Shifting sands

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Bill Dodwell examines the various ways to tax corporate profits and highlights the challenges involved with each

The Treasury Select Committee is conducting a wide-ranging inquiry into UK taxation, with a focus on corporate tax. The inquiry started with evidence from CIOT Tax Policy Director John Cullinane, OTS Tax Director John Whiting and tax campaigner Richard Murphy. Written submissions were then requested – and this article is an abbreviated version of comments on ‘Radical Proposals’ for corporate tax.

The place to start, in my view, is to reject the premise that the corporate tax base is shrinking. Today’s corporate tax yield is lower than the 2007/08 peak. However, in the years up to 2007/08 the largest sectoral contribution came from banking, followed by offshore oil and gas, followed by insurance. The banking crisis cut the banking contribution and created a very large over-hang of losses – which the Chancellor has decided should no longer be offset in full against banks’ current profits. The collapse in the oil price means that the North Sea yield today is significantly reduced. Finally, the coalition and current government have cut the rate of corporate tax from 28% and 21% to 20% – and have legislated to cut it further. Today’s yield is forecast by the Office of Budget Responsibility to increase from about £44 billion to over £50 billion by the end of the Parliament. That doesn’t look like a tax base in crisis.

My thesis is that none of the four types of so-called ‘radical’ proposals is a theoretical improvement on the current method of taxing corporate profits, allocated internationally where necessary by reference to the substantive activities carried on in each country. The Actions from the G20/OECD BEPS project are not perfect – and further work will be needed – but, if implemented as agreed, will increase the tax base and reduce base erosion. The political and technical focus over the next two or three years needs to be on embedding the Actions into domestic laws and international treaties.

Taxing revenues

It is relatively easy to rule out the replacement of corporation tax on profits by a tax charged on sales (turnover). Economically, taxes on revenues achieve quite different effects to taxes on profits. It is impossible for a turnover tax to approximate a tax on profits, as companies and sectors have large variations in profitability.

There is one example of a sector where some countries do levy tax based on sales: online gaming. Even when the rate is set by reference to a single sector, as with gaming, the rate can still be so high that it is no longer possible to operate profitably. The Financial Times reported that Betfair had withdrawn one of its offerings in Germany, due to a new turnover-based tax. The article notes 'Gambling taxes based on turnover rather than gross profits threaten the viability of operators' business models. A turnover tax introduced by France two years ago prompted several online operators to quit that market.' The article can be read here.

Taxing distributions to shareholders

The 2020 Tax Commission established by the Taxpayers' Alliance and the Institute of Directors proposed an integrated system of personal and corporate taxation. It proposed abolishing tax levied on the profits of companies and instead levying a tax on distributions to shareholders. However, the underlying premise of the plan was that public spending should be reduced to 33% of GDP. This is substantially below the current and planned levels of public spending.

It is also not obvious that the claimed economic consequences of the proposed system could apply to a single part of the package. Taxes on distributions, as opposed to taxes on profits, encourage different behaviours. Companies are encouraged to retain cash rather than distributing it.

The design appears to have a number of challenges:

- Paying tax only on distributions, as opposed to when profits are earned, would inevitably result in much less tax being paid. Public companies typically pay out less than one-third of their post-tax profits. Private companies – other than perhaps one-person companies – would be likely to retain funds for investment purposes. As a minimum, it would be necessary to align income tax and capital gains tax rates.
- Anti-avoidance rules to limit the retention of excess funds in companies are complicated to design and to apply.
- The system does not fit into the international system. For UK companies, the move to a double tax relief system for overseas income, combined with a high UK rate on distributions, would inevitably lead to the same type of issue as is reported for some large US multinationals – the retention of low-taxed cash

overseas.
- It is questionable whether overseas shareholders would be liable to the tax. If the tax were deemed to be a tax on shareholders, it would be limited under the UK's many double tax treaties to 5–15% (and zero under the EU Parent-Subsidiary Directive).

Taxing profits, with an allocation system (destination sales, or a formula)

These two approaches rely upon adding up the profits and losses of individual companies within a multinational group and then allocating a share of the global result to individual countries to be taxed at the local rate.

There are some major challenges which apply to both methods:

- Countries would abandon any form of control over the base. Presumably there would need to be some central authority which would manage the base.
- There is no common global accounting system, which is a fundamental part of any business tax system.
- There is no realistic system of compliance. Which tax authority would take the lead? How would countries check the tax calculations?
- There is no easy interface with countries not in the unitary system. Any group company which had dealing with other countries would need to consider arm's length pricing for goods and services bought and sold from other group members within the unitary system. The impact would be much more complexity – and another area for dispute.
- There would presumably need to be opt-outs for natural resources and agriculture.

The allocation method then needs to be considered. The underlying challenge is that no one has managed to come up with an allocation that picks up the value attributable to economic activity.

The notion that global profits could sensibly be allocated between countries based purely on destination sales is surely something that cannot survive outside the economics laboratory. There is no link between the value-generating activities of a business and the location of its customers. The theoretical economic advantage –

that the system would have no impact on location decisions – is surely the very reason why governments would not adopt it. Why would exporting countries hand over tax revenues? There would be a huge shift of tax revenues to countries with large populations and increasing consumption.

The European Commission’s allocation formula for its Common Consolidated Corporate Tax Base is more extensive. Variants of the three-factor allocation (the location of people, tangible property and destination sales) have been used by many (but not all) states in the United States to determine the allocation of profits. However, there are over twenty different models, as individual US states have decided to move to systems that suit their respective economies. If within a relatively cohesive country such as the US this has been found to be necessary – how much more necessary would it be for a global system?

Both allocation methods ignore the most valuable assets in business today: intangible assets. There is no agreed way to determine or value intangible assets, though. Further, the location of intangible assets may be altered much more easily than moving a factory. Yet ignoring intangible assets reaches an unfair result for countries which invest in and develop intellectual property.

The wide variation in costs globally would influence the allocation and would have the perverse effect of allocating higher profits to higher cost countries. Adopting a purchasing power parity approach would be challenging; it would not be feasible to adopt the Economist magazine’s simple burger index.

Finally, multinationals would have the opportunity to influence their allocations through choosing which activities to insource and which to outsource to third parties. For example, a high-margin business might choose not to sell its products in a high tax country. Instead, there is an opportunity for a third party distributor outside the high tax country to acquire the products and on-sell. The result is that a much lower distribution margin is taxed.

In summary, a unitary approach would not be any easier to operate in practice, nor would it offer a better allocation of profit to economic activities. Further, there is no sign that other countries wish to make such radical changes. It is understood that at the start of the BEPS project the G20/OECD countries debated whether they wished to consider a unitary system – and they concluded they did not.

Finally, it’s surely not realistic for a single country to adopt any of these proposals unilaterally. This is partly due to existing double tax treaties which define how to allocate profits and losses between countries but also due to the inevitability of double taxation or non-taxation that would arise if the UK were to have a completely different approach to that adopted globally.