

CORPORATION TAX REFORM:  
A RESPONSE TO THE GOVERNMENT'S  
AUGUST 2003 CONSULTATION DOCUMENT

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## 1 Introduction

In August 2003 the government issued a further consultation document on reform to the corporation tax system.<sup>1</sup> This consultation continues a process that started in July 2001 with a consultation document on large business taxation,<sup>2</sup> and which appears to have become an annual exercise. In response to last year's consultation,<sup>3</sup> the IFS published a briefing note,<sup>4</sup> and the issues covered there will not be discussed at length here.

The main focus of last year's consultation was the calculation of taxable income, in particular with respect to capital assets, the schedular system and the distinction between trading and investment companies. The new consultation deals with these issues again. Much of that is repetition, although proposals have become more specific. Particularly noteworthy is a proposed change to the tax treatment of finance leases. This consultation further includes a new topic - the international and particularly the European context of the UK corporation tax system.

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<sup>1</sup> HM Treasury/Inland Revenue (2003) "Corporation tax reform – A consultation document", London: The Stationary Office, August 2003 ([http://www.inlandrevenue.gov.uk/consult\\_new/corp-tax-reform.pdf](http://www.inlandrevenue.gov.uk/consult_new/corp-tax-reform.pdf)).

<sup>2</sup> HM Treasury/Inland Revenue (2001) "Large Business Taxation: the Government's strategy and corporate tax reforms – a consultation document", London: The Stationary Office, July 2001 ([http://www.inlandrevenue.gov.uk/consult\\_new/lbt.pdf](http://www.inlandrevenue.gov.uk/consult_new/lbt.pdf)).

<sup>3</sup> HM Treasury/Inland Revenue (2002) "Reform of Corporation Tax – A consultation document", London: The Stationary Office, August 2002 ([http://www.inlandrevenue.gov.uk/consult\\_new/taxreform\\_final.pdf](http://www.inlandrevenue.gov.uk/consult_new/taxreform_final.pdf)).

<sup>4</sup> Klemm, A. and J. McCrae (2002) "Reform of Corporation Tax: A Response to the Government's Consultation Document" Briefing Note No. 30, Institute for Fiscal Studies, London (<http://www.ifs.org.uk/corptax/bn30.pdf>).

This briefing note will first discuss in general terms the government's stated objectives for corporate tax reform. It will then cover briefly some areas that were already discussed in last year's consultation, focusing on the new developments. The international background to new proposals on transfer pricing and finance leasing is then discussed, followed by a more detailed analysis of these proposals.

## **2 The government's objectives**

The first chapter of the consultation document repeats the government's objectives for corporate tax reform, which are to promote "competitiveness and fairness" (paragraph 1.4). Before turning to the more substantial parts of the consultation, it is useful to consider the meaning of these terms.

"Fairness" has been defined as "ensuring that individual businesses pay their fair share of tax in relation to their commercial profits and compete on a level playing field".<sup>5</sup> Unfortunately the government does not say what it means by "their fair share" of tax. Nor is it clear whether competing "on a level playing field" refers to competition between UK firms operating in different industries, or between UK and foreign firms operating in the same industry.

In fact, notions of "equity" or "fairness" have little meaning in the context of business taxation. Corporation tax may be borne partly by customers in the form of higher product prices; partly by workers in the form of lower wages; and is borne by shareholders in the form of lower post-tax profits only to the extent that it is not shifted onto customers or workers in one of these ways. This is likely to vary substantially across different sectors of the economy, depending on the extent of international trade and the mobility of employees and capital used by the business. There is no simple link between the share of profits paid in corporation tax and the impact of the tax on the owners of the business. The government's distributional objectives can be achieved more easily using other elements of the overall tax and benefit system.

A "competitive" tax system is defined as "one which will make the UK an attractive location for business investment" (paragraph 1.8). This is arguably a more compelling objective for business taxation in an economy that is open to both trade and capital flows. The effect of a given level of taxation on the attractiveness of the UK as a location for investment will depend on the ease with which the activity could be relocated abroad. This objective thus implies light taxation on business activities that are highly mobile internationally, whilst permitting higher taxation on other activities that are relatively immobile. This contradicts at least simplistic notions of "fairness", that might

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<sup>5</sup> Paragraph 1.7, HM Treasury/Inland Revenue (2001) "Large Business Taxation: the Government's strategy and corporate tax reforms – a consultation document", London: The Stationary Office, July 2001 ([http://www.inlandrevenue.gov.uk/consult\\_new/lbt.pdf](http://www.inlandrevenue.gov.uk/consult_new/lbt.pdf)).

consider a system in which all businesses paid a similar share of their profits in tax to be “fair”. It would be helpful if the government clarified its interpretation of “fairness” in this context, and indicated the priority attached to these two objectives in cases where they appear to conflict.

The consultation document lists six features of a competitive tax system: a low rate and a broad base, neutrality, flexibility, consistency, transparency and responsiveness to market failure (paragraph 1.9). Unfortunately there are several contradictions here, and again no indication of the order of priority. To give just a few examples, a broad base may achieve the limited aim of treating different types of investment equally, but will tend to raise the cost of capital for all forms of investment. This is not neutral between capital intensive and labour intensive business activities. A transparent system would require some degree of stability, so that the tax implications of commercial transactions can be clear and predictable, whilst a flexible system may be changed unpredictably in response to a changing business environment. Competitiveness is also an inherently unstable concept, as it depends on taxes imposed by other countries. A corporate tax cut in France or Germany, for example, would tend to make the UK a less attractive location for internationally mobile business investment.

Summing up, it is disappointing that the government does not set out its objectives more clearly. Stating an underlying broader principle of reform can be useful, particularly when further reforms are expected to follow. The benefit of ill-defined and potentially contradictory aims is less clear, particularly if no order of importance is given.

### **3 Issues from the 2002 consultation**

The 2002 consultation dealt with three main topics: the taxation of capital assets, the treatment of losses and the distinction between trading and investment companies. As the IFS response to that consultation contained a detailed discussion of these issues, we provide just a brief overview of the issues here and point out where the proposals have been further developed in the current consultation.

A general theme of the 2002 consultation that continues in the current one is the aim of aligning the tax system more closely with company accounts. Despite the apparent simplifications that alignment may introduce, this could also lead to a number of difficulties. Some examples are discussed below, but a general point that can be made is that accounting systems are evolving. Particularly in the next few years there will be substantial changes, as new international accounting standards will be introduced for listed companies from 2005. It is very doubtful whether the tax system should be fully aligned with a new system, the details of which are not yet fully known and in any case are likely to change from time to time.

### 3.1 Capital assets

The taxation of capital assets is determined by numerous tax rules. The most important of these are capital allowances and the taxation of capital gains. Expenditure on capital assets generally cannot be deducted when computing taxable profits, but may qualify for a schedule of capital allowances. Receipts from the sale of capital assets may be taxed as ordinary profits or as capital gains. Neither approach necessarily reflects the accounting treatment of capital expenditures or receipts.

#### 3.1.1 Capital allowances

Typically capital equipment used in production falls in value as it is used. Company accounts therefore use the concept of depreciation to calculate profit figures that are adjusted for these falls in value. Corporation tax does not generally allow accounting depreciation provisions to be used to calculate taxable profits.<sup>6</sup> Instead the tax system provides capital allowances, which are set at rates prescribed by the government. There are three main rates, which are 25% (reducing balance) for most plant and machinery, 6% (reducing balance) for long-lived plant and machinery and 4% (straight line) for industrial buildings. Commercial buildings do not qualify for any allowance. As there is considerable variation across different types of assets in how quickly their value falls, it is typical for capital allowances to either exceed or be less than this true rate of economic depreciation. Capital allowances thus provide an incentive to invest in some types of assets, and a disincentive to invest in others.

The 2002 consultation document discussed replacing the current system of prescribed capital allowances with the depreciation charges used in company accounts. The new consultation document appears more cautious: “the Government is not committed to change in this area” (paragraph 2.49) and “would like to open up a wider debate on the role of capital allowances and their effect on investment decisions” (paragraph 2.50).

We welcome this caution. Replacing capital allowances with commercial depreciation provisions would have major implications for many firms. Some would benefit, e.g. retailers who depreciate their commercial property, while others would lose out, e.g. engineering firms that write off their plant and machinery more slowly than the 25% capital allowance rate. We estimate that on average depreciation rates used in company accounts tend to be lower than those specified by capital allowances. If so, tax relief for depreciation would become less generous on average if this reform were implemented. In other words, the cost of capital would on average tend to increase, which would

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<sup>6</sup> An exception is the case of intangible assets, for which firms can choose to use either accounting depreciation or a fixed straight-line depreciation rate of 4% to compute taxable profits.

almost surely result in lower total investment. Tax relief for depreciation in the UK corporation tax is not especially generous at present by international standards, and this reform would make the UK tax system less competitive.

The proposal would have some offsetting benefit if it led to all assets being depreciated for tax purposes at the true rate of economic depreciation. This would reduce differences in the tax treatment of different types of investment, and could lead to a more efficient allocation of total investment. However, it is not clear that accounting practice provides a good approximation of economic depreciation. Furthermore, if the accounting charges become relevant for tax purposes, there would be an incentive to use higher depreciation rates in order to bring forward the benefit of associated tax allowances. Accordingly, while in the short term this proposal is likely to increase tax revenues, over the long term it may have the opposite effect. To prevent too much abuse, a set of prescribed maximum rates of depreciation for different types of assets may then be required. In that event, rather than aligning tax allowances with company accounts, the outcome may be opposite, i.e. to align accounts with tax rules. It is not clear that this would be significantly simpler than the current system.

### *3.1.2 Capital gains*

Capital gains are currently taxed only on a realisation basis. In principle, this means when an asset is sold, although in many cases the tax charge can be deferred beyond the actual sale. A capital gain occurs when the sale price is higher than the tax written down value of the asset. Otherwise a loss occurs, which can only be offset against capital gains rather than against profits in general, thus effectively creating another ‘schedule’.<sup>7</sup> There is also an indexation relief, so that nominal gains that simply reflect general price inflation since the asset was purchased are not subject to tax. The consultation document “envisages” the abolition of indexation relief (paragraph 2.41), and states that the Government “remains attracted” (paragraph 2.33) to aligning the taxation of capital gains more closely with their accounting treatment.

If inflation were high and the costs of administering a fully indexed tax system were low, there would be a strong case for indexing capital gains as part of a tax on an inflation-adjusted measure of profits. However indexation relief for chargeable gains within corporation tax is something of an anomaly at present. Indexation of capital gains tax itself was abolished in the 1998 Budget, and the calculation of taxable profits for corporation tax generally makes no allowance for the effects of inflation. For example, interest payments are not adjusted for the effect of inflation on nominal interest rates. Given that inflation is low and

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<sup>7</sup> See section 3.2 below.

stable, the effects of this change will be modest,<sup>8</sup> although it will imply higher tax payments for firms that realise capital gains not protected by rollover relief.

Aligning the taxation of capital gains with their accounting treatment implies the possibility of taxing gains as they accrue rather than on realisation, where accrued gains are recognised in company accounts. If it were the case that current valuations of all assets could be determined easily, there would be a case for taxing all capital gains on an accruals basis. In practice the difficulty of accurately valuing many assets in the absence of a transaction has resulted in gains being taxed on realisation. The attraction of a hybrid system in which some gains are taxed on accrual and others are taxed on realisation, depending on the ease with which asset values can be estimated, is unclear. The case for deciding this on the basis of current accounting practice seems particularly unclear. The accuracy with which values need to be estimated for accounting purposes may not be as high as that needed to determine a tax charge; and, as in the case of depreciation allowances, there is a risk that the presence of tax consequences could affect accountants' judgements.

Another effect is that tax revenues would be more dependent on potentially volatile asset prices. This would be reinforced if, following accounting practice, capital losses became deductible against all forms of profits, rather than only against capital gains. A sharp fall in certain asset prices could then have a potentially large impact on revenue.

The general case for aligning tax and accounting treatments of capital gains seems to be undermined by the recognition that property would be exempted ("any new regime would therefore impose payment of tax on appreciation of real property only on disposal", paragraph 2.37). Property would seem to be one class of assets where capital gains are likely to be significant and asset values are relatively straightforward to establish. If the benefits of alignment do not outweigh the disadvantages in this case, it is difficult to see why the government "remains attracted" to the principle in the case of assets where valuations are likely to be more subjective.

The major problem with taxing capital gains on realisation is the lock-in effect, deterring firms from selling assets whose sale would trigger a tax charge. This problem is currently limited through rollover relief where the proceeds from the asset sale are reinvested. In effect this results in an exemption system for growing businesses whose asset stocks are increasing over time. Given the relatively weak case for change, it may be preferable to retain this system.

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<sup>8</sup> As was the case with capital gains tax for individuals, the consultation documents states that relief for indexation accrued up to the start of the new regime will be preserved (paragraph 2.41).

### 3.2 The tax treatment of losses

The consultation document also considers changes to the schedular system currently used to compute taxable income, which would have implications for the tax treatment of losses. Like most corporate income taxes, corporation tax is charged when taxable income is positive, but there is not a symmetric treatment when taxable income is negative, i.e. there is no payment from the Inland Revenue to the firm, equal to the tax rate times the loss. Instead, the loss can, at best, be set against taxable profits from a limited number of earlier years. When this carryback provision is exhausted, losses can only be carried forward to set against taxable profits in subsequent years, with no compensation for the delay before these losses can actually be used.

The schedular system in the UK corporation tax introduces further limitations on relief for losses. Profits and losses from different sources are not aggregated at the level of the firm, but are calculated separately under different 'schedules', and indeed 'cases' within schedules (for example, Schedule A Property Income and Schedule D Case I Trading Income), and for trading income, separately for different trades. In the same year, current losses can generally be offset against current profits from any schedule or trade. Losses carried back or forward, however, can generally only be offset against profits from the same schedule or trade.<sup>9</sup> Therefore even a firm that is profitable overall may have unrelieved tax losses. The effect of the schedular system however is that integrated companies are currently taxed in a similar way to groups, as group relief also allows losses to be offset against profits of other subsidiaries only in the same accounting period.

The 2002 consultation discussed the abolition of the schedular system or at least a reduction in the number of schedules and cases. As limitations on loss relief discriminate against large, risky investments, which, in the event that they turn out to be unsuccessful, could push a firm into a loss-making position, these proposals are broadly welcome. At the same time, however, it would seem to be important to consider a similar relaxation of group relief, to preserve a similar treatment between integrated firms and groups.

The 2003 consultation mentions two concrete proposals: either to allow full pooling of all sources of income, or to allow pooling of trading and property income only (paragraph 2.25). In principle the first option is preferable. The only reason to consider the second one might be revenue concerns.

It should also be noted that these changes to the schedular system would not lead to relief of losses for start-up firms, where the absence of loss relief may be most problematic, because start-up firms will typically not have profits from other activities. A more targeted approach to this issue would be to allow at

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<sup>9</sup> The exact limitations on the set-off of losses vary somewhat across different schedules and cases.



least some tax reliefs to be paid immediately to loss-making firms in their start-up phase, along the lines of the R&D tax credit for small and medium-sized companies introduced in April 2000.

### **3.3 Trading and investment companies**

The consultation document also proposes to eliminate differences in the computational rules that apply to trading and investment companies. The different rules are largely attributable to the features discussed previously – the distinction between income and capital, the schedular origins of the system and different loss reliefs. The consultation document discusses aligning the rules on expenses (paragraph 2.29), presumably with some anti-avoidance rules to prevent individuals incorporating private investment portfolios to secure the benefit of more favourable computation rules or tax rates.

The objective of a single business income computation that does not depend on the particular nature of a company's activities is an entirely appropriate objective. The traditional distinction between trading and other activities that is found in the UK is not replicated in continental corporate income taxes, nor is it a feature, for example, of the VAT system. Nevertheless, as the characterisation of particular activities and of the nature of the corporate entity conducting them lies at the heart of current corporate tax legislation, achieving this objective may involve substantially recasting the corporate tax legislation to produce a system of corporate profits taxation that differs even more fundamentally from the system of unincorporated business profits taxation.

## **4 New issues in the 2003 consultation**

### **4.1 Background: international developments**

As the world economy is continuing to integrate, it is welcome that the government is addressing corporate tax issues raised by this process. Before discussing the proposals in detail, it is useful to think generally about the issues raised by globalisation. First, the increasing mobility of capital makes the competitiveness of the corporate income tax a more significant objective, and may make 'tax competition' fiercer. Tax competition is the term used to describe the idea that governments may try to attract firms, capital or specific activities into their jurisdictions by offering lower taxes than other countries. Second there are international obligations that limit measures the government can take, e.g. through international and regional treaties, particularly the European Community Treaty.

The consultation document does not say much about competition for the location of real investment. It just contains the statement that the government will ensure that the UK system remains competitive to "help to sustain the

UK's high levels of both inward and outward investment" (paragraph 1.7). Among economists the issue of tax competition is controversial.<sup>10</sup> While there is some agreement that the increased mobility of capital is likely to put downward pressure on taxes, there is less agreement on whether this is harmful, beneficial or irrelevant.

A different but equally important issue is the enforcement of taxing rights. Unless prevented by legislation, multinational firms will want to report as much of their profit as possible in low tax jurisdictions. To limit the resulting loss of revenue, the UK and most other countries use a range of legislative measures, including transfer pricing and thin capitalisation rules, and controlled foreign company (CFC) regimes (see Box 1).

In many instances the effect of these rules is to treat transactions with parties located abroad differently from wholly domestic transactions. This is not surprising, given that in domestic transactions little or no tax is at risk. The non-discrimination provisions of the EC treaty, however, mean that some of these rules can be challenged, at least in the case of transactions with EU member states (see Box 1 for a brief description of some of the rules that might be in breach of the treaty). This is on the basis that tax rules should not treat cross-border transactions (at least within the EU) less favourably than domestic transactions, as to do so would inhibit the exercise of the single market freedoms guaranteed by the EC Treaty.<sup>11</sup> Often this will also affect transactions with countries outside the EU, because firms can route such transactions via the EU member states with the most generous rules towards non-EU countries.

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<sup>10</sup> For a survey of the economic literature on tax competition see Wilson, J. (1999) "Theories of tax competition" *National Tax Journal* 52, 269-304.

<sup>11</sup> Namely, the freedom of movement of goods and labour, the freedom to provide services, the freedom of establishment and the freedom of movement of capital. This last freedom in particular applies not only within the EU but to capital movements between EU States and other countries.

The principal question that arises, therefore, is whether it is possible to create non-discriminatory rules that are as efficient in enforcing taxing rights or whether domestic corporate tax systems are in danger of erosion.

**Box1: Legislation that may be in breach of the EC treaty**

Transfer pricing: International transactions between related parties (e.g. two subsidiaries of the same group) have to be at arm's length transfer prices. This is enforced through the transfer pricing legislation, which is based on OECD guidelines, and which prescribes methods of obtaining transfer prices. As this does not apply to domestic transactions, this could be seen as discrimination (see also section 4.2).

CFC regimes: Profits of foreign subsidiaries owned by UK resident companies that are subject to a low level (less than 75% of UK rate) of taxation are imputed to their owners and taxed. This is not the case for UK subsidiaries.

Group relief: UK subsidiaries of a UK based parent that are loss making are allowed to set profits occurring elsewhere in the group against their current losses. This is not possible for subsidiaries located outside the UK.

Thin capitalisation rules: UK subsidiaries may suffer a denial of a tax deduction for excessive debt provided by non-UK parent companies, but not when the debt is provided by a UK parent.

Finance leasing: Writing down allowances for plant and machinery are restricted to 10% (instead of 25%) if the lessee is not UK resident.

Dividend taxation: Corporation tax is not charged on dividends from UK companies, but generally there is no exemption for dividends from abroad, unless covered by the parent-subsidiary directive.

Exit Charges: Gains will be recognised when a company or asset moves outside the UK without any disposal taking place.

## 4.2 The proposals of the consultation in detail

The consultation document acknowledges that, in the case of transfer pricing, there is “uncertainty about the appropriateness of the UK rules in the light of the evolving jurisprudence of the European Court of Justice (ECJ)” (paragraph 3.8). This uncertainty is real as there are already cases pending that seek to challenge the current UK rules on CFCs, dividend taxation, thin capitalisation and group relief, and more may follow. The government is thus certainly correct, in thinking about appropriate action to take, should a part of the UK

corporate tax system be found to be in breach of EU legislation. Whether such action should be taken pre-emptively, or only as and when judgements occur, is less clear.

Of the issues outlined in Box 1, only two are addressed explicitly in Chapter 3 of the consultation document: transfer pricing and thin capitalisation. Finance leasing is also addressed in Chapter 2, but without emphasising the international dimension.

Transfer prices are the prices that related companies use to account for transactions. When such transactions occur, the price used does not affect the global profits of the group. It does however determine the location of profits between different taxing jurisdictions, when the parties are located in different countries. A higher price will lead to more of the profits arising in the country where the seller is located. This will thus be an attractive option when the buyer is located in a higher tax country. To prevent firms from shifting profits into those locations with the lowest taxes, firms are required by law to use arm's length prices, i.e. prices that unrelated parties would have charged. Where such prices do not exist, because a product is not freely traded or is unique to a group, there are a number of guidelines developed by the OECD according to which transfer prices need to be calculated. The UK follows these OECD guidelines for international transactions, but does not currently apply transfer pricing rules to the majority of wholly domestic transactions.

The consultation document proposes to extend the transfer pricing legislation to cover domestic transactions as well (paragraph 3.9). It also proposes to incorporate the thin capitalisation legislation into the transfer pricing legislation, so that these rules will also become binding on transactions between related domestic firms (paragraph 3.14).

As this would then mean that domestic and international transactions are subject to the same treatment, this proposal should make the transfer pricing and thin capitalisation rules robust to challenge at the ECJ. However, this comes at a cost. While not much tax is at stake for domestic transactions,<sup>12</sup> there will be compliance costs for firms in ensuring that transactions between domestic subsidiaries satisfy the legislation, and administrative costs for the Inland Revenue in applying these rules to domestic transactions. Even firms that already use transfer prices for their internal transactions will face higher costs, as they will have to document the calculation of the prices and be in a position to justify them.

Relative to the current position, it is clear that these proposals will have the effect of making the UK a less attractive location for firms to do business. The

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<sup>12</sup> Tax may be at stake for transactions between a loss-making and a profitable part of a group. For example, where one subsidiary has accumulated losses from previous years, shifting profits into that subsidiary will accelerate the rate at which these losses are relieved.

impact may be limited in time, if other European countries are compelled to act in a similar way by decisions of the ECJ. However it is difficult to see the advantage of moving quickly in this area. Moreover it is vital that these changes are introduced in ways that minimise the additional compliance burden imposed on international companies who may choose to conduct more of their business elsewhere.

While the consultation document does not address all aspects of corporation tax that may be challenged under EU legislation, the proposals concerning transfer pricing and thin capitalisation indicate the type of strategy that the government may employ in other cases. This approach is to take away from domestic transactions any benefits that are challenged, rather than to extend them to foreign transactions.

Is this a reasonable strategy? It may seem that there is little choice, given that removing restrictions on transfer prices used for international transactions, for example, could lead to a serious loss of corporate tax revenue. In the short term this is probably correct. In the longer term, however, these developments raise questions about the sustainability of national corporate income taxes within the European Union.

The extension of transfer pricing legislation to domestic transactions has no intrinsic logic. It is simply the result of a clash between the non-discriminatory treaty provisions as interpreted by the ECJ and the determination of national governments to protect their corporate tax bases. This does not seem to be a wholly satisfactory basis on which to formulate tax policy.

In the longer term there are two basic alternatives: either to embrace a more cooperative approach to corporate taxation within the European Union, or to restrict the influence of the ECJ over corporate tax issues. The latter approach would require some amendment of the current EC treaty. The former would require some agreement over the measurement of taxable profits earned by firms within the EU, and an allocation of these profits between member states by some form of formula apportionment. One possible approach has recently been suggested by the European Commission, who emphasise growing problems with the application of transfer prices to cases where there is no comparable market transaction.<sup>13</sup> Whilst neither of these alternatives commands wide support at present, this may change if ECJ rulings make it increasingly difficult for national governments to maintain their current levels of corporate tax revenues.

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<sup>13</sup> See European Commission (2001a) 'Towards an International Market without Tax Obstacles', Communication from the European Commission COM(2001) 582 final. A discussion of the background can be found in European Commission (2001b) 'Company Taxation in the Internal Market', Commission Staff Working Paper SEC(2001) 1681 final. An independent analysis of these issues is provided in Gammie, M., A. Klemm and C. Radaelli (2001) 'EU Corporate Tax Reform', Report of a CEPS Task Force, Centre for European Policy Studies, Brussels.

### 4.3 Finance leases

Finance leases are those leases in which almost all of the risks and benefits of ownership are transferred to the lessee. All other leases are called operating leases. Finance leases are thus very similar to financing investment by debt, except that the legal ownership of the asset remains with the lessor. Currently any capital allowances can be claimed by the legal owners of an asset only. Therefore, in the case of a finance lease, the allowances are claimed by the lessor, not the lessee. This feature of the tax system makes leasing assets relatively attractive for firms that cannot currently claim capital allowances, e.g. because they do not currently have taxable profits. This is because a profitable lessor can claim the allowances and pass part of these tax savings on to the lessee in the form of lower leasing fees. The government now suggests moving the entitlement to capital allowances on plant and machinery from lessors to lessees (paragraph 2.55). Furthermore, instead of being able to deduct leasing fees in total, lessees would only be able to deduct the finance cost element thereof. They would thus be treated for tax purposes as if they legally owned the assets.

The economic issue underlying this proposal is similar to that for the reform of the schedular system: should the tax system be symmetric in its treatment of profits and losses? While the current system is clearly asymmetric, this is made worse by the schedular system, which increases the likelihood of losses remaining unrelieved. It is however mitigated by the current treatment of finance leases, which allows loss-making firms at least to benefit from capital allowances, by leasing assets rather than purchasing them. There would seem to be some inconsistency between the proposals to reform the schedular system, and the proposal on finance leasing.

The proposed change to the treatment of finance leases is particularly surprising in the light of comments made when the R&D tax credit for small and medium-sized enterprises (SMEs) was introduced. Then it was said that “by making the new tax credit payable to companies not yet in taxable profit, the new tax relief recognises the greater cash constraints that innovative, early-stage companies face and the extra assistance that they need”.<sup>14</sup> Start-up firms that wish to invest but do not yet have taxable profits, and new inward investors that do not yet have UK taxable profits, are among the main users of finance leasing. The proposed change will have the effect of raising the cost of capital for these firms, and is difficult to reconcile with the objective of making the UK an attractive location for business investment.

The motivation for this proposal seems more likely to be the threat of a successful challenge at the European Court of Justice. Currently lessors are only allowed the full capital allowance if the lessee is located in the UK, which

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<sup>14</sup> HM Treasury (1999), Pre-Budget Report November 1999, Press Release HMT 2.

may be in breach of the European Community Treaty. So while this proposal is not discussed in Chapter 3 of the consultation document, on international issues, it looks very like another example of the government withdrawing benefits that have applied to domestic firms, in order to comply with EU law.

If the proposal is implemented, there will be a number of risks. First, it is possible that firms will switch to using more operating leases, which are not covered by the proposed changes. As operating leases differ more substantially from debt finance than finance leases, the use of operating leases would represent a more significant tax distortion to commercial behaviour than the current use of finance leases. Second, it may become increasingly difficult to distinguish between the two types of leases, as firms will try to set up operating leases that come as close as possible to finance leases. This would lead to uncertainty for firms about the tax implications of particular leasing contracts, and administrative costs for the government.

Both these distortions and the impact of the proposed change on the cost of capital could be avoided by making capital allowances repayable to firms that do not currently have taxable profits, as is the case for the R&D tax credit for SMEs.<sup>15</sup> In principle this should apply to all firms and all capital allowances. If the cost of this is currently too high, the benefit could be limited to firms below a size threshold or who have been operating in the UK for less than some time period, or perhaps to plant and machinery investment. In these ways the benefit could be targeted onto start-up firms and new inward investors, who would otherwise be among the main losers from the proposed change to the taxation of finance leases.

## **5 Conclusions**

The latest consultation document on corporation tax reform covers a wide range of different and in some cases unrelated issues. One clear message that pervades this series of consultations is that the government perceives little cost to continual tax reform. The Chancellor used his first Budget speech to emphasise the benefits of stability: “without stability all plans for investment, employment and education founder. In a global economy, long-term investment will come to those countries that demonstrate stability in their monetary and fiscal policies, and in their trading relationships”.<sup>16</sup> It is difficult to see how an annual cycle of corporation tax reform can contribute to a stable environment for business investment decisions.

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<sup>15</sup> Alternatively firms could be permitted to trade such unused capital allowances. They would be of value to firms with UK taxable profits.

<sup>16</sup> HM Treasury, Budget Speech 1997, lines 9-10.

Whilst simplification of the schedular system and other restrictions on tax losses would be welcome, we have doubts about the general principle of aligning taxable profits more closely with commercial accounts. In some cases, such as capital allowances, there is a risk that making tax bills dependent on accounting procedures could distort the information presented in company accounts. Particularly at the present time when accounting standards are changing rapidly, it is not clear that tax rules should be tied to the outcome of this process.

We welcome the government's recognition of international pressures that are influencing UK corporation tax rules. There are indeed big issues to be addressed here. In comparison, some of the areas that have been addressed at length in this consultation process, for example on the reform of the schedular system, or differences between trading and investment companies, appear relatively minor, even where there is scope for some beneficial rationalisation of existing tax rules.

The increased willingness of the European Court of Justice to apply the test of non-discrimination to corporate tax provisions presents a serious problem for national governments that want to preserve current levels of revenue from their corporate income taxes, without significantly greater cooperation at the EU level. The response of the UK government suggests a willingness to impose higher costs on firms in order to protect corporation tax revenue. The proposals on transfer pricing will impose higher compliance costs, and the proposal on finance leasing will reduce the value of capital allowances for firms that do not currently have taxable profits.

These proposals make the UK a less attractive location for business investment. There is a danger that they will diminish confidence in the government's commitment to the objective of maintaining a competitive corporate tax system. If this is not the signal that the government intends to convey to business, then it will be important to implement the transfer pricing legislation in ways that minimise the additional compliance costs, and to protect start-up firms and inward investors from the impact of changes to the tax treatment of finance leasing on their cost of capital.