Briefing note: Proposals for the reform of Corporation Tax

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The recent deluge of headlines about Google's tax settlement with HMRC has once more demonstrated public anger with the tax system. The consensus that substantial reform of Corporation Tax is required has never been greater.

The Treasury Select Committee has realised his and opened an inquiry titled "UK tax policy and the tax base". One of the questions being asked is "should the Government consider other forms of taxation (such as the proposals of the 2020 Tax Commission) when considering how to raise tax in the future, particularly from businesses and wealthy individuals?"

Amongst the conclusions of the 2020 Tax Commission, a joint project between the TaxPayers' Alliance and the Institute of Directors, was the replacement of Corporation Tax with a tax on income distributed from capital. This briefing note explains the problems with the current system, the proposals of the 2020 Tax Commission and the problems with the other reforms being proposed.

The note makes three points:

1. Corporation Tax is fundamentally unsustainable
2. Corporation Tax should be replaced by a Single Income Tax on distributions
3. Alternative proposals do not meet the challenge

1. Corporation Tax is fundamentally unsustainable

- **Inherently opaque and complex**

Opacity and complexity has undermined the legitimacy of the system and large multinationals are being accused of greater avoidance than actually takes place, at least in the UK. Recent coverage of Google's UK tax affairs has cast further doubt on the viability of Corporation Tax. A mismatch between its legal and economic "incidence" and its inherent complexity cause public mistrust and bring the system into disrepute.

- **Suggestions of a 3% "Google Tax" are misguided but illustrative**

Figures from commentators claiming that Google has paid a 3 per cent rate of Corporation Tax demonstrate a poor understanding of current tax rules which are, admittedly, highly complex. This 3% figure comes from supposing that Google's UK profits can be calculated by applying the company's global profit margin to its UK sales. But UK Corporation Tax is not designed to measure UK profits by assuming a universal profit margin based on a company's UK sales; it is designed to measure the amount of a firm's profit that can be attributed to value created in the UK.

- **Locating profits is tricky, much depends on transfer pricing**

Some of the profit from British pharmaceutical companies' foreign sales is attributable to the UK due to R&D, branding and other central functions undertaken here. Similarly, the converse applies to sales in the UK by foreign firms like Google. The prices between a head office and its international subsidiaries (such as how much head offices apply to subsidiaries' sales for using a brand) determine where profits are registered and is known as 'transfer pricing'. This is easy for widely-traded commodities, but is harder to accurately measure for things like brands which are not traded on open markets. Inevitably, there is room for interpretation and judgment.

- **Why do so many countries use profits as a base for tax?**

1. To pay for public goods and services companies use

The problem is that there is little to link profits with a company's use of, among other things, infrastructure, the legal system or state-educated employees.

2. A convenient proxy for taxing shareholders and employees

But other taxes achieve this objective – principally Income Tax (on earnings and dividends) and Capital Gains Tax.

- **The Corporation Tax burden falls mainly on employees through lower wages**

Because corporate taxes must result in less money for shareholders if companies are unable to pass the burden onto customers or employees, the burden of Corporation Tax always falls upon the customers, workers or investors. This "incidence" is a result of relative responsiveness of the parties to changes in prices, wages and returns. Labour is generally less responsive than capital, and most empirical studies demonstrate that labour bears most of the burden.

While initiatives such as the OECD's Base Erosion and Profit Shifting project may address some arbitrage arrangements, they ultimately fail to address the subjectivity involved and weaken the scope for states to experiment and compete on factors other than rates. Further international cooperation is required to prevent abuse of transfer pricing and permanent establishment rules.

- **Corporation Tax is disproportionately economically damaging**

Taxing profits weakens the profit motive by reducing the after-tax returns from efficient allocation of resources. This is turn leads to lower productivity growth which means lower growth and incomes.

2. Corporation Tax should be replaced by a Single Income Tax on distributions

The Institute of Directors and TaxPayers' Alliance 2020 Tax Commission proposed:

- **A single tax on distributed income from capital to replace Corporation Tax**
- **Levied at a corporate level** for administrative ease, similarly to PAYE on wages, on distributions which leave the UK corporate sector
- **Levied at a flat rate**. But higher rate taxpayers could be asked to self-assess above this, and those under the personal allowance could claim a rebate
- **Charged on net capital outflows**, typically dividends and interest on loans. Inflows of capital, such as loans and interest received, and shares issued and dividends received, would be deducted from gross capital outflows, typically dividends and interest on loans, but also share buybacks and loan repayments. The remainder would be the taxable net outflow.
- **Net capital inflows should generate a credit**, which may be carried forward to offset future liabilities so that tax is not charged on companies returning original capital to investors. Only income would be taxed.
- **No cash payments should be made by HMRC for credits**, which should be used only to calculate taxable distributions.
- **Credits should be tradable**, to remove the incumbency bias and to remove incentives for companies to distort their structures in attempts to realise the value of credits.
- **Lease and repurchase agreements should be treated as loans**.
- **Income from foreign capital should be taxed** with foreign corporation tax and dividend withholding taxes deductible from the tax liability. If the sum of corporation tax and dividend withholding tax is equal to or more than the UK rate, a 100 per cent credit would be issued. If the sum of the foreign rates is less than the UK rate on distributions, partial, proportional credits would be issued to gross up rates to the UK level.
- **Owners who sell their businesses would still bear a tax burden**. The price at which a business is sold or valued is determined by the after tax returns that the buyer expects to receive, meaning that they effectively pay through a discounted sale price now, or actually pay if they retain the business and receive distributions in future.
- **Debt bias would be eliminated** because debt and equity would no longer be treated differently. Profits – the return to equity – would no longer be taxed so equity would no longer be at a disadvantage to debt. Distributions would be taxed instead of profit, irrespective of whether the cash flowed to debt or equity.

Further reforms such as the abolition of Capital Gains Tax and the introduction of local sales taxes and income taxes should be considered as part of a wider package of reforms.

3. Alternative proposals do not meet the challenge

Other reform proposals usually fit into two categories: a "destination" or "unitary" base, which apportion profits on a different basis to the "source" or "residence" basis Corporation Tax uses now. Neither addresses the economic problem of taxing companies by how efficiently they use resources.

Destination based

- Allocates profits where companies make their sales. Income from sales within the UK would be taxed after expenditure relating to UK sales was deducted.
- Breaks the link between value creation and tax.
    - The sale of a Mercedes from a UK showroom would allocate profits to the UK exchequer despite the car being designed and manufactured in Stuttgart.
    - A company that mined a diamond in Tanzania that was cut in Belgium and sold in London would not be liable for corporate taxes in Tanzania or Belgium.
- International agreement would be required with the proposal likely to be resisted by developing countries with trade surpluses and substantial extractive industry sectors.
- A destination approach based may increase the UK tax base of foreign multinationals such as Google and Facebook, but it would decrease the UK tax base of companies like AstraZeneca and BP.

Unitary taxation

- Sometimes called "formulary apportionment", profits are allocated by an internationally agreed formula based on three factors: assets, labour and sales.
    - The extent to which value added can be attributed to assets, labour or sales varies greatly between industries.
    - Some companies (such as heavy manufacturers or oil companies) are more capital-intensive. Others, such as financial corporations, are more labour intensive. A one-size-fits-all formula would be impractical and impossible to agree in practice. Industry specific formulas have been proposed to fix this defect, which in turn raise questions of complexity and avoidance.
- Such a policy would be distortionary. For example a too-high weighting towards labour would be a relative incentive for companies to move shift jobs to countries with low tax rates but a relative disincentive to move capital.
    - Industry-specific formulae would be highly complex and impossible to agree in practice with countries and lobbyists trying to carve out preferential rates for different industries.
    - Within industries, the mix between capital and labour can vary substantially.