

CBI TAX CONFERENCE – 13 OCTOBER 2008

DEVELOPING A CORPORATE TAX STRATEGY

Good afternoon.

I suppose the first question one should ask as regards the development of a corporate tax strategy is whether or not we should have one. Successive governments seem to have worked on the basis for many years that there is no need for an explicit corporate tax strategy. Indeed they seem to have seen it as a positive hindrance, a restriction on their freedom to manoeuvre. Statements are made such as “No Government can restrict the freedom to act of successor governments”, and of course, constitutionally, this is correct, but is it right to continue with this traditional short term political approach to such an essential part of the modern business environment?

I can't also help but wonder if one of the reasons why there has been little sign of a consistent long term corporate tax policy over the years is the simple fact that companies don't vote. Spending time on developing a corporate tax strategy is not exactly a vote catching idea with the general populace, especially when most governments have far more pressing problems filling the front pages of the newspapers. However, in recent times, tax has become increasingly front page news. Major companies emigrating from the UK because of an unattractive tax regime does not make good reading for a Government trying to maintain a positive image of the UK economy.

For the businessman the benefits of a corporate tax strategy are obvious. How can you possibly expect any business to make decisions about a 5, 10 or 20 year investment without a reasonable amount of confidence that the tax environment will be broadly consistent over that period? Sadly our experience in recent years in the UK is one of constant and unexpected changes in the tax system, and, perhaps worse, those changes all seem to have a general anti-business feel about them.

I would at this point however like to make a few positive points about our tax system:

Firstly consultation has improved over the last few years. We have had some low points – the DTR changes in 2000 and more recently the capital gains changes announced in last year's PBR, but overall there is now more consultation than there was and, as a tax professional of some years' standing it is interesting to compare Budget days of old, which

were full of surprises, and today's Budgets which are often rather boring affairs because we already know what major announcements are to be made, apart of course from the small print in the press releases which never seems to feature in the Budget speech itself. So consultation has improved, but even so, of this year's Finance Act, only 62% of the legislation was the subject of consultation prior to its announcement. This is better than it was but I think you'll agree that there's still considerable room for improvement!

The second point is that the UK's tax system is still fairly competitive in a number of areas; not least the freedom from withholding tax on dividends and its fairly generous regime for interest relief. The Government will point out quite rightly that we came very close to the top of last year's World Bank report on which countries were best for business. Unfortunately this report was based on the ease of doing business in different countries for a small flowerpot manufacturer and I think many of us in this room might be looking at things from a different perspective, but my point is that this country's tax system is not yet broken. It is the direction of travel and the unpredictability of that process which worries business, and it is looking increasingly uncompetitive, especially in areas such as the CFC legislation.

I think that business's case for a need for a corporate tax strategy is obvious, but should the Government feel the same way?

It is clear that from a Government perspective that flexibility is essential, no one would deny that, especially in the current uncertain financial climate. It is also clear that no government can bind its successor in any absolute terms, but surely if the Government wishes to make the UK an attractive place for business in the future then some outline plan of the direction in which we are heading is essential, and I hope that the Government would agree that making the UK an attractive place for business is a worthwhile objective.

As I have said the UK tax system has been coming under increasing criticism in recent years, sometimes on specific issues, but more frequently the criticism follows a number of underlying themes. There is a growing feeling that the system is becoming less competitive internationally, and in particular that it is becoming too complex and more and more unpredictable, in essence that it is becoming less and less business friendly. I remember an oft quoted aim from the early years of the Blair Government that the UK should be "a good place to do business in and a good place to do business from". I wonder how many of those here believe that the Government has lived up to that aim in the tax field.

However, before looking at a strategy for the corporate tax system perhaps one should also ask if the Government has or sees the need for a strategy for the type of economy it would like to see develop in the UK. If we look around at the approach of the Irish Government or the Dutch Government, they do seem to have an idea of what sort of economy they are trying to develop. In true businesslike fashion they have identified their key strengths and weaknesses and then tried to develop their Unique Selling Proposition. A speech by the Dutch Finance Minister a few years ago sounded like something you might hear from the Marketing Director of a major company. It said, "Come to the Netherlands. We like companies. We will treat them favourably". Gordon Brown said something similar at the Mansion House not long ago, but then we had the capital gains tax changes at last year's PBR and we no longer believed him!

The Irish likewise seem to have a very clear and distinctive business strategy. They have developed a clear competitive advantage with their low tax rate and their response to EU initiatives is always interesting in that it is totally focussed on the preservation of that competitive advantage. It may not always look very altruistic but it demonstrates a stable, long term strategy that has attracted a number of new companies to Ireland.

Does the UK have such a clear vision of the type of economy it would like to develop here? It seems obvious that the idea of a broad based manufacturing economy for the UK may be a thing of the past, although there is certainly room for high-end quality or specialist manufacturers. Alternatively should we become an offshore service economy or a base for international HQ operations? I'm not sure I feel able to answer these questions but I think the Government should and at the moment I don't think the Government has such a vision. However, if we have a tax strategy that says we will try to develop a tax neutral business environment except where intervention is required to compensate for market failures, which seems to be roughly where we are now, how then will we know if there has been a market failure if we don't know what type of economy we're trying to create.

Very few would argue that the UK should adopt a 12½ % tax rate overnight in order to attract business in the way that Ireland has done. There is simply too much to lose from the current tax base and any tax gain from business growth would probably not be sufficient to compensate for this loss, at least not in the short term, but the Government could do so much better than we do at the moment.

The Government could at the very least set out a framework for a future corporate tax strategy, without tying the hands of subsequent governments. This would give business

some confidence in the future direction of the tax system and would provide the foundations for a sound business environment. Surely this is the sort of thing the Government should be doing in order to build confidence at a time of instability.

So what should the key elements of such a framework be?

Headline rate

While the headline rate is not something that is that important of itself it is clear that commentators on our system use it in league tables. I have to say that I also think that many CEO's of major international companies, when making location decisions, may not look much further than the headline rate when assessing a country's corporate tax system. The Irish achieved headlines by moving their rate to 12.5% and whilst I do not believe there should be a race for the bottom I think that the Government should ensure that the rate stays in the "lower quartile" of the major industrialised countries. A policy statement of an intention to move the rate down at say 1% per annum for the next 10 years (finances permitting of course) would be very powerful and give business managers a clear direction. I accept that such action would require the tax base to be widened but perhaps that might be positive in itself.

Simplification

We have one of the longest tax codes in the world. This is not an achievement of which we should be proud. We should as a matter of policy simplify the system. This has been promised before, and is occasionally wheeled out as the rationale for some politically motivated change, as happened with the capital gains changes at last year's PBR, but it never really happens and the tax code just gets longer and longer.

In order to achieve this the Treasury must be set realistic targets. The areas to be tackled could be agreed in advance with business who would commit resources to assist. The Tax Law Rewrite programme was an admirable model for such a project in many ways, but unfortunately simplifying the language of the legislation is no substitute for simplifying the legislation itself and this programme has therefore achieved very little in the eyes of many.

An obvious starting point for simplification would be the schedular system. This is the most amazing hangover from the days when it was thought improper for a single tax inspector to know all the financial affairs of a gentleman. What we need is a system of business taxation

which taxes all business income less all genuine business expenditure under a single heading and permits free offset of excess costs against all future business profits, treating a group of companies as a single taxpaying entity, which was allegedly the intention of the group relief scheme.

Various excuses are trotted out such as “too difficult” or “too expensive” but it really is about time we did something to sort this out. The system as it stands is full of inequities and traps for the unwary. It is one of the major reasons why those who can afford good tax advice pay less tax than those who cannot. This cannot fit in with Gordon Brown’s oft quoted aim of a “fair” tax system.

There would certainly be potential costs, on both sides, of a transition. When we last looked at this, a few years ago, one of the major issues was that of brought forward interest, which, as most of you will know, cannot be set against future trading profits, or against any future profits of another company within a group. Suddenly allowing a free offset of what was a very large figure could be very expensive in terms of lost tax revenues, although probably not as expensive as Government figures suggest since much of this interest will, I suspect, be trapped inside permanently loss making companies. Even so I’m sure we could find a compromise solution, probably in terms of restricting the use of such losses for a period. Limping along with a system that does not make any commercial sense should not be an option.

I’m afraid that I do have to agree with the Government that much of the complexity is due to anti-avoidance legislation and here the corporate sector must put up its collective hand and admit that there has been some unacceptable behaviour. A Government cannot be seen to have a tax system which is perceived as optional.

However it is also well understood that most opportunities for aggressive tax planning are provided by the complexity of the legislation. Wherever the system contains boundaries, asymmetries and discontinuities then there will be opportunities for tax planning which may go beyond the intentions of Parliament. This is in itself of course a difficult area. The legislation is so complex that serious planning is required in many cases to obtain the reliefs that Parliament fairly obviously did intend, so how do you differentiate between tax planning designed to achieve Parliament’s intentions and that designed to achieve something more?

But my serious point is that simpler legislation, with fewer boundaries and fewer asymmetries will provide less opportunity for unacceptable tax planning. I also believe that

a system with fewer inequities, and which is more internationally competitive, will provide less incentive for unacceptable behaviour. Perhaps I am being too naïve but I do believe that most large corporations would prefer to be generally compliant if they believed that the system delivered a fair and internationally competitive answer. It's the unfairnesses and the need to maintain competitiveness with corporates based in other countries that drive so much of this behaviour.

Simplicity then is attractive for both sides, but a simple system will have rough edges. Last year's capital gains tax changes may not have been driven by a desire for simplicity, even though they were described as such, but there is no doubt that they were a simplification of a notoriously complex area. Simplification will not therefore please everybody. A simple system will not have room for so many special benefits and incentives. There is therefore a balance to be struck but personally I prefer the simple approach.

I would also say that the major problem with last year's capital gains tax changes was not a case of simplicity overriding special reliefs, it was the totally unexpected removal of what was perceived to be a very valuable and very effective business incentive which had been in place for a number of years.

A fundamental tenet of any corporate tax strategy must be that if the Government is going to introduce incentives then it must leave them in place for a reasonable period and must give good warning of their removal. Introducing a zero tax rate for small companies and then removing it with no warning after a few years because "too many people were incorporating for tax reasons" defies belief. What sort of behaviour were they trying to encourage and what sort of behaviour did they expect? The home computer scheme was another incentive withdrawn without notice, much to the embarrassment of 2 Government departments which were about to introduce such schemes.

Stability

This then leads on to the issue of stability. One of the most common complaints I hear about the current tax system is the constant change. Chancellors over the years, of both political complexions, have shown an irresistible urge to meddle. Perhaps it is the simple need to be seen to be doing something when not much actually requires to be done. But what is not acceptable is when structures which have been widely used and accepted for many years are suddenly declared heinous crimes. My favourite is preference share lending between non-financial corporates. This was a long standing practice which did not

look particularly criminal to me. The borrower obtained no tax relief for the dividend and the lender was not taxed on it. This was a perfectly symmetrical, tax neutral arrangement, which seemed to do no harm to anybody and seemed to have been accepted by HMRC for many years. Suddenly it became a heinous crime, requiring structures to be unwound and causing financing costs to increase for those companies with losses who could not therefore obtain tax relief for their financing costs. I'm not actually convinced that preference share financing between two unrelated non-banking corporates was an intended target. It may just have been a victim of the shotgun approach common to HMRC's attack on tax avoidance but nevertheless the impact on financing costs was the same.

Stability also impacts at a very granular level. The life insurance industry develops products specifically targeted to take account of the way income and capital is taxed. These products by their nature have long lives and constant changes in taxation are destructive. These are typically not products that are offensive tax avoidance for the wealthy but long term savings products that governments in countries with an aging population that has insufficient savings should perhaps be encouraging.

What we need is more long term thought and less politically motivated knee-jerk reaction.

Transparency

Transparency bites on a number of fronts. It is also perhaps a polite word for honesty. We need honesty about what is happening in the tax world.

This is a particular issue with the EU. The Government needs to be realistic about this as too much tax legislation has become vulnerable to EU challenge. This is bad for Government finances and produces an uncertain playing field for corporates. The ECJ has not made life easy for tax policymakers but pretending that the problem does not exist, as the Government did for many years, and then introducing grudging half fixes of the problems following ECJ decisions does not make them go away. We now have the unedifying spectacle of the Government having introduced a grudging response to the M&S decision only to have the EU Commission now saying that the Government has not fully complied with the judgement, leading to further uncertainty on both sides. This does not look good. We signed up to the Treaty of Rome and we have to learn to live with it, for better for worse.

Summary

In summary then what would I like to see?

Firstly I would like to see the Government publish a policy framework, a strategy for our corporate tax system.

If we can agree that a policy for business taxation is a good idea lets publish it and open it up for discussion. The policy needs to be specific enough to permit meaningful consultation and in doing this the Government will have to be bold. Such change will not be without winners and losers and this should be recognised on both sides, with sufficient resolve to accept the consequences.

Secondly I would like to see a statement of intent to reduce the headline rate over time by, say, 1% per year, subject to finances permitting.

Thirdly we need a drive for simplification of the system. There are some obvious starting points for this and it would have the double impact of making life easier for corporates and reducing the opportunities for unacceptable tax avoidance. It may also produce a system with some rough edges and with fewer special reliefs but I think business should be sufficiently grown up to accept this as the price of simplicity.

Fourthly we need stability. Please stop this constant meddling. Other countries do not seem to feel the need to tamper with their tax system on a yearly, or in this country, a twice yearly basis, why do we? And if the Government wants to introduce a special relief to address market failure it should not be removed without proper notice.

And finally all this needs to be done within the context of proper consultation. Lengthy consultation can produce uncertainty but I believe that is far preferable to constant surprises. Over the past few years business has shown itself capable of contributing very positively to the policy and legislative process, resulting in what I believe to be better tax policy and better targeted legislation. We can be trusted.

For more detail on our ideas for the modernisation of the UK's corporate tax system I would refer you to the CBI's Tax Task Force Report.

Thank you for listening.