Eamon Donaghey and Micheál Collins *KPMG, Belfast; Nevin Economic Research Institute*	The Future of Corporation Tax Policy on the Island of Ireland

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DeAngelo, L.E. (1981). Auditor Size and Audit Quality, *Journal of Accounting and Economics*, Vol. 3, No. 3, pp. 183–199.

European Commission (1996). *Green Paper on the Role, the Position and the Liability of the Statutory Auditor Within the European Union*, October, Brussels: European Commission.

Faulkner, R.R. (1982). Improvising on a Triad, in *Varieties of Qualitative Research*, Vol. 5, Van Maanen, J., Dabbs, J.M. and Faulkner, R.R. (eds.), pp. 65–101, Beverly Hills, California: Sage Publications.

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