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Race to the top: developing a Corporation Tax regime to support sustainable growth

Policy briefing # 3

"Developing a competitive Corporation Tax regime is about supporting the UK's 'race to the top' as a world-beating dynamic and productive economy"

In its first 100 days in office, the CBI called on the new Government to commit to a Comprehensive Business Tax Roadmap to articulate the way ahead on business tax. The Government's pledge in the Summer Budget to set out such a Roadmap in April 2016 was welcome. This paper – third in a series in advance of the Government's Business Tax Roadmap – argues that developing a competitive Corporation Tax regime is about supporting the UK's 'race to the top' as a world-beating dynamic and productive economy. This requires building a Corporation Tax regime that supports the drivers of sustainable growth: investment and innovation.

The UK Government states in its *Productivity Plan* that "the tax system can support productivity by providing incentives, stability and certainty for long-term investment and innovation, avoiding distorting economic choices, and minimising the administrative burden of paying taxes."

The business community could not agree more: a world-class Corporation Tax (CT) regime is an essential prerequisite to addressing broader economic objectives. First, it contributes revenues to fund the public services and critical infrastructure that a modern economy demands. Second, it helps to drive the investment and innovation needed to sustain growth and deliver prosperity for all.

In this paper, we commend the steps taken in the last Parliament to enhance the overall competitiveness of the UK's CT regime. To lock in these gains, stability, certainty and clarity should be the watchwords to guide the Government's thinking in this Parliament.

Building on this, and to support the Government's productivity agenda, we also outline some policy options that we believe would ensure that the UK CT regime better supports productive investment and innovation in the economy.

Recommendations

To drive investment…	To drive innovation…
1. Maintain the structure of existing capital allowances in order to contribute to a stable environment for investment 2. Keep the level of the UK's Writing Down Allowances (WDAs) competitive relative to other nations 3. Broaden the capital allowances regime to cover structures and associated buildings 4. Improve the effectiveness of Enhanced Capital Allowances (ECAs) to ensure they deliver on policy objectives e.g. promoting investments in energy efficiency	5. Maintain the attractiveness of incentives such as the Research and Development Expenditure Credit in the UK relative to international peers 6. Ensure that the UK's R&D innovation incentives cover the full range of R&D activity from research through to development 7. Ensure that the benefits of worthwhile R&D tax incentives can be accessed by a range of businesses, particularly at the smaller end 8. Allow smaller firms below tax thresholds to benefit from the R&D tax credit as they innovate, rather than waiting until the end of the year 9. Tackle other significant barriers to innovation by smaller and medium-sized firms, including the costs of hiring high-skilled staff

1. A country's Corporation Tax (CT) regime is a critical foundation of a modern economy; it is vital to get it right

The CT regime is not enough in and of itself to deliver a tax environment that can support sustainable growth. This explains the CBI's rationale in calling for a 'Comprehensive Business Tax Roadmap' to ensure the full range of taxes affecting business support investment and innovation.

But a government's approach to CT sends a critical signal on the degree to which that country is open for business and its overall attractiveness. This is particularly the case in a global economy such as the UK's. Furthermore, given that the incidence or costs of CT ultimately falls on shareholders, employees and consumers, the challenge is to find an approach that secures tax revenue from company profits with as limited an impact on wider economic activity as possible.

The UK Government recognised this in the last Parliament with welcome reforms, including the reductions in the headline rate of CT

Conversations with businesses of all sizes, from a range of sectors, up and down the country, have made it clear that the Government can take some pride in its record on CT to date. The Coalition Government's announcement of a Corporate Tax Roadmap in 2010 was an innovative way of clearly setting the agenda on CT and a welcome step-change in tax policymaking. Furthermore, a May 2015 survey of tax directors saw 92% of respondents agree that the Coalition Government had been successful in making progress towards creating "the most competitive corporate tax regime in the G20".[1]

Staggered reductions in the headline CT rate to the joint lowest in the G20 – alongside broader reforms – played a key role in attracting and retaining economic activity in the UK. The number of companies looking to move out of the UK has dropped from 8% in 2012 to just 1% in 2014.[2] Meanwhile, in 2014 the UK was the leading destination in Europe both for Foreign Direct Investment (FDI) overall and FDI in Research & Development (R&D).[3]

In addition, evidence shows that the phased reductions to date have stimulated business investment, a critical component in the UK's recovery since the financial crisis. Analysis from the Oxford University Centre for Business Taxation estimates that the reductions in the headline CT rates to date will boost business investment by £11 billion.[4] This investment will, in turn, feed through to wages and consumption in the economy meaning higher tax revenues elsewhere.

Broader reforms to the CT regime have helped to encourage investment and innovation

In addition to headline rates, effective tax rates (or the actual tax liability which a business pays) and the overall rules of the CT regime also have an impact on investment decisions. They influence businesses' appetite to engage in activities with positive spill-over benefits to the wider economy, such as developing new innovations. In that context the introduction of the Patent Box together with the 'Above-the-Line' R&D Expenditure Credit (RDEC) were welcome as potent incentives to support innovation.

The 2010 Roadmap also brought reforms to Controlled Foreign Company (CFC) rules, introduced in Finance Act 2012. These rules – which deal with the taxation of income arising in overseas subsidiaries of UK groups – helped cement the UK as the hub of choice for global companies while ensuring fair protections for the UK's tax base.

2. Stability, certainty and clarity must be the watchwords for the CT regime

The Coalition Government was clear in its 2010 Roadmap that "a stable tax system is vital to business". Any tax regime has to have stability as one of its first principles, recognising that business location decisions require long term clarity on the direction and nature of the CT regime.

Businesses' calls for stability in tax in the UK at present also reflect that they are generally positive about the current structure of the UK's CT regime. Therefore, the Government should ensure it locks in the gains from the last Parliament through its 2016 Business Tax Roadmap.

These watchwords must be preserved in the implementation of OECD recommendations on international tax reform

The CBI has been a consistent supporter of the OECD Base Erosion and Profit Shifting (BEPS) project. These reforms have the potential to update international tax rules to ensure that CT is paid in the locations where the related economic activity occurs. As we outlined in our paper on international taxation, trust is a key foundation of any successful tax regime, and the emphasis on reducing tax avoidance and

double taxation to underpin trust in the regime is one which we support.

Nonetheless, with recommendations spanning a wide range of activities, the UK Government must continue its clear dialogue with business on both the content and timescales behind the implementation of reforms. It is important that the UK Government does not go beyond the recommendations of the BEPS project to introduce reforms that may hamper the UK's ability to attract investment. This will ensure that the implementation of reform is done in such a way that it supports the key objective behind this paper – a CT regime that can support the drivers of sustainable growth.

Stability, certainty and clarity must also be applied in sector-specific taxation

In 2011, the Coalition Government took a judgement to introduce a Supplementary Charge for oil and gas, which led to a drop off in investment and an increase in decommissioning in the UK Continental Shelf. This came alongside significant other external pressures on investment in a maturing oil basin.

The Government's actions since – through the introduction of a roadmap on the fiscal regime for oil and gas – are a welcome step forward. These actions provided *clarity* on policy objectives, *certainty* on the measures it wishes to undertake, and *stability* in setting out when these will occur over a particular timescale.

It is this same focus which is required in another critical sector of our economy – financial services – where the key principles of stability, certainty and clarity have not always been evident in recent years (see Exhibit 1).

In the Summer Budget the Chancellor announced phased reductions in the Bank Levy rate over the Parliament and introduced a new 8% CT surcharge on the banking sector, on the grounds that "banks and building societies should make an additional contribution to reflect their unique risks". However, this "additional contribution" has been decided at a time when macroprudential policy interventions (e.g. higher capital ratios) have and will continue to play the primary role in mitigating risk in the banking sector.

This suggests that both the Bank Levy and CT surcharge may be driven more by the challenges of clearing the deficit. In light of this, we would urge a review of the timeframe over which the Bank Levy can be removed, including bringing forward to the current parliament – by the end of which the public finances are forecast to be in surplus – the effective date for the change in tax base to charge only UK liabilities. We would additionally welcome an indication from the Chancellor that the surcharge should be seen as a temporary counterbalance to historically low Corporation Tax receipts from the banking sector. This would pave the way for the Surcharge to be reduced and subsequently removed as this corrects and as the public finances improve.

Providing this clarity is essential to an industry which has felt a large increase in successive regulation and taxation in recent years. The sector needs to know the future direction of travel in the UK, not least so it can continue to focus on lending to households and businesses while investing in productive innovations that can cement the UK as a FinTech leader.

EXHIBIT 1: THE TAX ENVIRONMENT FOR FINANCIAL SERVICES HAS SEEN SIGNIFICANT CHANGE

Stability? – The CBI has always been clear that banks must make a fair contribution to deficit reduction. But in addition to the Bank Levy, a broader range of financial services firms will now unexpectedly see their aggregate tax burden sharply increase with the introduction of an 8% surcharge in the Summer Budget.

Certainty? – The Bank Levy saw nine increases in total in the last Parliament, before the Government clarified its position in the Summer Budget.

Clarity? – The successive changes in the Bank Levy created a lack of clarity as to the objective of the Levy - was it to reduce risk, or was it to raise revenue? The Government's move in Autumn Statement 2014 to restrict the amount of losses which banks can carry forward to deduct from their profits sets a worrying precedent for bringing tax revenues forward in time. It also challenges the accepted treatment of losses as tax deductible in the CT regime more generally.

3. The overall goal must remain a CT regime that can support the drivers of sustainable growth: investment and innovation

While promoting stability, certainty and clarity is essential to the workability of a CT regime, this does not in itself answer the question of how the tax system can support broader economic objectives. CT receipts count alongside all other taxation in funding critical public services. But the overall CT regime also plays a critical part in galvanizing the private sector's ability to invest and develop new innovations.

Notwithstanding the positive changes to CT in the last Parliament, this section outlines further policy options for the Government to enhance our CT regime and boost the twin drivers of sustainable growth: investment and innovation.

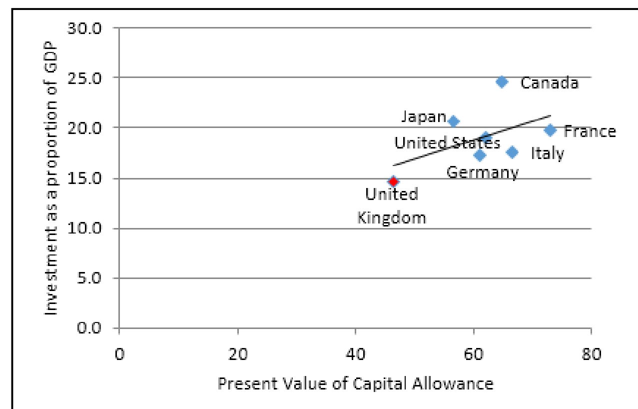
The CT regime can drive business investment by reducing the cost of capital

Investment is a key ingredient to sustainable growth as it involves building on current success to expand capacity further in future – whether in physical, creative, or financial assets. Encouragingly, business investment has made a major contribution to growth in the UK in recent years, with CBI surveys showing that investment intentions remain solid.

Undoubtedly, the UK's position on investment in 'intangible' assets in particular – such as software, training, and brand – is strong. But the UK still falls down on physical investment when compared to international peers. While fixed capital investment accounted for around 16% of UK GDP between 2010 and 2014, the corresponding figure was 20% in other developed countries. A stronger contribution from physical investment is central to improvements to our infrastructure, where the private sector is required to deliver the lion's share of the UK's £466 billion pipeline in the Government's National Infrastructure Plan.

The tax system plays an important role in stimulating this business investment. The tax deductibility of corporate interest helps companies with ambitious investment plans (especially in the infrastructure sector) to attract the long-term debt finance which is needed to fund capital projects. In addition, the ability to deduct a portion of the significant expenditure incurred in projects from a business's tax liability through capital allowances can help to lower the cost of capital, making investments more viable. Research by Bond and Xing find 'very robust evidence' that more generous capital allowances for equipment in particular can help to tip investment decisions over the line.[5] Furthermore, Figure 1 shows a positive link between the 'present value' or worth of capital allowances and investment as a proportion of GDP in G7 countries.

Figure 1: More generous capital allowances drive higher investment in the economy



Source: CBI analysis

Figure 1 also makes clear that the UK falls down on these structural incentives to support capital investment. The introduction of a permanently enhanced Annual Investment Allowance at Summer Budget 2015 was therefore welcome and is one example of a valuable step that will drive investment by small and medium-sized firms in particular. But the UK still has the lowest present value of capital allowances in the G20. CBI analysis suggests that if the UK were to raise its capital allowance regime in line with the G7 average, then the investment share of GDP could be raised from 14.7% to 18%.

From conversations with CBI members, businesses are supportive of the structure of capital allowances that already exist. But they are concerned that the UK's lack of international competitiveness here will only be exacerbated as investment conditions abroad – particularly in the euro area - start to normalise.

Further steps to drive business investment

Immediate steps

1. Maintain the structure of existing capital allowances in order to contribute to a stable environment for investment:

- The structure of the capital allowances system which exists for a variety of pools for plant and machinery assets is well understood. They ensure that companies can claim for the significant costs incurred throughout the life-cycle of a capital investment.

2. Keep the level of the UK's Writing Down Allowances (WDAs) competitive relative to other nations:

- These WDAs indicate the deductible depreciation amount which a firm can deduct from its profits in a given year, based on its total stock of plant and machinery accumulated over time.
- With its current 18% depreciation rate on plant and machinery, the UK is ranked 10th in the G20.

Improvements to consider to achieve broader policy objectives

3. The CBI still believes that there is a compelling case to broaden the capital allowances regime to cover structures and associated buildings:

- The main explanation behind the UK's lack of international competitiveness on capital allowances is that some significant areas of expenditure remain arbitrarily excluded from taxable profits. This absence means that manufacturers and infrastructure providers in particular get no relief for the upfront costs involved in investing in plant and machinery assets.
- We need a tax regime that helps to support companies with significant long-term investment in such capital assets. A capital allowance for new structures and associated buildings set at 2% would cost the Government £40 million in the first year and £190 million in the final year of the forecast in static terms.

4. Improve the effectiveness of Enhanced Capital Allowances (ECAs) to ensure they deliver on policy objectives:

- Feedback from some small and medium-sized firms indicate that the existing ECAs – which allow 100% relief for the costs of investment in energy-efficient and water-saving assets in the first year – have helped to reduce the marginal costs of key projects. But, for many, they remain too complex to claim.
- This is because qualifying lists of eligible technologies often fail to match-up with the latest industry standards. This means that gold star assets exhibiting the latest productive technology in energy efficiency often fail to qualify. Furthermore, feedback varies on how easy it is for firms with eligible products for an ECA to receive the necessary certificate from HMRC.
- The Government can help in two ways: 1) bring the list of qualifying assets for existing ECAs in line with modern technology e.g. the latest BREEAM standards on energy efficient equipment; 2) Simplify the process – a firm should be able to demonstrate in a clear and simple fashion to HMRC that investing in a particular asset will lead to clear improvements in energy efficiency over a particular timeframe.
- In time, making ECAs more effective would then allow a consideration of first-year allowances to support other objectives. For example, the Government could consider an incentive that would reduce the user cost of capital for investing in assets that can be shown to improve productivity. This could enhance 'in firm' productivity and help to support productivity growth overall.

Businesses have also suggested a number of ways in which the capital allowances regime could be improved to ensure that the incentives in place have maximum impact, as set out above.

Tax incentives for R&D and innovation benefit the wider economy

In the CBI's innovation position paper, we highlighted that tax incentives for R&D play a critical role in stimulating business innovation. They recognise that the benefits of business innovation are not only limited to the innovating businesses, but to the wider economy and society. International evidence also confirms their potency. Bloom et al, for instance, found that tax incentives for R&D in the United States led to significant additional R&D expenditure.[6]

Businesses are clear that the current R&D tax credit schemes are an essential part of the wider innovation ecosystem that makes the UK an attractive place to invest. This is particularly since the introduction of the 'Above-the-Line' R&D Expenditure Credit (RDEC), which is recognized in pre-tax ("above the line") profits, meaning even loss-making companies stand to

benefit. Furthermore, CBI members of all sizes confirm that the attractiveness of the UK's CT regime is a key consideration for international corporations when deciding where to locate their R&D and innovation activity. Here, the Patent Box has played a key role in driving Foreign Direct Investment while supporting jobs and investment by domestic firms.

As the latest figures from HMRC on R&D tax credits attest, these are tax incentives which are proving critical to regional growth, with a significant number of claims coming from SMEs and large firms outside of London and the South East.[7] Furthermore, recent research suggests that choosing whether to support innovation by domestic firms or attracting mobile income stemming from innovation by foreign-owned companies is not a zero sum game. Crescenzi et al show that investments by foreign owned corporations boost the innovation capacity of domestic firms operating in the same sector.[8]

But the UK remains in a competitive marketplace for such innovative activity, with countries responding to the conclusion of the OECD BEPS process by assessing their existing incentives. For instance, Ireland has announced plans to introduce a 'knowledge box' at 6.25% while other European regimes operate a broader definition of qualifying assets within their innovation or IP boxes, including copyrighted software. The UK also risks falling behind

Further steps to drive innovation

Immediate steps

5. Maintain the attractiveness of incentives such as the Research and Development Expenditure Credit in the UK relative to international peers:

- A continued focus on the attractiveness of the 'Above-the-Line' RDEC credit in particular would ensure that the UK remains an attractive environment for innovation, particularly as reductions in the headline CT rate will cause the worth of the credit to fall.

6. Ensure that the UK's R&D innovation incentives cover the full range of R&D activity from research through to development:

- The CBI still believes that there is a case for broadening the definition of R&D to cover the "innovation bridge" between research and taking a new product to market. This would ensure that the production and development of high value innovations takes place in the United Kingdom, rather than allowing the spillover benefits of R&D to move overseas. Such activity could be covered by a 'supercharged' R&D tax credit.

Improvements to consider to achieve broader policy objectives

7. Ensure that the benefits of worthwhile R&D tax incentives can be accessed by a range of businesses, particularly at the smaller end:

- The Government should explore extending the eligibility and application of existing R&D incentives to partnerships – firms without the traditional business structure, but which carry out innovative activities.
- In addition, the Government could look to ensure that partially owned smaller companies that demonstrably operate "at arm's length" from their parents can qualify for the SME regime.

8. Allow smaller firms below tax thresholds to benefit from the R&D tax credit as they innovate, rather than waiting until the end of the year:

- The Government could help smaller businesses better manage cash-flow by allowing part payment of R&D credits by HMRC in the course of a company's accounting period rather than the company having to wait until they have prepared their financial statements and tax return before being able to make a claim at all. Part payment could easily be based on provision by the company of evidence of expenditure – for instance, the provision of PAYE or VAT data on the wages paid to R&D personnel.

9. Tackle other significant barriers to innovation by smaller and medium-sized firms, including the costs of hiring high-skilled staff:

- We recognise that staffing costs for R&D projects currently count as a qualifying expense under the existing R&D tax credit, but smaller and medium-sized firms still tell us that employment costs remain a significant barrier when considering whether to undertake high risk-high return projects.
- The CBI has previously recommended that R&D tax incentives should allow a deduction against payroll taxes for employees working on R&D to lower the cost hurdle further.
- Alternatively, broadening an existing incentive such as the employment allowance to cover skilled R&D personnel for smaller firms could also help to lower the cost of hiring. This is particularly in the context of the addition of further business costs through policies such as the National Living Wage and the Apprenticeship Levy.

other international peers such as the United States who recognise that 'proof of market' activity is the key mechanism that helps translate ideas into products. Given these moves, it is vital that the UK looks to remain an attractive environment for innovation in this Parliament, particularly given the imperative that we boost our productivity score.

Finally, the policy options listed also recognise that it is smaller and medium-sized firms who will require the most assistance with the costs behind innovative investments, which are inherently high risk-high return in their nature. Recent CBI work highlights just how critical these firms are to the UK economy – particularly those in the scale-up phase.[9] Doing what we can to ensure that the regime supports the R&D and innovation activities of firms with high-growth potential is critical if we are to sustain and strengthen the UK's current economic growth.

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[1] *Government tax policies: the tax director's view,* Tax Journal, May 2015

[2] KPMG, *Annual Survey of Tax Competitiveness,* 2014

[3] EY, *Attractiveness Survey,* 2015

[4] Oxford University Centre for Business Taxation, *Business Taxation under the Coalition Government,* February 2015

[5] Bond and Xing, *"Corporate Taxation and capital accumulation: evidence from sectoral panel data for 14 OECD countries",* 2013

[6] Bloom et al., *Do R&D Tax Credits work? Evidence from a Panel of Countries 1979-1997,* 2002

[7] 'Regional analysis of number and cost of R&D tax credit claims, 2013-14' in HMRC, *Research and Development Tax Credits Statistics*, September 2015

[8] Crescenzi et al., *Foreign multinationals and domestic innovation: Intra-industry effects and firm heterogeneity*, April 2015

[9] CBI, *Life in the Fast Lane,* November 2015

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