

9. Company taxation

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Summary

- Corporate tax rates have fallen in many developed countries since the current UK corporation tax rate of 30% was introduced in 1999. This trend may make it difficult for the UK to sustain a 30% tax rate and remain an attractive location for investment. Decisions of the European Court of Justice may also threaten the government's medium-term projections for corporation tax revenues.
- 2005 saw two separate increases in the taxation of North Sea oil and gas producers. We explain why it is fear of further tax rises, rather than the level of the tax rate itself, that is likely to have a detrimental impact on investment.
- The 2005 Pre-Budget Report announced the final demise of the zero starting rate of corporation tax, introduced in 2002. We review the brief history of this curious initiative, and suggest there are important lessons to be drawn.

9.1 Introduction

Two major current issues in company taxation are the implications of international developments for UK corporation tax, and the government's agenda to reduce tax avoidance by companies. The former is discussed in Section 9.2, while the latter is discussed separately in Chapter 10. This chapter also looks at recent developments in North Sea oil taxation (Section 9.3) and the taxation of micro businesses (Section 9.4).

9.2 International pressures and the European Court of Justice

Recent years have seen the continuation of a general downward trend in corporate income tax rates in developed countries, which started with the UK cut from 52% to 35% over the period 1984 to 1986, and the 1986 US tax reform. In Europe, an important development has been the accession into the European Union of a number of central and eastern European countries with relatively low corporate tax rates, such as Estonia, Hungary, Latvia, Lithuania, Poland and Slovakia. This has been followed by actual or proposed cuts in corporate tax rates in, for example, Austria, Finland, Germany, Greece and the Netherlands.

In his initial years as Chancellor of the Exchequer, Gordon Brown appeared to be following this international trend. The UK corporation tax rate was reduced from 33% to 31% in 1997, and again to 30% in 1999. However, the UK tax rate has been static since then, while a number of other countries have lowered their corporate tax rates. As a result, as shown in Table 9.1, the UK rate of 30% no longer appears as low now as it did in 1999. Among the EU

member states, Austria, Denmark, Finland, Ireland, Portugal and Sweden now have lower corporate tax rates than the UK, as do nine of the 10 recent accession countries.¹ If the downward trend elsewhere continues, there must be some doubt as to whether the UK will be able to sustain a corporation tax rate of 30% and remain an attractive investment location for international companies. It is worth noting that a more aggressive stance on tax avoidance by the UK government does not enhance the attraction of the UK for multinational investors. Chapter 10 provides a more detailed look at the issue of (corporate) tax avoidance and the government's current strategy to combat it.

Table 9.1. Statutory corporate income tax rates, including local taxes

	UK Tax rate	G7		EU15		EU25	
		Average rate	UK rank	Average rate	UK rank	Average rate	UK rank
1996	33	43.5	1	38.1	3	-	-
1999	30	39.8	1	35.9	4	-	-
2005	30	36.3	1	30.1	7	26.3	16

Notes: All averages are unweighted means. Typical local taxes and surtaxes are included. A rank of 1 indicates the lowest corporate tax rate in the group of countries considered.

Sources: G7 countries – IFS Corporate Tax Database. EU countries – Eurostat, *Structures of the Taxation Systems in the European Union, 1995-2004*, and Eurostat News Release, 134/2005.

The European Court of Justice (ECJ) has also become a more significant influence on the structure of company taxation within the EU. Provisions of EU Treaties covering non-discrimination, the freedom of movement of capital and the freedom of establishment have been used by companies to challenge the legality of various features of national tax systems.

Recent changes to UK transfer pricing legislation and planned changes to the taxation of finance leases have clearly been driven by the need to comply with EU law.² Last year, Marks and Spencer was successful in a case brought against the UK government involving tax relief against UK corporation tax for losses that had been made by some of its European subsidiaries. The ECJ ruling greatly limited the circumstances in which losses made by an overseas subsidiary can be set against profits made by the parent company, so that the revenue implications of this decision for the UK exchequer are not serious. Nevertheless, another long-standing principle of the UK corporation tax has been overturned by a decision of the ECJ.

Looking forward, two current challenges to aspects of UK corporation tax could have significant implications if they are upheld by the ECJ. Both concern the taxation of overseas subsidiaries of UK companies.

Where overseas subsidiaries are located in low-tax jurisdictions, so-called Controlled Foreign Company (CFC) rules allow the UK government to tax the profits of these overseas subsidiaries directly. Cadbury Schweppes is challenging the legality of these rules as they have been applied to two subsidiaries located in Dublin and taxed under the Irish International Financial Services Centre regime. If this challenge is successful, the application of CFC rules

¹ The exception is Malta.

² These developments were discussed in section 8.2 of R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds), *The IFS Green Budget: January 2005*, IFS Commentary no. 98, <http://www.ifs.org.uk/budgets/gb2005/index.php>.

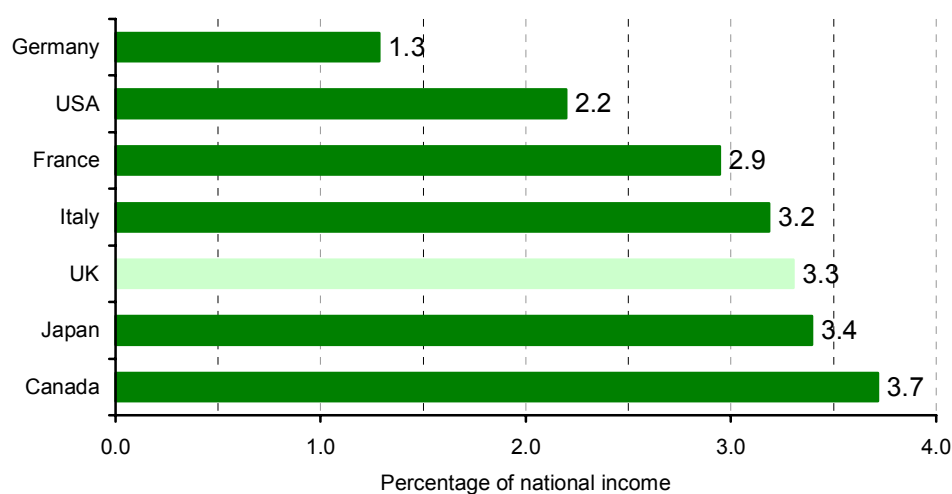
within the EU would be brought into question. CFC rules are mainly required to limit the extent to which international companies have an incentive to shift profits for tax purposes into tax havens outside the EU. Nevertheless, restrictions on their application within the EU could still have serious implications for UK corporation tax revenues, potentially making it easier for UK companies to route profits through other EU countries that have less effective CFC legislation against non-EU tax havens than that which applies in the UK.

The second case concerns dividends paid from a subsidiary to a parent company. Corporation tax is not charged on dividends received by a UK parent from a UK subsidiary. But dividends received by a UK parent from overseas subsidiaries are not exempt from UK corporation tax. The UK operates a credit system, under which dividend income from overseas subsidiaries is subject to UK corporation tax, with a credit given for corporate income tax paid by the foreign subsidiary on the underlying profits that were earned and taxed abroad. In practice, this means that there may be a UK corporation tax charge when dividend income is received from subsidiaries located in countries with a lower corporate tax rate than the UK. This difference in the treatment of dividends received from UK and overseas subsidiaries is also subject to a challenge at the ECJ. If this is upheld, the UK could either switch to an exemption system under which dividend income from overseas subsidiaries would also be exempt from UK corporation tax, or apply the credit system also to dividends received from domestic subsidiaries. The former would imply giving up any tax revenue that is currently collected from dividend income received by UK companies from their foreign subsidiaries. The latter option would raise administrative and compliance burdens for companies with a group structure within the UK, but would protect this source of revenue. In effect, this was the approach taken by the UK government in the case of transfer pricing, where rules initially designed to apply to transactions between parents and subsidiaries in different jurisdictions were extended to apply also to transactions between affiliated UK firms.

In the longer term, another factor influencing the development of UK corporation tax may be the proposal from the European Commission for a common consolidated corporate tax base within a participating bloc of countries.³ Under this proposal, a company's taxable profits would be calculated for the bloc as a whole, rather than separately for each individual country as happens under national corporate tax systems at present. This tax base would then be allocated to the individual countries according to a form of formula apportionment, and individual countries would then be free to apply their own corporate tax rate to their allocation of this tax base. At least initially, the UK would not be likely to participate in such a development. Moreover, the likelihood of this proposal being implemented is open to question. Previous Commission proposals for major reforms of corporate taxation within the EU have enjoyed limited success. In this case, there are formidable technical and political hurdles to be overcome in order to get agreement both on the definition of the common consolidated tax base and on its allocation between participating countries. If a significant group of countries were eventually to adopt a common corporate tax base, however, this could also reduce the attraction of the UK as a location for multinational firms wishing to operate within the EU. Costs of complying with multiple tax systems would then be reduced for firms that located or expanded within the participating bloc.

³ European Commission, *Towards an Internal Market without Tax Obstacles*, COM(2001) 582 final, Brussels, 2001.

Figure 9.1. Corporate tax revenues as a share of national income for the G7 countries, 1999–2003 average



Note: For the UK, these OECD figures include corporation tax revenue from the North Sea sector.

Source: OECD, *Revenue Statistics*,

<http://caliban.sourceoecd.org/vl=3834695/cl=51/nw=1/rpsv/ij/oeecdstats/16081099/v55n1/s25/p1>.

These international developments all raise questions about the sustainability of the government's current level of revenue from corporation tax. In 2004–05, UK revenue from corporation tax (excluding the North Sea oil sector) was around 2.6% of national income. This figure is already quite high among developed countries.⁴ Figure 9.1 shows OECD figures for all corporation tax receipts as a share of national income for the G7 countries in the period 1999 to 2003.⁵ The government's medium-term projection for non-North-Sea corporation tax revenue nevertheless sees it increasing to 3.3% of national income.⁶ However, this medium-term projection was reduced from 3.5% at the time of the March 2005 Budget⁷ to 3.3% in the December 2005 Pre-Budget Report. Even this level may prove difficult to sustain or may risk having a detrimental impact on investment in the UK.

9.3 North Sea taxation

There have been major changes to the taxation of profits earned by North Sea oil and gas producers in recent years. In 2002, there was the introduction of a 10% supplementary rate of corporation tax for the ring-fenced operations of North Sea producers, on top of the standard 30% corporation tax rate. Together with other changes introduced at the time, this was estimated to raise around £0.5 billion per year.⁸ In 2005, changes to the timing of ring-fenced

⁴ This relatively high level of corporate tax receipts rests in part on the profitability of firms in the financial sector – see M. Devereux, R. Griffith and A. Klemm, 'Why has the UK corporation tax raised so much revenue?', *Fiscal Studies*, vol. 25, pp. 367–88, 2004.

⁵ For the UK, these OECD figures include corporation tax receipts from the North Sea sector.

⁶ Table B15 of HM Treasury, *Pre-Budget Report 2005*, Cm. 6701, 2005, http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr05/report/prebud_pbr05_repindex.cfm.

⁷ Table C9 of HM Treasury, *Budget 2005: Financial Statement and Budget Report*, 2005, http://www.hm-treasury.gov.uk/budget/budget_05/budget_report/bud_bud05_report.cfm.

⁸ Section 6.3 of R. Chote, C. Emmerson and H. Simpson, *The IFS Green Budget: January 2003*, IFS Commentary no. 92, 2003, <http://www.ifs.org.uk/budgets/gb2003/index.php>.

corporation tax payments brought forward an additional £1.1 billion into the tax year 2005–06.⁹ In his December 2005 Pre-Budget Report, the Chancellor announced a further increase in the supplementary rate of corporation tax to 20% from January 2006, so that profits from North Sea oil and gas production will be subject to a 50% corporation tax rate. This tax increase is expected to raise an additional £2 billion per year from 2006–07 onwards.¹⁰

The introduction of a higher rate of corporation tax for North Sea oil and gas producers in 2002 was part of a wider reform of the North Sea tax regime. As well as raising the tax rate, this reform also introduced 100% first-year allowances for investment in North Sea operations, and saw the ending of licence royalties. For fields that began development after 16 March 1993, this left the profits of North Sea oil and gas operations subject to a single tax, corporation tax, at a 40% rate.¹¹

This regime, with 100% investment allowances, appeared to be broadly neutral in its impact on investment decisions. Consider a project that requires an upfront investment of I and is expected to generate a stream of future net revenues with a present discounted value of R . A value-maximising investor will wish to undertake the investment if R is greater than I or if the net present value of the project, $NPV = R - I$, is positive. Now suppose that the investment expenditure qualifies for tax relief at a tax rate of t . The cost to the investor, net of tax relief, is reduced to $(1 - t) \times I$. If future net revenues are taxed at the same rate t , their post-tax net present value is reduced to $(1 - t) \times R$. The net present value of the project subject to this tax regime is then $(1 - t) \times (R - I) = (1 - t) \times NPV$. Provided the tax rate is constant and less than 100%, all investment projects that were attractive to investors in the absence of the tax remain attractive to value-maximising investors in the presence of the tax. Revenue is raised from projects with strictly positive net present values and not from investments that are marginal in the sense of only just covering their investment costs.

This approach has often been advocated as a way of taxing natural resources.¹² Since oil and gas deposits are scarce relative to demand, their development is normally expected to generate returns that are substantially higher than investment costs. These excess returns or ‘rents’ provide the tax base. Provided the tax regime is credible, this base can be taxed at a high rate, so ensuring a substantial share of the rents for the government. The neutrality of the system also ensures that all the fields that would be developed in the absence of the tax continue to be developed in the presence of the tax, so that potentially economically viable reserves are not left in the ground.

However, the neutrality of this tax regime rests crucially on the constancy of the tax rate. If the tax rate that applies to future returns is expected to be higher than the tax rate at which upfront investment costs attract tax relief, then projects with a positive net present value in the absence of tax may become unattractive to investors after taking all tax payments into

⁹ Paragraph C49 of HM Treasury, *Budget 2005: Financial Statement and Budget Report*, 2005, http://www.hm-treasury.gov.uk/budget/budget_05/budget_report/bud_bud05_report.cfm.

¹⁰ Table 1 of HM Treasury, *Regulatory Impact Assessment for the 2005 Pre-Budget Report Changes to the North Sea Tax Regime*, <http://www.hmrc.gov.uk/ria/ns-oiltax-changes.pdf>.

¹¹ Older fields that began development before 16 March 1993 continue to be subject to petroleum revenue tax.

¹² See, for example, R. Garnaut and A. Clunies Ross, *Taxation of Mineral Rents*, Clarendon Press, Oxford, 1983, and S. Bond, M. Devereux and M. Saunders, *North Sea Taxation for the 1990s*, Institute for Fiscal Studies, London, 1987.

account.¹³ In other words, this tax regime will deter otherwise viable investment projects if there is an expectation that the tax rate is likely to increase.

Given this, it is unfortunate that the effective tax rate applied to the ring-fenced profits of North Sea oil and gas producers has now been increased twice in the last year.

The change to the timing of North Sea corporation tax payments, announced in Budget 2005, required payments to be made earlier than had previously been the case. For a taxpayer that can lend at a 10% annual interest rate, a tax rate of 50% with a one-year payment lag is equivalent to a current tax charge of $0.5/1.1 = 45.5\%$. A reduction in the payment lag thus increases the effective tax rate.

In fact, the main effect of these changes to the timing of North Sea corporation tax payments was to bring forward an instalment payment of around £1.1 billion from April 2006 to January 2006. This gave a temporary boost to corporation tax receipts for the fiscal year 2005–06, but has only a modest impact on the effective rate at which North Sea profits are taxed.

The increase in the supplementary tax rate to 20%, announced in the 2005 Pre-Budget Report, is far more significant. The concern for North Sea investment is not so much that a constant tax rate of 50% would be damaging, but that the suspicion of a rising tax rate is likely to deter investment. The government now argues that the 50% tax rate is ‘striking the right balance between producers and consumers, ... to promote investment and ensure fairness for taxpayers’.¹⁴ At the time, however, the tax regime introduced in 2002 was also said to ‘ensure a regime that raises a fair share of revenue and encourages long-term investment’.¹⁵ The worry for the industry is that much the same rhetoric could be used to support further tax increases in the future.

Of course, these increases in North Sea taxation have come against a background of high world oil prices, so that any detrimental effect on investment in the short term may be masked by the effect of higher oil and gas prices on the underlying viability of new fields. Nevertheless, the government is well aware of the damage that may be done in the longer term by fears of future tax increases. In his December 2005 Pre-Budget Report, the Chancellor took the unusual step of ruling out further increases in North Sea taxation during the life of the current Parliament. Unfortunately, the Chancellor’s credibility in this area is somewhat tarnished. The regime he introduced in 2002 was then said to establish ‘a more secure basis on which companies can plan for the future’.¹⁶ Given this recent history, and the timescale involved in the development of offshore oil and gas fields, it is unclear how far this

¹³ Consider a project for which $R = I$, which would be marginal in the absence of tax. Write the tax rate applied to future net revenues as $t_F = t + \Delta t$, where t is the current tax rate and Δt is the expected change in the tax rate. Then the net present value in the presence of tax is $(1 - t_F) \times R - (1 - t) \times I = (1 - t) \times (R - I) - \Delta t \times R$, which is negative if the tax rate is expected to increase.

¹⁴ Paragraph 5.129 of HM Treasury, *Pre-Budget Report 2005*, Cm. 6701, 2005, http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr05/report/prebud_pbr05_repindex.cfm.

¹⁵ Paragraph 5.82 of HM Treasury, *Budget 2002: Economic and Fiscal Strategy Report*, 2002, http://www.hm-treasury.gov.uk/budget/bud_bud02/budget_report/bud_bud02_repindex.cfm.

¹⁶ Paragraph 5.82 of HM Treasury, *Budget 2002: Economic and Fiscal Strategy Report*, 2002, http://www.hm-treasury.gov.uk/budget/bud_bud02/budget_report/bud_bud02_repindex.cfm.

promise will go towards restoring investors' confidence in the stability of the UK tax regime for oil and gas production.

9.4 The starting rate of corporation tax: an obituary

In 1999, the Chancellor introduced a new starting rate of corporation tax at just 10%. This applied to companies with taxable profits of up to £10,000, and provided some benefit to those with taxable profits of up to £50,000. Previously, firms with taxable profits of up to £50,000 were taxed at the standard small companies' rate of 20%. In 2002, this starting rate of corporation tax was reduced to zero for firms with up to £10,000 of taxable profits.

The objective of these measures was to encourage the formation and growth of micro businesses. According to Budget 1999, 'the 10 per cent rate will encourage investment and enterprise'.¹⁷ In Budget 2002, the zero rate was introduced 'to provide further support to new and growing companies'.¹⁸ The benefit of this low starting rate was clawed back as the level of profits increased, so that there was no benefit at all for firms with annual taxable profits of £50,000 or over.

The zero rate, in particular, provided a strong incentive for self-employed individuals to set up small companies. Dividends paid by companies are taxed at a lower rate than income from employment, and dividends are not taxed at all for individuals paying the basic or lower rates of income tax.¹⁹ A sole trader can easily convert employment income into business profits simply by paying him or herself a lower wage or salary. By converting up to £10,000 into profits and paying these to him or herself as a dividend, the sole trader could enjoy a substantial tax saving.

Not surprisingly, the main effect of this zero starting rate of corporation tax was to encourage existing self-employed individuals to incorporate, to take advantage of this tax saving. This development was widely predicted,²⁰ and should have come as no surprise to the Treasury. The economic benefits, if any, of converting the legal form of existing activities from self-employment to small incorporated businesses were never clear.

In 2004, the government responded to this development by restricting the benefit of the zero starting rate of corporation tax to profits that were retained by the company. Profits paid out as dividends were effectively taxed at the standard small companies' rate, which by then had been reduced to 19%. This removed the main tax advantage of the measure for individuals replacing one form of cash income (salary) by another (dividends).

In his December 2005 Pre-Budget Report, the Chancellor announced the abolition of the starting rate of corporation tax altogether. Given where the system had got to, this was an

¹⁷ Paragraph 3.19 of HM Treasury, *Budget 1999: Economic and Fiscal Strategy Report*, 1999, http://www.hm-treasury.gov.uk/budget/budget_99/budget_report/bud99_report_index.cfm.

¹⁸ Paragraph 3.31 of HM Treasury, *Budget 2002: Economic and Fiscal Strategy Report*, 2002, http://www.hm-treasury.gov.uk/budget/bud_bud02/budget_report/bud_bud02_repindex.cfm.

¹⁹ Formally, dividend income is subject to personal income tax, but for basic- and lower-rate taxpayers the income tax due is entirely offset by dividend tax credits.

²⁰ See, for example, L. Blow, M. Hawkins, A. Klemm, J. McCrae and H. Simpson, *Budget 2002: Business Taxation Measures*, IFS Briefing Note no. 24, 2002, <http://www.ifs.org.uk/bns/bn24.pdf>.

entirely sensible simplification. However, we are now back to precisely where we were in 1998, with profits of up to £50,000 being taxed at the standard small companies' rate, regardless of whether they are paid out as dividends or retained by the firm (see Table 9.2). In the mean time, thousands of individuals have incurred effort and expense to set up legally incorporated businesses that they would not have otherwise have done.

Table 9.2. Tax rates on profits for micro enterprises

Announced	Starting rate under £10,000	Small companies' rate over £50,000	Basic rate of income tax
Budget 1996	23%	23%	23%
Budget 1997	21%	21%	23%
Budget 1998	20%	20%	23%
Budget 1999	10%	20%	22%
Budget 2002	0%	19%	22%
Budget 2004	0% retained profits 19% distributed profits	19%	22%
PBR 2005	19%	19%	22%

Note: For profits between £10,001 and £50,000 a system of marginal relief applied such that the average tax rate fell between the starting rate and the small companies' rate.

Sources: Various Budgets and Pre-Budget Reports.

The taxation of sole traders and micro enterprises is a difficult area for any tax system, coming at the boundary between the personal and corporate income taxes. For many years, UK government policy was to tax the profits of micro businesses at the same rate as the basic rate of personal income tax. This alignment of tax rates removed the possibility of saving income tax by converting salary into dividends, at least for owners of small companies who were basic-rate taxpayers.

As summarised in Table 9.2, Gordon Brown has deviated from this policy both by cutting the small companies' rate of corporation tax below the basic rate of income tax, and more significantly by the short-lived introduction of a much lower starting rate of corporation tax. The former provides an incentive for small-business owners who are basic-rate taxpayers to convert salary into dividends, but the incentive is probably not sufficiently large to encourage many sole traders to incur the costs of incorporation. The latter provided a strong incentive for self-employed individuals to incorporate, and the growth in incorporations during 2002 and 2003 was an entirely predictable result.

This episode provides a clear example of how the introduction of distortions into the tax system can have unintended effects on economic behaviour. The impact on tax revenue was large enough for the Chancellor to be obliged to close a 'loophole'²¹ in the tax system which he himself had introduced only three years earlier. We can only hope that the Treasury will draw appropriate lessons from this unfortunate experience.

²¹ Budget Speech, 2004.