



Section 2

Proposed reforms



Reforming the UK corporate tax system

There are some that argue that as capital mobility deepens, source-based corporate income taxes will eventually become unsustainable. Source-based taxation is founded on the principle that tax can be charged by the country where the economic activity that gives rise to the income or gain is located. However, an increasingly global economy raises two major conflicts for such a tax system.

First, changes in company structures and diminishing regard to national boundaries make it increasingly difficult to identify where value creation is physically located. This is compounded by emerging forms of “virtual” economic activity that do not have a readily identifiable physical location at all. Second, even where the source of profits is relatively straightforward, capital and labour mobility are making location choices increasingly responsive to the corporate income tax burden. Some commentators suggest that, in the presence of high levels of capital mobility, small open economies, such as the UK, should not levy any source-based taxes as they will drive mobile economic activity elsewhere.⁸⁵

The Mirlees Review, under the auspices of the IFS, is expected to consider potential alternative structures for taxing companies.

However, the demise of source-based corporate income tax is likely to occur only in the very long-term. Current rules for allocating profit, combined with the fact that capital is not yet perfectly mobile, mean that for the foreseeable future a tax system that is based, at least to a degree, on source-based taxes is likely to be sustainable provided it is internationally competitive.

This report therefore focuses on reforms to the existing system rather than on more distant, and more fundamentally different, alternatives.

Competitiveness must be a policy objective

To ensure the health of the UK corporate tax system in the medium-term, competitiveness must be adopted as a specific policy objective. In an open economy, the retention of national sovereignty over taxation implies a degree of tax competition between nations. Corporate taxes represent a policy tool and should be used to ensure Britain punches above its weight in the global economy. A domestic corporate tax system in a world of mobile capital is as much a source of competitive advantage (or disadvantage) as other factors affecting business.

Tax competitiveness therefore needs to be defined by reference to jurisdictions which compete successfully for the most mobile and profitable business. This will involve looking to a much broader range of competitor economies when designing tax policy than has hitherto been the case. This does not mean that the UK needs to maintain absolute equality in tax rates or incentives with all its competitors. It does mean however that, in its entirety, the tax system must contribute to the UK's status as a first-class investment location.

Key principles for a corporate tax system

In order to ensure that this competitiveness is achieved, proposals for tax reform must be founded on certain key principles, namely:

- Simplicity and clarity
- Certainty and stability
- Flexibility
- Neutrality

These key principles should be understood within a framework of competitiveness. They are not policy objectives in their own right and should not be pursued if the effect is to diminish the competitiveness of the UK corporate tax system.

Nor can each of the above principles always have equal status in the tax system – sometimes they will conflict. The relative ranking of the key principles must be flexible. However, the principles themselves are likely to change very little. Indeed, they bear a remarkable resemblance to the basic principles of an ideal tax system outlined by Adam Smith in 1776 (equity, certainty, convenience and economy).⁸⁶

Simplicity and clarity

Tax legislation should be clear and simple to understand. A simple tax system should engender a high degree of compliance as tax liabilities are clearly understood by taxpayers and tax authorities alike.

Business repeatedly identifies complexity as the single biggest issue facing the UK tax system. It is noteworthy that in a 2007 KPMG survey on tax competitiveness, clarity of legislation was identified as the single most important factor, even ahead of tax rates.⁸⁷ However, in practice, simplicity and clarity are extremely difficult to achieve. Simplicity is often sacrificed to achieve certainty (through tightly drafted and complex legislation) and therefore if it is not adopted as an important principle for the UK corporate tax system, the risk is that very little progress would be made towards achieving it.

Certainty and stability

The tax system should clearly specify how tax liabilities should be determined and how and when they are to be paid.

This means that taxpayers should be able to anticipate in advance the tax consequences of a transaction and be certain of the application of tax law. The tax system should be stable and not characterised by endless legislative change. If new law is required there should be transparency and openness in its design. Tax administration should also be clear and consistent.

Certainty and stability are considered by business to be of key importance. The 2007 KPMG survey revealed that business considers consistency to be the second most

important factor in delivering a competitive tax system.⁸⁸ Certainty and stability are qualities that are seen as lacking in the current UK corporate tax system – these were key targets of the Varney Review of HMRC's links with large business.⁸⁹

In particular the recent retrospective application of certain tax rules has undermined certainty in the corporate tax system. It is an important principle that the tax treatment available at the time of the investment should persist throughout the life of the investment.

It is revealing that the importance of stability was recognised by the then Chancellor, Gordon Brown, in his first budget: “Without stability all plans for investment, employment and education founder. In a global economy, long-term investment will come to those countries that demonstrate stability in their monetary and fiscal policies and in their trading relationships.”⁹⁰

It is ironic that what has followed has been a decade characterised by unprecedented legislative change in the UK corporate tax system, much of it characterised by a high degree of complexity and inadequate consultation.

Flexibility

To enhance competitiveness in a world where business is changing increasingly rapidly, corporate taxes must be flexible.

Using corporate taxes to enhance competitiveness may have implications beyond headline rates – for example if the UK's competitors maintain a R&D tax credit regime, can the UK do without it? The UK will also have to stay alert to the need to respond (or better, take the lead) in other areas of tax policy.

Flexibility, although important, may be inconsistent with stability and simplicity, particularly if a flexible tax regime results in a degree of legislative complexity. Therefore, although the corporate tax system should be responsive to changing business practices and external competitive pressures, the key principles of stability and simplicity

should be overridden only where there is a compelling policy reason for doing so.

Neutrality

Neutrality broadly means that the corporate income tax system should not distort business decisions – both in terms of whether a transaction is undertaken and how it is structured. It also means that taxpayers in similar situations and carrying out similar transactions should be subject to similar levels of taxation.

Neutrality should mean, for example, that corporate taxation should neither encourage nor discourage incorporation, and once a business is incorporated it should make no difference whether it is structured as a multi-tiered legal entity or on a divisional basis. If a corporate tax is structured in such a way as to tax business profits, neutrality should also mean that all business income is taxed and full relief is given for all business expenses.

Neutrality could be regarded as a second-order principle because it is important to recognise that it may be compromised in achieving a fully competitive tax system. For example, some would argue that strict neutrality would require equal treatment of debt and equity finance. However, any reduction in the tax deductibility of debt finance would compromise a fundamental tenet of corporate taxation – that taxable profits should exclude all genuine business expenses – as well as having a significant detrimental effect on competitiveness, as other jurisdictions permit interest deduction. This example illustrates that while neutrality might be attractive, it will not always be possible to achieve given the imperative of maintaining international competitiveness.

There are also important questions concerning the extent to which taxation should be used as a micro-economic policy tool. The more features of the tax system that are used as a specific tool of government policy, the less neutral it is likely to be. As a general principle, the instances in which it is appropriate to use the tax system

as a policy tool (for example, to correct a market failure) are likely to be rare. Using the tax system to intervene in the market is likely to be appropriate only in the following combination of circumstances:

- the nature of the market failure is clear;
- there is evidence that the failure is significant;
- the tax system can tackle the source of the failure;
- tax policy can have a significant effect on behaviour and;
- the policy does not cause significant distortions elsewhere.

In many cases taxation is a rather blunt policy instrument and more often than not specific policy measures operate to mask a market failure rather than correct it. Therefore, the circumstances in which tax policy can be used to intervene in the market should be very limited indeed.

It is important that the principle of neutrality is not taken to mean equity or fairness. These concepts, whilst clearly appropriate for the tax system as a whole, have little meaning in the context of corporate taxation where in an open economy it is not business that actually bears the burden of the tax.

Compliance with EU and international obligations

Given the current political realities within which the UK operates, it is important to acknowledge that the UK is bound by certain international fiscal obligations, particularly within the EU. The UK tax system should comply fully with these.

The extent to which the UK retains sovereignty with reference to corporate tax is an important political decision, but the corporate tax system must recognise that certain key principles are already enshrined in EU law or OECD practice. In the EU context, the fundamental freedoms (for example, the freedom of establishment and the free movement of capital) are entirely consistent with the principle of neutrality outlined above and

should be embraced in the way the UK taxes cross-border business. When EU law requires changes to the UK tax code, the UK should respond by extending the domestic freedom to cross-border transactions, rather than extending the more restrictive cross-border rules to domestic transactions.

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Reform of the UK corporate tax system

The task force has identified five key areas for reform:

1 Delivering a competitive tax system

The current ad hoc approach to corporate tax policy-making needs to be replaced by a planned and integrated long-term strategy, in which competitiveness is a central objective.

The competitiveness of the tax system needs to be objectively measured in terms of tax rates, the overall tax burden, and the complexity and certainty of the system. The competitiveness of the UK corporate tax system should also be formally benchmarked against a wide group of competitor economies.

The statutory corporate tax rate needs to be reduced to 18% in the medium-term. Dynamic analysis of tax policy must be adopted to enable proper analysis of the full effects on the economy and tax revenues of all tax changes.

2 Radical simplification of the existing system

The corporate tax system has become over-complex, has failed to respond to changing business methods and behaviour, and encourages complex tax-planning. The basis on which business is taxed needs to be radically simplified. Business should be taxed on all profits minus all genuine business expenses (which includes interest payments) computed under one single head of charge.

Non-UK source profits should be exempted; there should be further alignment of tax and accounts-based profit, including allowing full accounts-based depreciation to replace capital allowances and a radical reform of the capital/revenue divide; the schedular system should be abolished; and a UK tax consolidation regime should be introduced.

3 An improved legislative and administrative process

The current process for formulating tax legislation and administering the tax system in the UK is deficient. Scrutiny of UK tax law and policy is poor by international standards. The costs of administering the system are rising and the relationship with business is often inconsistent and there is room for better cooperation.

The process for making tax policy needs to be improved through a well-resourced Tax Policy Division in HM Treasury which draws on experience from within the commercial sector; the publication of a detailed three-year rolling programme of government's legislative priorities; the introduction of robust impact assessments to accompany new policy; and a formal process for tax consultation. When the policy proposals become firm legislative plans the drafting needs to be improved to include a clear statement of purpose against which the draft legislation can be evaluated.

The parliamentary process for considering this draft legislation can be significantly improved by strictly limiting budget secrecy – most new tax law should be enacted outside the confines of the annual finance bill to give more time for scrutiny. Parliamentary scrutiny can be made more effective with better resources and more independence. An independent tax law commission should be established to review tax law once enacted.

Finally, the administration of tax legislation and policy can be improved with adequate resourcing of HMRC to enable it to implement the Varney Review recommendations.

4 A tax system that promotes enterprise

Growing and enterprising businesses are of critical importance to the UK economy. The tax system should enable these businesses to thrive and compete on a level playing-field with larger businesses.

The compliance burden of the corporate tax system falls disproportionately on SMEs. Hence, radical simplification of corporate taxation will disproportionately benefit smaller businesses without any sector-specific incentives. But there is merit in more targeted measures specifically to support this sector of the economy.

This includes reducing the small companies' rate to 18% in the short-term then merging it with the main rate at this level; enhancing the investment allowance for SMEs; and making this to be available in full even where a SME is not generating sufficient taxable profits. To further reduce the burden of regulation and compliance on SMEs they should be exempted from many of the complex rules designed to target complex MNEs, and the principles of modern risk-based tax administration embodied in the Varney Review should be extended to smaller businesses.

5 Meeting the international challenge of diverse national tax systems

Globalisation poses challenges that are unlikely to be addressed adequately by unilateral reform – international policy initiatives are required.

The UK government should play a leading role in both EU and OECD discussions on further coordination of national tax systems to reduce double taxation and compliance costs for business, including on initiatives such as streamlining the advance pricing agreement process, exploring the potential for international standardisation of transfer pricing documentation requirements, and the introduction of safe harbours for routine transfer pricing issues.

Tax harmonisation in principle is not considered to be the most effective way of addressing the problems of cross-border commerce. But if formal harmonisation of tax systems becomes inevitable, then the UK government should take a leading role in the discussions to find the most workable solution for UK business.

The proposals in this report should be implemented over the medium-term to ensure the health of the UK corporate tax system. The reforms to the building blocks of the system and the proposals to support enterprise could be achieved within a five-year timescale but it may be necessary to phase the reduction in the main corporation tax rate over a period of eight years to avoid putting undue strain on the government's finances.