Corporation tax: beating the competition

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Online Report: Feb 2010

Contents

Page:

Online Report: Feb 2010

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Executive summary

The UK's corporate tax system has slid down the league of tax competitiveness in recent years. The overall tax burden is well above the OECD average, and the main corporation tax rate is much less competitive than it was. The tax system has also grown in complexity, and compliance costs are high.

The threat to the economic health of the UK is made clear by the decision of a number of groups to relocate their holding companies outside the UK, and the fact that many other groups are considering the same move.

While Ireland has recently suffered a reversal of economic fortunes, its earlier decisions to bring spending under tight control and to reduce the corporation tax rate to 12.5 per cent brought remarkable economic success. Both the private sector and the public sector benefited enormously.

Our central recommendation is to reduce the UK's corporation tax rate to 15 per cent over a ten-year period. We consider several other large-scale reforms to the corporation tax system, but conclude that the arguments against them are sufficiently strong that there is no compelling case in favour of them.

We also recommend improvements in relation to gains on companies' holdings of shares in other companies, and in relation to loss relief. These are improvements that would reduce tax revenue by far less than the all-important reduction in the corporation tax rate, and that could usefully be made at the same time.

Richard Baron and Corin Taylor

1 How the UK has lost tax competitiveness

Measuring the overall competitiveness of a country's tax system is not a simple task, and selected measures may of necessity be slightly crude, but the evidence in the UK does paint a clear picture of decline. Over the past decade, the UK has lost much of the competitiveness that its tax system once enjoyed. The increasing complexity and instability of the UK's business tax system are further reasons for the growing trend of companies relocating overseas.

The overall tax burden

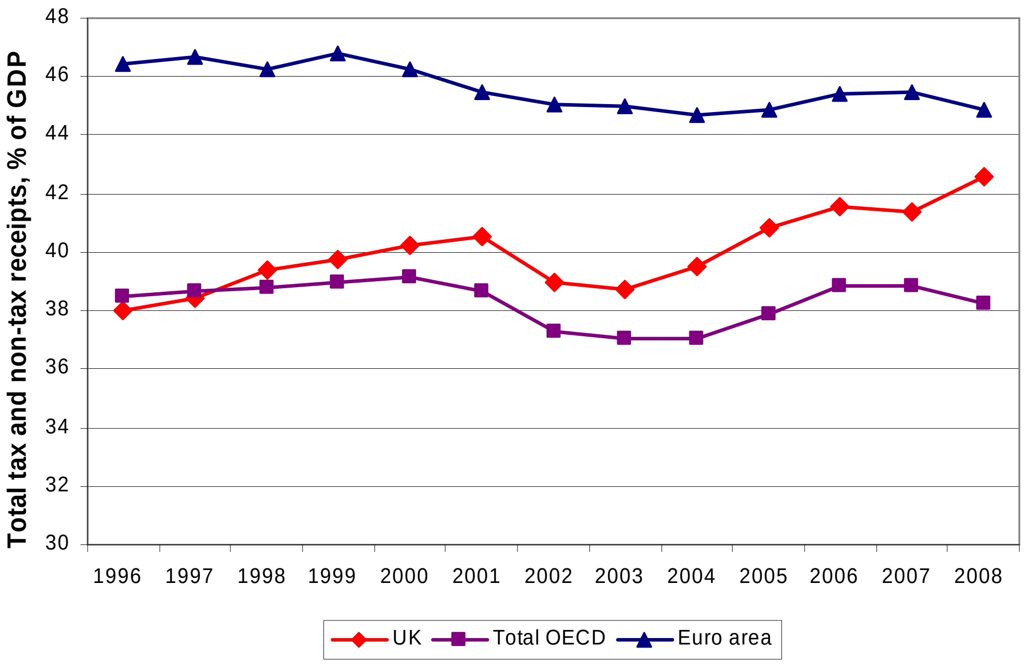
The financial crisis and its associated effects on the tax burdens of countries around the world will clearly distort the data in the short term, but the longer-term trends pre-date the 2008 crash and will no doubt re-appear once the global recovery is underway. Over the past 12 years, the UK's tax burden has moved in the opposite direction to that of other developed economies:[1]

The overall burden of tax in the UK, as a share of GDP, has moved from the eighth lowest in the OECD in 1996 to well above the average today.

In 1996, the UK's tax burden was 38 per cent of GDP, compared with 38.5 per cent in the OECD as a whole. In 2008, before the financial crisis really hit tax revenues, the UK's tax burden was 42.6 per cent of GDP, compared with an OECD average of 38.2 per cent.

Compared with the eurozone, the UK's tax burden was 8.4 percentage points below the eurozone average in 1996, but in 2008 the differential had fallen to just 2.3 percentage points.

Chart 1.1: The UK's loss of tax competitiveness



[1] OECD, *Economic Outlook No. 85*, June 2009, Annex table 26

Rates of business tax

It is not just with respect to the overall burden of tax that the UK has lost competitiveness. Rates of corporation tax are also far less competitive than they were a decade or so ago:[2]

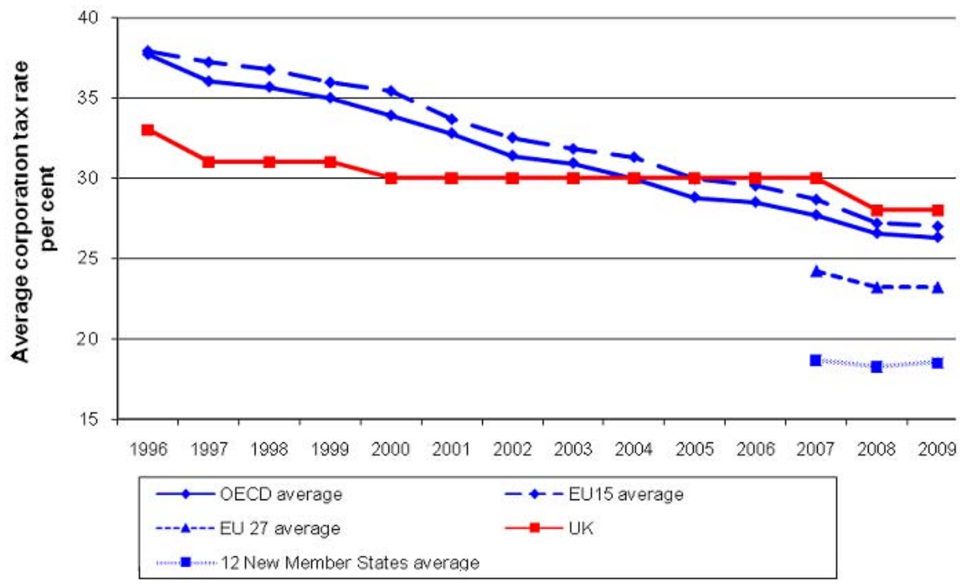
In 1996, the UK's corporation tax rate was joint fifth lowest in the OECD. In 2009, it was the joint 17th lowest.

In 1996, the UK's corporation tax rate of 33 per cent compared favourably with the OECD average rate of 37.7 per cent. In 2009, the UK's rate of 28 per cent was above the OECD average of 26.3 per cent.

Compared with the EU15, the UK had the third lowest rate of corporation tax in 1996, and its rate was well below the EU15 average of 37.9 per cent. In 2009, the UK's rate was only the ninth lowest, and above the average EU15 rate of 27 per cent.

Among the 27 EU countries as a whole, in 2009 the UK's corporation tax rate was the eighth highest, and well above the average rate of 23.2 per cent.

Chart 1.2: The UK's loss of corporation tax competitiveness



The UK should not, however, simply be comparing itself against the developed economies. Around the world, developing countries are rapidly improving their competitiveness, and becoming more attractive locations for international businesses, for many more reasons than simply cheap labour.

The rate of corporation tax is one of many factors that has enhanced the competitiveness of regions such as Asia-Pacific, and indeed corporation tax rates around the world have been falling rapidly:[3]

- In 2000, the average corporation tax rate in the 86 countries surveyed worldwide was 31.1 per cent, above the UK's rate of 30 per cent in that year. In 2009, the average rate across the 116 countries surveyed was just 24.2 per cent.

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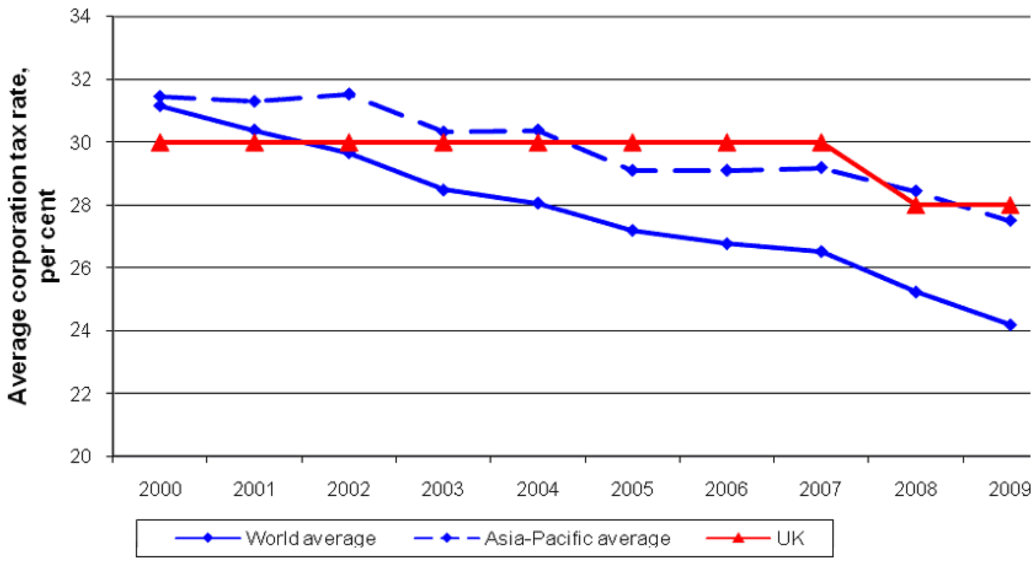
[2] KPMG, *Corporate and Indirect Tax Rate Survey 2009* (and previous years)
[3] Ibid.

- In 2000, the average corporation tax rate across the 19 Asia-Pacific countries surveyed was 31.4 per cent. In 2009, the average rate across the 20 Asia-Pacific countries surveyed had fallen to 27.5 per cent.

The UK will never match the Asia-Pacific region for low-cost labour, and nor should it. But this country needs to be ahead in other ways, and the rate of corporation tax should be, and indeed used to be, one of the factors where the UK led the world:[4]

- Out of the 86 countries surveyed worldwide, the UK had the joint 29th lowest corporation tax rate in 2000. In 2009, the UK's rate was the 68th lowest out of the 116 countries surveyed.

Chart 1.3: The UK's loss of corporation tax competitiveness worldwide



Businesses of course pay far more than corporation tax. Corporation tax is just one of 22 different taxes affecting companies, although it is the largest. Measures of the total taxes paid by businesses show that the UK is far from competitive:

- In a survey of FTSE 100 companies, PricewaterhouseCoopers (PwC) found that total taxes borne were 45 per cent of pre-tax profits in 2008.[5]
- Out of the other countries on which data were collected using the same "total tax contribution" methodology, the UK FTSE 100 companies faced the third highest average total tax rate, behind Belgium and the US; the third highest average total tax rate as a percentage of turnover, behind Canada and the Netherlands; and the second highest average figure for employment taxes per employee, behind Belgium.[6]
- The World Bank has also produced estimates of the total tax rate for 183 countries around the world. The UK ranks 67th on this measure.[7]

[4] Ibid.
[5] PricewaterhouseCoopers, *Total Tax Contribution: PricewaterhouseCoopers LLP 2008 survey for the Hundred Group,* 2009
[6] Ibid.
[7] World Bank and PricewaterhouseCoopers, *Paying Taxes 2010: The global picture*

Tax complexity

The impact of a tax system is not just limited to its rates and its overall burden. Complexity and compliance costs also matter a great deal. Unfortunately, the UK does not score well on either measure:

- The UK is now ranked 84th out of 133 countries on the "extent and effect of taxation" (which measures the impact of a country's tax system on incentives to work and invest) by the World Economic Forum. In other words, 83 countries around the world have tax systems that suffer from fewer disincentives than the UK's. In 2004-05, by contrast, the UK ranked 18th out of 104 countries and in 2005-06, 23rd out of 117.[8]
- The PwC survey of FTSE 100 companies referred to above also found that, on average, FTSE 100 companies face tax compliance costs of over 1.5 per cent of the total taxes borne.[9]
- Out of the other countries that also collected data using the same methodology, the FTSE 100 companies faced the highest average cost of tax compliance of any country, except for the US.[10]
- This fall in the international rakings is not surprising when one considers the growth in the bulk of tax legislation. 25 years ago, the annual CCH collection of UK tax legislation comprised two volumes, together occupying five inches of shelf space. Today, there are seven volumes and they take up more than a foot of shelf space.

Instability

In addition to falling tax competitiveness and increased complexity, the UK's tax system has been chronically unstable, with constant changes undermining the ability of businesses to plan for the future. A few examples will illustrate the point:

- In 2002, a zero corporation tax rate was introduced for companies with profits of up to £10,000 a year. The result, which was predictable (and predicted internally before the announcement), was a rush to incorporate by many small businesses, keen to take advantage of the combination of the zero rate and the low taxation of dividends. In 2004, the hopelessly complex non-corporate dividends rate was introduced in a desperate attempt to shore up the policy. Finally, in 2006, the policy was abandoned.
- The rules on personal service companies, popularly known as IR35, suddenly changed the environment for thousands of contractors with effect from April 2000. The disruption was very great, but there is no evidence that there have been more than a tiny number of successful Revenue investigations. The Professional Contractors' Group found that right across the country, the extra tax collected was only £1.5 million a year, and that of 1,468 Revenue investigations with which it had been involved, only six resulted in additional tax liabilities.[11]

Businesses relocating

The complexity and uncompetitive state of the UK's tax system have already been key factors in the decision of a number of large groups to move their holding companies overseas, while an increasing number of businesses are considering making the same move. KPMG's most recent annual survey on the UK's tax competitiveness found that the

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[8] World Economic Forum, *Global Competitiveness Report,* 2004-05, 2005-06 and 2009-10
[9] PricewaterhouseCoopers, op. cit.
[10] Ibid.
[11] PCG Press Release, 26 May 2009

proportion of groups surveyed that were actively considering leaving the UK had more than doubled, from 6 per cent the previous year to 14 per cent, and that those groups included four in the FTSE 100.[12] And initial results from a survey of 57 very large groups that KPMG conducted in its November 2009 annual survey of the UK's tax competitiveness showed that over half had either looked at the implications of moving out of the UK or were actively considering it. Of the 20 FTSE 100 companies surveyed, four were actively considering moving.[13]

The departure of companies from the UK is one, high-profile, way in which the negative impact of higher taxation on economic growth manifests itself.

[12] KPMG, *UK Tax Competitiveness Survey 2008*
[13] KPMG press release, December 2009

2 Lessons from Ireland

The current reversal of economic fortunes in Ireland should not be allowed to obscure the achievement of the previous 20 years, particularly in developing an exceptionally strong, modern, export-oriented business base. A major contributor to Ireland's export performance in both manufacturing and services has been its success in becoming host location to multinational companies in key high value-added sectors like pharmaceuticals, medical devices and ICT.

As the Republic's Government acknowledges, Ireland's very competitive corporation tax regime played a crucial role in attracting such investors and it has made clear that, notwithstanding the current severe pressure on the public finances, this competitive advantage will be maintained.

Ireland's transformation was such as to merit the description of an 'economic miracle'. The country may currently be going through very difficult times, and though it certainly made mistakes and benefited from the previous benign global economic conditions, that should not obscure Ireland's achievement, nor the reasons for it.

Spending control and tax reductions

The story of how successive Irish governments transformed the country's tax system, turning Ireland into one of the world's best performing economies up to the current global economic crisis, has been extensively documented. But the evidence is so strong and convincing that it is worth recounting again.

In 1987, Ireland's economic position was precarious, with stagnant growth, high unemployment, spiralling deficits and the International Monetary Fund (IMF) threatening to intervene in the Irish economy.

The 1987 Budget began a process of major economic reform, cutting spending drastically to bring the deficit under control.[14] The next Budget continued the fiscal consolidation: current spending was reduced by 3 per cent and capital spending by 16 per cent.[15] These spending reductions were accompanied and also followed by major and continuing tax cuts:

- The standard corporation tax rate was steadily reduced from 50 per cent in 1987 to 12.5 per cent in 2003. This 12.5 per cent rate remains, apart from Bulgaria and Cyprus, the lowest main rate of corporation tax in the EU. Special rates of corporation tax that favoured certain industries, such as the 10 per cent rate on manufacturing and Dublin's International Financial Services Centre, were abolished in favour of one low rate for all companies.
- Personal tax rates were steadily reduced from 35, 48 and 58 per cent in 1987 to 20 and 42 per cent by 2001. In 2007, the top rate was reduced to 41 per cent.[16]
- In 1998, the capital gains tax rate was reduced from 40 per cent to 20 per cent and special capital gains tax rates were abolished.

[14] P. Honohan, *Fiscal Adjustment and Disinflation in Ireland: setting the macro basis of economic recovery and expansion*, in F. Barry (ed.), *Understanding Ireland's Economic Growth*, 1999
[15] B. Powell, *Economic Freedom and Growth: the case of the Celtic Tiger*, CATO Journal, January 2003
[16] Budget 2007, www.revenue.ie

The 15-year 'economic miracle'

These tax reductions and simplifications, together with a range of policies to improve education and increase economic freedom, helped transform the country's economic fortunes. In per capita terms, Ireland moved from one of the poorer countries in the EU to one of the richest. The country's current economic woes should not obscure these achievements:

- Ireland's growth "miracle" is well known. Between 1993 and 2006 real GDP grew at an average of 7 per cent.[17] GNP, which excludes profits made by foreign companies, increased almost as quickly. GNP grew by an average of 4.4 per cent between 1990 and 1995, 8.8 per cent between 1995 and 2000 and 4 per cent between 2000 and 2005.[18]
- Deficits were brought down below 3 per cent of GDP from 1990-1995. In 1997 the economy moved into surplus and remained in surplus until the global financial crisis began.[19] Net debt was virtually eliminated.[20]
- Between 1987 and 2003 overall tax receipts increased four-fold, while corporation tax receipts increased 16-fold. This allowed public spending to grow by 220 per cent, compared with a comparable rise in the UK of 120 per cent over the same period.[21]
- The Irish economy has been hugely successful in creating jobs, with unemployment falling rapidly from 16.2 per cent in 1988 to 4.4 per cent in 2006, while the number of people in employment increased by two thirds over the past 20 years.[22]
- Ireland's history of mass emigration (apart from a brief reversal in the 1970s) ended. Net emigration averaged almost 17,000 a year between 1926 and 1991. Between 1991 and 1996, net migration was roughly in balance. Between 1996 and 2002, net immigration was 26,000 a year as the Republic became an increasingly attractive place to live and work.[23]
- Overall flows of foreign direct investment into Ireland increased from an annual average of around $140 million in the 1980s to $2,700 million a year in the second half of the 1990s. As a result, the total stock of foreign direct investment in Ireland in 2002 reached $157 billion, the highest in the world in per capita terms after Hong Kong.[24]

EU funding

It is often argued that Ireland's 'economic miracle' came about as a result of the generous EU funding that Ireland has received. But a closer look at the economic data suggests that this is not the case. During Ireland's more difficult years between 1979 – when the country joined the ERM – and 1994 – when growth started really to take-off – the net payment to Ireland from the EC averaged 4.5 per cent of Ireland's GDP, while real GDP growth averaged 3.4 per cent. Between 1994 and 2006 – the years of the "Celtic Tiger" – real GDP

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[17] OECD, *Economic Outlook No. 81*, May 2007, Annex Table 1: Real GDP percentage change from previous year
[18] Irish Congress of Trade Unions, *Coming Challenges on Productivity*, Spring 2006
[19] OECD, *Economic Outlook No. 81*, May 2007, Annex Table 27: General government financial balances surplus or deficit as a per cent of nominal GDP
[20] OECD, *Economic Outlook No. 81*, May 2007, Annex Table 33: General government net financial liabilities per cent of nominal GDP
[21] Tax Reform Commission, *Tax Matters: Reforming the Tax System*, October 2006, p.46
[22] OECD, *Economic Outlook No. 81*, May 2007, Annex Table 14: Standardised unemployment rates per cent of civilian labour force; P. Tansey, *Productivity: Ireland's Economic Imperative*, Microsoft, 2005, Table 6
[23] Tax Reform Commission, *Tax Matters: Reforming the Tax System*, October 2006, p.46
[24] Forfas, *Ahead of the Curve, Report of the Enterprise Strategy Group*, July 2004, Table 11

growth averaged 7.4 per cent annually, while net EU subsidies fell to an average of 2.1 per cent of GDP.[25]

This is not to argue that European subsidies played no role at all, but we must look to other causes for Ireland's astonishing economic performance. In the absence of sensible fiscal policy in Ireland in the 1980s, high levels of payments from Europe were not sufficient to avert economic crisis. When, in 1987, the Irish government managed to get a grip on the crisis, it was due to tough domestic spending choices, not European subsidies, which stayed at a similar level.

The current economic crisis

Like other countries, the Republic of Ireland is experiencing a severe recession, but this would be much worse – and the prospects for recovery much more limited – if it did not have a competitive economy with a strong export-oriented base of Foreign Direct Investment (FDI) and a particularly strong tradable services sector, to the creation of which low corporation tax made a crucial contribution.

Ireland's current economic difficulties are the result of other policy decisions and would arguably be even worse without a low rate of corporation tax. It is widely accepted that a major cause of the current financial crisis was low interest rates that played a critical part in leading markets to underprice risk.[26] Membership of the Euro meant Ireland had to share a common interest rate with other, more sluggish, economies. This could clearly have led to Ireland facing a lower interest rate than was appropriate, contributing to an underpricing of risk and the build up of an asset bubble.

Ireland's previous economic strength bodes well for recovery. GDP is now falling rapidly, but these falls will offset only a small part of the incredibly fast GDP growth of the past 15 years. Government debt is increasing rapidly, but from a very low base. An income tax surcharge has been introduced temporarily (and other taxes have been increased), but income tax rates were at reasonably competitive levels to begin with.

Importantly, the Irish government, which unveiled its Budget on the same day as the recent Pre-Budget Report in the UK, has grasped the nettle on deficit reduction (unlike in the UK), cutting spending by around 7 per cent while keeping further tax rises to a minimum. Finance Minister Brian Lenihan said in his Budget speech:

> *"Some have argued we should continue to borrow and wait for the economy to grow again before tackling the budget deficit.... In our everyday lives we do not borrow to pay for our household bills. We cut back and seek to live within our means. The same strictures apply at national level. Borrowing hundreds of millions a week to pay for day-to-day spending is just not on. Stabilising the deficit is the next key milestone in our plan to deliver economic recovery for this country.... Others have argued for increases in taxes as a means of stabilising the deficit.... But we have reached the limit. We will not create jobs by increasing the penalty on work and investment.... So if we cannot tax our way out of our difficulties and we all agree in this House that we cannot borrow our way to recovery then the only remaining option is to reduce our spending. No one wants to cut spending but the cost of providing public services has*

[25] EU payments to and contributions from Ireland data: European Commission, *EU Budget 2006 Financial Report*, Annex 4 http://ec.europa.eu/budget/library/publications/fin_reports/fin_report_06_en.pdf. GDP data: Eurostat and OECD.stat. NB: 1970-1978 in AU; 1979-1998 in ECU and since 1999 in EUR

[26] C. Goodhart, *Explaining the financial crisis*, Prospect, 31 January 2008

to be reduced to bring it in line with sustainable revenue levels and to help restore our international competitiveness." [27]

It is futile and counterproductive to try to conceal or downplay Ireland's current difficulties, but at the same time the country's achievements should also not be forgotten. Most importantly of all, Ireland would arguably be in a far worse position if it did not have such a competitive business tax regime, and the Irish government recognises that it would be folly to change it:

> *Our Corporation Tax rate of 12½ per cent has become an international 'brand', known the world over. It is a powerful expression of our pro-enterprise ethos and continues to attract new business and new jobs to this country. In a time of great uncertainty for international business, it is important that we send out a clear message. The 12½ per cent Corporation Tax rate will not change. It is here to stay."* [28]

[27] Financial Statement of the Minister for Finance, 9 December 2009 http://www.budget.gov.ie/Budgets/2010/FinancialStatement.aspx. The speech was also highlighted by the Reform think tank in a bulletin on 9 December 2009

[28] Financial Statement of the Minister for Finance, 9 December 2009 http://www.budget.gov.ie/Budgets/2010/FinancialStatement.aspx

3 Restoring the UK's tax competitiveness

Chapter 1 has set out the problems with UK corporation tax, and with the tax system generally. We need to find improvements that will make the tax system both more competitive and simpler. At the same time, we need to ensure that the improvements will be fiscally affordable, and that they can be implemented steadily. And we must avoid changes that would have serious adverse side-effects, whether only on implementation or in the long term. Changes can be disruptive, and they need to be justified by the benefits.

In this chapter, we set out a range of corporate tax measures that we recommend. We also discuss a range of policies that might be superficially attractive, but that would not really be desirable, either because they would not do much to address current difficulties, or because they would have undesirable side-effects. With a new Parliament and a government with a new mandate only a few months away, a wide range of options will be discussed. It is important to consider the disadvantages, as well as the advantages, of options.

There are many reforms to other parts of the tax system that an incoming government should also consider. But the key thing is to ensure that the UK is attractive to businesses. Only they can provide jobs, and incomes and profits which will allow taxes to be collected to pay for public services. That is why this paper concentrates on corporation tax.

3.1 The structure of corporation tax

Corporation tax works by computing an amount to tax – the tax base – and then applying a tax rate to that amount. This section concentrates on the overall structure of corporation tax. Section 3.2 covers more detailed aspects of the tax base.

There are several reasons why it is appropriate to consider changes to the current structure of corporation tax, as follows:

- The tax treatment of financing costs can have a significant effect on the international competitiveness of a country's tax system.
- The basic structure of the current system gives multinational groups the opportunity to divert taxable profits overseas. It is therefore necessary to add burdensome anti-avoidance provisions, in particular the rules on transfer pricing, on thin capitalisation (now dealt with through transfer pricing rules) and on controlled foreign companies.
- The current system has been subject to a number of legal challenges based on European law, and may face new challenges.

Our discussion of ways in which the corporation tax system could be improved starts with the tax rate. Although the rate is not a structural feature, both the rate in itself and its relationship to tax rates in other countries have significant implications for the system as a whole.

A reduced corporation tax rate

The headline rate is important to perceptions of a tax regime's competitiveness. Given the distribution of rates at the moment and the reductions in rates in several countries in recent years, as set out in chapter 1, a 15 per cent rate would be a very good target. A low rate would have a number of advantages, including the following:

- A low rate would enhance competitiveness, reducing the proportion of profits taken in tax and the proportion of total tax revenue which came from business profits. While all taxes are ultimately borne by individuals, the critical point for mobile businesses choosing countries in which to reside is the level of taxation of their profits. Considerations of fairness in the distribution of a given country's tax burden are irrelevant when a business is choosing between countries. Not only is a group which fails to seek out the best deal on tax failing in its duty to its shareholders. It also puts its competitiveness as against groups which do seek out the best deal at risk, thereby jeopardising jobs and its contributions to tax revenues in the countries where it does pay tax.

- A low rate would make the tax base less exposed to manipulation, because it would reduce the incentive to divert profits to other countries. There is no point in diverting profits to countries with higher tax rates, and it may not be cost-effective to divert them to countries with only moderately lower tax rates. Measures to prevent such diversion, such as the controlled foreign companies regime, could be less severe and would need to be applied less frequently.
- Some special reliefs would be less significant than with a high rate, allowing their restriction or elimination in order to create a simpler tax system which was even less open to manipulation, and in order to finance a still lower rate.
- A significant reduction in the rate would facilitate the making of other changes, because it would compensate businesses which would otherwise be adversely affected.

The taxation of providers of capital through corporation tax

Corporation tax is computed on profits after deducting the interest expense which is the return to the providers of loan capital. It is therefore effectively a tax on the return to the providers of share capital, although it can also be a tax on labour when a shareholder, often an owner-manager, supplies labour to a company and takes dividends, or an increase in the value of the shares, rather than taking a full reward for the labour in the form of a salary.

Ideally, the tax system should not bias companies between loan capital and share capital. It is worth focusing on the ways in which that bias could be avoided, because that allows us to consider a number of different possible changes to the corporation tax system in a structured way. But the avoidance of the bias is by no means the only objective we should have. Options that are listed here would have disadvantages as well as advantages. The options that we consider are a full imputation system, a tax only on distributions, a deduction for dividends and disallowing net interest payments.

A full imputation system

Full imputation would mean giving tax credits at the main corporation tax rate, so that with a tax rate of 28 per cent, a shareholder who received a net dividend of £72 would be treated as receiving income of £100, on which tax of £28 had already been paid. Dividends would effectively be treated as if they were paid out of pre-tax profits. This would match the treatment of interest, which does come out of pre-tax profits and is then fully taxable in the hands of the recipient.

There are however arguments against this approach. There would be significant difficulties in devising a system which complied with European law, while at the same time fully protecting UK tax revenues, following the Court of Justice of the European Communities (CJEC) decision in case 319-02 *Manninen*. It is also likely that in negotiating tax treaties, the UK would have to allow payment of at least some of the tax credit to foreign investors who would not pay UK tax on the income.

A tax only on distributions

A tax on distributions would mean applying a single rate of tax to dividends paid. Dividends would not be taxable income in the hands of the recipients. Interest, on the other hand, would continue to be taxable in the hands of non-corporate recipients but would not give rise to the new tax charge on the paying company, thus allowing parity of treatment for share and loan capital if suitable tax rates were chosen. (Interest would not be taxable in the hands of corporate recipients except to the extent that they converted it into dividends paid out, which would then not then be subject to further taxation. And the question of the deductibility of interest payments would not arise, because distributions rather than profits would form the basis for corporation tax.)

Taxing only distributions would favour re-investment, which would be a good thing if there was a tendency to under-invest in order to make distributions but a bad thing if the re-allocation of capital was deterred and capital was retained in less productive uses because of the tax penalty on distribution. It would also have the advantage that because the amounts of distributions are obvious, elaborate computations of taxable profits would not be necessary.

While this approach would have some advantages, it would unfortunately suffer from some serious disadvantages, as follows:

- It would be very hard to find a way to allow its application to large corporate shareholdings, given that the European Union's Parent-Subsidiary Directive prohibits cross-border withholding taxes where there is a corporate shareholding of 10 per cent or more (Directive 90/435 as amended). A withholding tax might be applied to dividends paid to non-European corporate investors with stakes of 10 per cent or more, but they could avoid the tax by inserting an intermediate holding company in another European Union member state with an appropriate tax regime, unless it was possible under European Union law to craft a provision which would mean that such conduits would be ignored even when they had some other activities in order to avoid being pure conduits.
- It would be hard to define distributions. Transfer pricing law would play a vital part in preventing the disguise of distributions as sales. Payments out of share premium accounts would be an issue for companies incorporated in countries where such payments were allowed.
- It would be necessary to decide whether there should be any deduction for capital put in, for example by deduction from taxable distributions until the capital put in was exhausted.
- Some companies would refrain from distributing profits, leaving the tax charge on the capital gains made by shareholders as the only charge. This charge might not be effective. There would be no charge on some corporate shareholders or on any non-resident shareholders unless the law was changed, and even then there would be no way of making a charge effective if a sale was from one non-resident to another non-resident.
- Even if there were an effective charge on gains made by shareholders, there would be avoidance opportunities to address, such as putting debt into a company before its sale for a reduced price.
- Overall, the proposal would give so many opportunities to defer the payment of tax, and would so reduce total tax revenues, that it would not be practical to introduce except when tax revenues significantly exceeded what was needed to finance government spending.
- There would be a transitional issue as to whether profit taxed as such before the change should be taxed on distribution after the change.

A deduction for dividends

Schemes to give a deduction for the cost of corporate equity have been proposed in the past, and there are economic arguments for them. Unfortunately, they would vastly reduce the tax base, requiring a large increase in the tax rate. Given that corporate tax rates are falling in many competitor economies, this would hardly be a sensible move.

Disallowing net interest payments

It would be possible to disallow the deduction of interest paid to the extent that it exceeded interest received. That is, there would be no deduction for loan relationship debits in excess of credits. Trading and non-trading debits would be merged into a single category. Net interest received would remain taxable.

Such a move would be radical, but it is worth considering because it would have the following advantages:

- It would fund a reduction in the corporation tax rate. The reduction is hard to calculate, but it would probably be about 4 per cent. If interest were to be disallowed, the broadening of the tax base should immediately be matched by a proportionate reduction in the rate. The smallness of the estimated rate reduction reflects the fact that a lot of interest paid is between group members, and a high proportion of that is between UK group members. Intra-UK-group interest would disappear as soon as a disallowance was introduced, and a large proportion of interest that was paid to non-UK group members would probably disappear, with equity replacing loan capital. Thus the broadening of the tax base would by no means equal the total interest that is currently paid by companies. (To the extent that there was a supplement to group relief to allow the matching of payments and receipts within the same group, as discussed below, there would be no need to eliminate interest, but equally there would be no broadening of the tax base.)
- It would put debt capital and equity capital on the same footing, with no deduction for the cost of either. This would remove the bias in the tax system towards higher gearing.
- It would allow the repeal of a great deal of anti-avoidance legislation, much of which relates to interest.
- It would save the UK Exchequer from subsidising foreign Exchequers. At the moment, the UK's generous rules on the deduction of interest mean that a disproportionate amount of debt of multinational groups is located in the UK. Deductions are therefore from UK profits, when some of them should be from profits made in other countries.

On the other hand, the disallowance of net interest payments would have the following disadvantages:

- It would remove what is perceived as a large competitive advantage of the UK, the absence of restrictions on the deductibility of interest. (The worldwide debt cap which takes effect at the start of 2010 will impose a restriction, but not a severe one.)
- It would affect the distribution of the tax burden between highly-geared and lowly-geared businesses, leading to some disruption and frictional costs. Re-structurings of groups would be required.
- Non-UK groups investing in the UK would be placed at a disadvantage compared to the current position. There would also be a risk of interest being disallowed in the UK but taxed abroad.

- This disruption would extend to the customers of businesses. If for example a property company was financed largely by borrowing, it would have to increase rents charged to its tenants. To the extent that the property sector was more highly geared than the economy as a whole, there would be an overall redistribution of the tax burden towards property-intensive businesses such as retailers. This would not however apply where properties were owned by pension funds, which would notice no difference because they are not generally taxed in any case.
- Debt-financed companies in distress would have to pay tax on their pre-interest profits, as well as having to pay interest on their debt capital.

Conclusion

Given the substantial disadvantages of these proposals, to set alongside their advantages, we cannot advocate them. But simply reducing the rate of corporation tax will itself reduce the disparity between the treatments of share capital and of loan capital. With a lower rate, the difference between the deductibility of interest and the non-deductibility of dividends will become less significant. This is something which we therefore strongly advocate, for this reason as well as for the other reasons set out above.

3.2 The corporation tax base

Corporation tax works by computing an amount to tax – the tax base – and then applying a tax rate to that amount. In this section, we discuss the computation of the tax base.

Principles of a good tax base

A good tax base is one that is:

- well-correlated with ability to pay, so that it does not impose unacceptable cash-flow burdens on businesses;
- not economically distortionary more than is inevitable with taxation;
- not prone to manipulation by tax planning;
- easy to understand, so that it does not cloud the taking of commercial decisions;
- easy to compute, so far as possible using information that a company would gather anyway for commercial purposes rather than requiring extra information to be collected.

Not all of these objectives can be achieved at once. For example, features of a tax system which allow for losses or for the fact that a group's overall results may not be simply the sum of the profits of the members of the group, in the interests of avoiding distortion, lead to complexity and create opportunities for manipulation. There is unlikely to be any perfect tax base. It is, however, still worth asking how far the current tax base meets the above criteria, and whether it would be worth changing the tax base.

The case for and the case against change

The current tax base is reasonably well-correlated with ability to pay. The starting-point is accounting profit, and that is then adjusted. Allowances for capital expenditure are on average more generous than depreciation, although not as generous as they have been in the past. Losses can mostly be set against current and future profits of the same type. The most significant types of loss can also be set against current profits of any type, either within the same company or elsewhere in the group. Unrealised profits on capital assets are generally not taxed. Occasionally a company may find that its corporation tax bill is disproportionate in relation to the profits which it has managed to turn into cash, but that does not happen often.

Economic distortions do exist in the current tax base. There are some areas, for example expenditure on capital items, where there is distortion but the distortions can be in either direction. Some capital items, such as buildings, attract no allowances apart from the deduction of the cost from any sale proceeds in computing a capital gain, and tax relief for the interest on money borrowed to fund the purchase. Others, such as plant and machinery, attract allowances which are in general, but not always, more generous than depreciation.

The current tax base is certainly prone to manipulation by tax planning. We can see this from the very large amount of anti-avoidance legislation that has been put in place, and from the need that the Government has felt to create a system that requires the reporting of tax avoidance schemes. Such reports can lead to further legislation. The result is ever-increasing complexity, which can affect not just those contemplating tax avoidance, but other taxpayers who simply want to compute their profits correctly.

Turning to ease of comprehension and of computation, the current tax system is notorious for its complexity. The computation of taxable profits is a significant source of that complexity. The corporation tax return form is eight pages long, and there are several supplementary pages for special situations, although there is a four-page version of the form for companies which have straightforward tax affairs and which do not have any one of a whole range of types of income, nor claim any one of a whole range of reliefs. The guide to the return form has 22 pages of detail to read. A study in 2005 found that the total administrative cost imposed by the need to make corporation tax returns, including the cost of supplementary returns and of checks, was £608 million, of which £358 million fell on businesses with fewer than 50 employees.[29]

Thus to the extent that there is a case for change, it is primarily a case based on complexity. A different tax base might be simpler to use and less likely to cloud commercial decisions. It might also be more likely than the current tax base to be stable, if it was less prone to manipulation and did not therefore need to be patched up repeatedly with anti-avoidance legislation.

While the current system may not be perfect, it is one to which companies have adapted. There is therefore a case against any changes which would require significant changes to the ways in which information was gathered, and particularly against changes which would require new information to be gathered. Merely withdrawing a specific relief should occasion little disruption, but changing its terms, or introducing a new one, could be much more disruptive. Even the mere withdrawal of a more general relief, such as a loss relief, could be disruptive if it required the re-arrangement of a group’s affairs in order to maintain tax liabilities at current levels. The case for any change that might be disruptive therefore needs to be strong before one can be sure that it would be worthwhile.

Adjustments to accounting profit

The current starting point for computing the tax base is the profit shown in the accounts. Several adjustments are then made, some significant (such as the replacement of depreciation by capital allowances) and some less so (such as the disallowance of expenditure on business entertaining, and the deferral of deductions for remuneration which is not paid within nine months after the accounting date).

[29] *Administrative Burdens – HMRC Measurement Project*, KPMG, 2006, volume 2, part 7, pages 12-15

One possible change would be to sweep away all of these adjustments, and simply to say that the accounting profit was the tax base. The corporation tax rate would be changed in proportion so as to avoid an increase in the total burden of corporation tax.

This would have the merit of simplicity, but a number of issues would arise. Some of these were raised in responses to the Government's consultation on corporation tax reform, launched in August 2002, which contemplated change along these lines. The issues to address would include the following:

- Accounting standards are no longer as focused on the computation of profit as they once were. Instead, they tend to concentrate on the movement in the overall value of a company. This might lead to tax liabilities ceasing to be satisfactorily correlated with ability to pay. One source of this risk would be the inclusion of unrealised profits in profits as measured by accounting standards. International Accounting Standard 40 (IAS 40), for example, allows the valuation of investment properties at fair value, leading to the inclusion of unrealised profits in the profit and loss account. IAS 39 requires the valuation of some financial assets at fair value. Another issue would be whether to tax the result shown in the comprehensive income statement or that shown in some more narrowly defined profit and loss account.

- It would be possible for a company significantly to affect its taxable profit by changing its accounting policies, for example by changing its depreciation rates. Some such changes would only result in timing differences, but it can be worth a company's while to create such differences in order to defer the payment of tax. This is an issue of fairness, but probably not a very serious one. Variations in depreciation rates and in other accounting policies would be limited by the requirement for accounts to give a true and fair view, and all companies would be able to take advantage of the scope for variation.

- Losses are not carried forward and set against future profits in accounts, but are debited to reserves. Some form of loss relief would therefore need to be added. Furthermore, either losses of specific types brought forward from before the change would need to be restricted to use against the corresponding types of profit after the change (necessitating the identification of those types of profit, an exercise which would not be required for accounting purposes) or some other measure to control the cost of allowing a free set-off of losses brought forward would be needed.

- Individual companies are currently taxed, but the accounts for individual members of a group are less meaningful than the accounts for the group as a whole. On the other hand, if one were to move to taxing the profit shown in the consolidated accounts, it would be difficult to separate out the non-UK element. There would also be the question of whether to deduct any minority interest in the results of subsidiaries.

The conclusion must be that there are arguments in favour of taxing accounting profits, but that the difficulties would be considerable. We cannot therefore propose a move to the taxation of accounting profits as one which should definitely be made. It is however worth considering changes to the tax base which would have comparable effects, with a view to getting to a point where a large proportion of companies could simply pay tax on their accounting profits. We now consider some such changes.

Adjustments to accounting profit – capital allowances

One option would be to replace capital allowances with accounts depreciation. This option was considered and in the end rejected in the Government consultation on corporation tax reform that ran from 2002 to 2005, but the rates of capital allowance have since changed, and this does make it worth re-considering the question.

The main advantages of such a change would be as follows:

- There would be no need to identify capital expenditure just for tax purposes and categorise it correctly.
- Depreciation would be available on all capital assets which were depreciated in the accounts. Capital allowances are only available on certain types of asset, and not, for example, on buildings.
- Special legislation for leased assets would not be necessary, because accounting and tax profits of lessors and of finance lessees would not get out of line.
- There would be no scope within a pure depreciation system for governments to give special incentives for particular types of expenditure or to particular types of business. Some would see this as a disadvantage. We do not however believe that it is appropriate for governments to micro-manage the economy, and we would be happy to see obstacles placed in the way of such interference.

The main disadvantages would be as follows:

- It would be possible to manipulate taxable profits by choosing high depreciation rates, subject to the requirement to produce accounts which showed a true and fair view. This would generate timing differences, which would amount to the permanent deferral of tax if investment in capital assets grew steadily. This opportunity would however be open to all businesses, so it would not necessarily create unfairness as between different businesses.
- It would not be possible to disclaim depreciation in return for higher deductions in future years, whereas capital allowances can be disclaimed. This is significant because losses can only be passed across to other group members in the year in which they arise: thereafter, they are trapped within the loss-making company and can only be used against its own future profits. A group will therefore often disclaim capital allowances to avoid generating losses which would only get trapped within individual companies. It might appear easiest to deal with this problem by allowing group relief for losses generated in earlier years, but that would necessitate the introduction of elaborate rules to protect against avoidance, comparable to the rules on pre-entry capital losses.
- The change would have redistributive effects. The current system favours businesses which need to invest in plant and machinery over those which need to invest in buildings, and also includes special benefits for the first £50,000 a year of investment and for particular types of asset. A change to a depreciation system would benefit some types of business and reduce allowances for others. This is the reason why recent changes to rates of capital allowance are significant. The reduction in the main rate on plant and machinery from 25 per cent to 20 per cent a year, on a reducing balance basis, reduces the difference between this rate and typical depreciation rates. On the other hand, the increase in the long-life assets rate from 6 per cent to 10 per cent increases the difference, albeit on a smaller total quantity of assets than are affected by the main rate. The elimination of allowances on buildings probably increases the gap for industrial and agricultural buildings, but leaves it unchanged for other commercial buildings. There should however be no overall effect on the corporation tax burden, because the tax rate should be adjusted inversely to the change in the overall tax base.
- There would be a particularly significant redistribution of tax to the utilities, because they have substantial capital assets which they maintain and do not depreciate. They do get a tax deduction for their maintenance work, but the effect would be that unlike now, they would never get a deduction for the initial cost of their investments. Some special transitional arrangement might be necessary, if accounting standards prevented them from depreciating their assets. They would not necessarily suffer in themselves, given that we envisage a significant reduction in the rate of corporation tax, but they might still suffer relative to other businesses.

- There would be transitional effects. The gaps between the accounting and tax written-down values of assets would need to be closed. This would involve some temporary complexity, and might lead to unacceptable tax charges in the short term.
- Another transitional effect would be on reported profits, as deferred tax balances were written back. That would be a matter for financial reporting standards authorities. It would be important to have complete clarity about how any legislative changes affected results, and to allow groups to write back balances over appropriate periods of time, so that investors did not mistakenly think that fluctuations in reported results reflected any fluctuations in the nature or profitability of business activities.

On balance, a change from capital allowances to accounts depreciation is worth consideration, although we do not firmly recommend it. It would bring the taxable profits of many companies very close to their accounting profits. There would still be differences so long as odd quirks in the tax system, such as the disallowance of business entertaining, persisted, but the scope for error by missing out on required adjustments would be greatly reduced.

Gains on the sale of shareholdings

There is currently a substantial shareholdings exemption. This exempts capital gains, and disallows capital losses, on shareholdings of at least 10 per cent in trading companies which are sold by trading groups. It makes the transfer of businesses relatively easy, but its restrictive conditions make it easy for groups to make gains exempt while making losses allowable. Furthermore, the restriction to sales by trading groups causes difficulties in practice, with large and complex multinational groups being unable to tell whether they qualify.

There is therefore reason to extend the exemption, to the point where all gains and losses that companies make on shares are ignored. This would have the following advantages:

- Losses could no longer be multiplied by using several layers of shares.
- At present the exemption for gains on substantial shareholdings is restricted to companies that have been trading within the previous three years. This gives great scope for avoidance by delaying the liquidation of loss-making subsidiaries until the exemption no longer applies.
- The disposal of businesses would become even simpler, encouraging the transfer of businesses to groups with the greatest opportunities for synergy.

On the other hand, the exemption would have a disadvantage. It would become too easy to sell other assets in corporate envelopes and avoid paying tax on the gains on those assets. An anti-avoidance measure would therefore be needed. One possible anti-avoidance measure would be to distinguish between the assets of a business and other assets which had simply been placed in a corporate envelope, either on their own or alongside a business. The obvious test would be to tax gains on the underlying assets when, and only when, they had been put into a corporate envelope with a view to their sale. If assets were transferred into companies within, say, two years before the sale of the company, there would be a rebuttable presumption that this had been done with a view to their sale. Such assets could be treated as sold by the group, disregarding any corporate envelope, with the gain being computed by reference to their base cost to the group.

Given that some such protection for the Exchequer could be put in place, and given that other tax avoidance opportunities would be eliminated, we recommend extending the substantial shareholdings exemption so that all gains and losses that companies make on shares are ignored for tax purposes.

Loss reliefs

The current general pattern of loss reliefs is to allow set-off against all types of profit, including profits of other group companies, in the year of loss, some carry-backs by one year, and much more restricted set-off, often against profits of the same class and always only within the company which made the loss, in later years. By far the most significant losses by value are trading losses, to which these rules apply, with carry-back against all profits but carry-forward only against profits of the same trade, and non-trading loan relationship deficits, to which these rules also apply, with carry-back only against non-trading loan relationship income and carry-forward only against non-trading profits. There is also a temporary limited extension of loss carry-back, announced in November 2008. It is worth considering whether the rules should be changed.

A good system of loss relief should satisfy the following criteria:

- It should give enough relief to avoid imposing very high effective tax rates on cyclical businesses.
- It should not be so generous as to allow the taxation of too small a proportion of profits made, because that would either greatly reduce revenue from corporation tax or require the imposition of high tax rates.
- It should not be open to extensive manipulation, in particular to the manufacture of losses which had not really been suffered at all, or (more arguably) which had not really been suffered by the person benefiting from relief.
- It should only allow relief for each pound of loss once.
- It should not be so restrictive as to deny effective relief for losses.
- It should give effective terminal loss relief for businesses which are closed or which collapse. The repayment of past taxes can be a significant source of funds for creditors.

The first criterion makes a case for preservation of the entitlement to carry losses back 12 months, and perhaps for carry-back relief to be extended to all losses. Such relief should however continue to be restricted to relief against profits within the same company, not because there is not a reasonable economic case for allowing relief elsewhere in the group, but because to do so would require rules to prevent the buying in of profit streams or the selling of potentially loss-making companies in anticipation of losses, comparable to the rules for pre-entry capital losses.

The second and third criteria make a case for preventing loss-buying. The obvious effect of allowing loss-buying would be to reduce the national tax base down towards the total of profits minus the total of losses, which might in itself be a reasonable thing to do. It would mean that effective relief would be immediately obtained for all losses which were significant enough to make it worth selling companies in order to have them relieved.

The consequences of not preventing loss-buying would however be more far-reaching than that potentially desirable result, because it would become much more worthwhile than currently to dress up non-commercial hobbies as businesses in order to seek relief. There are rules in place to prevent that being done in order to shelter personal income and the profits of family businesses from tax, where no sale of an activity is needed in order to allow loss relief. The rules work by blocking relief for losses in activities not run on a commercial basis. Those rules would in theory be effective if losses on activities were sold, but any new opportunity to sell losses would greatly increase the pressure to do so and the existing rules might become ineffective. The current rules, primarily in Taxes Act 1988, sections 768 to 768E, would therefore need to be tightened up considerably.

The fourth criterion would make a case for a general anti-avoidance rule, to the effect that only the real economic loss suffered by what was effectively a single economic entity (for example a group, or a company plus its owner) should be eligible for relief. Such a rule would however have to be carefully drafted so that most businesses, most of the time, could have confidence that it would not apply to them. Otherwise, the administrative burden would be intolerable.

The fifth criterion would make a case for a system which included reasonably generous reliefs, but reliefs which were not so generous that they needed to be subject to severe restrictions in order to preserve the tax base. We propose the following:

- Abolition of the current division into different types of income, so that there is no need for types of profit and loss to be identified.
- Relief by carry-back for one year, within the year and by carry-forward of all losses against all profits.
- Group relief as now: in-year only but against all profits.
- The preservation of terminal loss relief for trading losses made in the last year of trade, by carry-back against total profits of the preceding three years.

This package would require a number of other changes, as follows:

- Losses brought forward up to the date of change would need to continue to be restricted in use for several years, in order to control the cost of switching to the new system. It is quite likely that capital losses brought forward up to the date of change would have to be restricted to use against capital gains permanently, because the amounts involved would be very large.
- It would be essential to prevent the continued artificial creation of capital losses, given that they would be usable against all kinds of profit. Excluding gains and losses on shares from tax computations should go a long way towards achieving this.
- The rules against loss-buying and restricting the use of pre-entry capital losses would need to be tightened up, because the increased value of losses would bring them under increased pressure.
- Allowing loss relief against all profits is sensible so long as all of a company's activities can be regarded as commercial. There would be a risk that privately owned companies would be used by their owners as a place to locate expensive hobbies, which would then generate "losses" to be set against profits. It would be essential to have rules to ensure that any such loss relief was denied.

4 Costings and implementation

Any proposal must be costed to establish its affordability. In this chapter, we show that the total fall in annual revenues from the full implementation of our proposals for corporation tax would at most be £22.4 billion, and that it could well be as low as £12.4 billion. The maximum cost represents only 3 per cent of total government spending. While the deficit remains high, even this level of tax reduction would be hard to afford. But we propose implementing the plan, and in particular the rate reductions which contribute the bulk of the cost, over a ten-year period. That should allow control of the growth in public spending to make these tax reductions, as well as reductions elsewhere in the tax system, easily affordable.

There is a specific reason to implement the plan over a period of ten years. This is the life of two full Parliaments. It should be politically feasible to stick to a single programme of reform over that period. It would not of course be possible for any Parliament to bind its successor beyond a general election. But a clear commitment by the Government of the day, and preferably by opposition parties too, to implement a programme of reform would do much to restore confidence in the future competitiveness of the UK's tax system. And it is essential to have a plan which includes action, and not merely the promise of action, from the start. Only action, and action which the business community perceives as likely to continue throughout the execution of the programme of reform, will inspire business confidence and attract business to the UK.

References to tables in the form "T1.2, May 2009" are to tables that are published by HM Revenue & Customs and to the date of the edition used. These tables are available at http://www.hmrc.gov.uk/thelibrary/national-statistics.htm.

Reduce the main and small companies corporation tax rates to 15 per cent

The main rate is currently 28 per cent. The small companies rate is 21 per cent, but this is projected to rise to 22 per cent from 1 April 2011, a rise that is factored into Government projections, so we have taken 22 per cent as the starting point. The cost is hard to specify precisely, because the revenue from corporation tax fluctuates considerably depending on the state of the economy. But a reasonable figure for annual revenue is £45bn (T1.2, May 2009). This gives an upper bound on the Exchequer cost of £45bn x (28 – 15)/28 = £21bn.

The actual cost would not be as high as this, because reductions in the main rate from 28 per cent to 22 per cent would have no effect on the revenue from charging the small companies rate, and would also reduce the marginal relief that was given when profits were between £300,000 and £1.5m. The data that would be needed to make a full calculation are not published, but some idea of the size of the effect can be gleaned from the fact that the existence of the small companies rate and the marginal relief reduces corporation tax revenue by about £4bn a year (T11.2, May 2009). On this basis, £21bn could not be an over-estimate by more than £4bn. It is reasonably cautious to take £20bn as our cost.

Allowing for dynamic effects

Plenty of economic studies have shown that reduced tax rates are good for economic growth. It is therefore reasonable to suppose that a programme of tax reductions will itself increase yields from some taxes, helping to finance the programme.

It is perfectly possible for half of the effect on revenue of a reduction in the rate of corporation tax to be recouped in tax revenue increases. On this basis, the long-term annual cost of reducing the rate would not be £20bn, but £10bn.

Timescale

We propose reducing the main and small companies corporation tax rates by 1 per cent a year for seven years, then the main rate by 2 per cent a year for three years. This would meet the urgent need to restore the UK's competitiveness by working towards a corporation tax rate of 15 per cent. Reductions in the first seven years would bring the small companies rate down to 15 per cent and the main rate down to 21 per cent. Then reductions in the following three years would bring the main rate down to 15 per cent.

The total cost would be spread over the period. Since the vast majority of the revenue from corporation tax is paid at the main rate, we can spread this across the 13 per cent reduction in the main rate, giving £1.54bn per percentage point. This would be the cost for each of the first seven years, with £3.07bn in each of years 8 to 10.

Do not tax gains or allow losses on shares held by companies

The cost is difficult to estimate because figures for companies' capital gains are not published. Only figures for "trading income" and for "other income and gains" are given (in T11.2 and T11.5). But capital gains have long been known to form only a small proportion of taxable profits, largely because of the ready availability of capital losses to set against the gains. And the substantial shareholdings exemption, which already exempts gains on majority shareholdings in trading companies that are held by trading groups, reduces tax revenue by only £260m a year (T1.5, April 2009). Given that most commercial businesses will not have any reason to hold shares other than shares in subsidiaries or in companies that carry on joint ventures, it would not be plausible to think of the total revenue at stake as being more than £2bn. It may well be considerably less.

This proposal could not be introduced at the start of a programme of reform unless tax revenues were already strong and the fiscal position stable. But it could be introduced after the first three years or so, once the economy, and therefore tax revenues, had started to benefit from the effects of reductions in the corporation tax rate and from the confidence which the promise of future rate reductions would engender.

Changes to companies' loss reliefs

Any change to the rules on relief for losses has three effects, two transitional and one permanent. The first transitional effect arises from the fact that losses brought forward from before the time of the change become either easier or harder to relieve quickly. The second transitional effect arises from the fact that new losses carried forward may on average be relieved faster or more slowly than before the change. This shows up in a change in the stock of losses. Thus if losses used to take four years on average to relieve but following a change take three years, the stock of losses carried forward must as part of the transition diminish by one year's worth of losses carried forward. The permanent effect arises from the fact that some losses never get relieved. If it becomes easier or harder to obtain relief for losses, the amounts that go permanently unrelieved will decrease or increase, and that will decrease or increase tax revenue.

Not only would the transitional effects be one-off. They could be spread quite thinly if required, for example by imposing restrictions on the use of losses in the early years. We therefore concentrate here on the permanent cost.

By far the most significant losses are trading losses and non-trading loan relationship deficits. The changes that are proposed in this paper would give rise to three significant effects on tax revenue, as follows:

- Non-trading loan relationship deficits could be carried back against the previous year's profits of all types, instead of only against non-trading loan relationship income.
- Non-trading loan relationship deficits could be carried forward against future years' profits of all types, instead of only against non-trading profits.
- Trading losses could be carried forward against profits of all types in future years, instead of only against profits from the same trade.

The effects of these changes need to be priced on the basis of a corporation tax rate of 15 per cent, given that the cost of reducing the rate to that level, on the basis of the current tax base, has already been taken into account above.

Data to allow a proper estimate of the permanent cost are not available. But T11.2, May 2009, indicates that if we leave to one side North Sea oil businesses and life assurance businesses (for which figures are not given), the total loss relief obtained each year is approximately £20bn. This suggests that losses of approximately the same amount are generated in any one year. We then need to estimate the proportion of losses generated that go permanently unrelieved. Data are not available, because loss relief claims are not made for such losses, but anecdotally, the proportion would appear to be under 10 per cent. Some of these would not come to be relieved under the proposals set out here, but others would come to be relieved. We can guess that half of the unrelieved losses might come to be relieved. That would give a total annual tax cost of £20bn x 10 per cent x 0.5 x 15 per cent = £75m.

As the published statistics do not allow us to cost the effects on North Sea oil businesses and on life assurance businesses, and as these types of business already have special regimes which segregate different items in ways that do not apply across the corporation tax system, we do not propose extending this reform to those types of business. It may be that this reform, or some similar reform, should be made for North Sea oil businesses or for life assurance, but that would be for further consideration at the time.

Timescale

The changes should be affordable after six years had elapsed, once the rate of corporation tax was low enough to make the impact on revenue reasonably low. The costing of £75m a year is based on a corporation tax rate of 15 per cent. There would also be transitional costs, which could, as explained, be spread thinly. After six years had elapsed, the corporation tax rate would be 21 per cent, giving a permanent cost of £75m x 21/15 = £105m a year at first, diminishing over the following three years to £75m as the corporation tax rate fell. There would also be the transitional cost, which could be limited to £295m a year to give a total cost of £400m a year. As the permanent cost fell, restrictions could be relaxed so that the transitional cost rose, keeping the total cost at £400m a year until the transitional period ended.

The overall cost

If we add the above costings, we get to a total long-term cost of £22.4 billion ignoring dynamic effects, and a total of £12.4 billion allowing for dynamic effects. Either figure would be a very small price to pay for restoring the UK's tax competitiveness, a move that would bring jobs and capital to the country. Ultimately the public finances would benefit, as well as the private sector.