Rate-setting power

General Features

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Malachy McLernon considers the practical implications for business and tax advisers of the corporation tax bill for Northern Ireland

Northern Ireland’s politicians have been told that they will be given control of corporation tax rate setting powers before the May general election. But there are strings. First the Stormont executive must agree to welfare changes, reform the devolved institutions and deal with legacy issues.

Background

On 23 December 2014, after four years of discussions culminating in 11 weeks of negotiations between the executive parties and input from the UK and Irish governments, the Stormont House Agreement was signed. This paves the way for legislation to devolve corporation tax rate setting powers to Northern Ireland, as announced in the Autumn Statement. The Corporation Tax (Northern Ireland) Bill was published on 8 January 2015.

Northern Ireland Secretary Theresa Villiers stated: ‘If the Stormont parties press ahead on agreeing their final budget and on delivering welfare reform legislation, the government will use all its best endeavours to get the legislation on to the statute book before [parliamentary] dissolutions. The parties in Northern Ireland believe that corporation tax devolution can help them to rebalance the economy and attract investment because of Northern Ireland’s unique position of having a land border with the Republic of Ireland.’

The bill provides the executive with a powerful lever to transform the Northern Ireland economy and place it on a significantly higher growth path.

Corporation tax in the UK is 21% compared with 12.5% in the Republic of Ireland, an imbalance that the Northern Ireland executive has been seeking to redress for a long time. The decision on the corporation tax rate will ultimately be made by the Northern Ireland Assembly, which is expected to reduce it, either directly or in stages, to parity with the republic. The weaknesses of the Northern Ireland economy reflect 30 years of conflict, its demographics and location, as well as issues regarding deprivation and its rurality. Rebalancing the Northern Ireland economy will depend on higher-productivity sectors becoming larger and firms in all sectors growing. The lower rate should help attract foreign direct investment into Northern Ireland and supplement the region’s other attractions for international businesses – a highly skilled workforce, a competitive employment environment, and a robust legal and regulatory regime.

The Stormont House Agreement also sets out a plan for the Northern Ireland executive to put its finances on a sustainable footing, following last year’s budget crisis. Villiers said this had threatened the ‘stability and credibility’ of the devolved institutions. The executive will be expected to introduce the government’s welfare reforms, with some agreed adaptations paid for out of Northern Ireland’s block grant.

Wider public sector reforms are also included in the agreement. Meanwhile, improvements to the way the executive and assembly work include the establishment of an official opposition and a reduction in the number of government departments and members of the legislative assembly (MLAs).

Under the agreement, the UK government has committed £150 million over five years to fund structures to deal with the legacy of Northern Ireland's past. These include an oral history archive, a new historical investigations unit to look at deaths caused by the Troubles, and an independent commission for information retrieval, which has been established by the UK and Irish governments.

Lower corporation tax benefits

In March 2011, the government published a paper setting out options to rebalance the Northern Ireland economy by growing the private sector and increasing its capacity to export. The paper listed a number of potential benefits:

1. Research on corporation tax suggests that the most significant benefits of a reduction in the corporation tax rate in Northern Ireland would come through additional investment in new foreign-owned firms and in existing firms. Increased investment typically leads to growth and jobs.
2. Some foreign-owned firms may also shift profits from the rest of the world into Northern Ireland to benefit from the lower tax regime. A lower corporation tax rate in Northern Ireland may enable some profits to be retained in the UK from companies that would otherwise shift them abroad, though a proportion of increased investment in Northern Ireland would be diverted from other parts of the UK.
3. The impact of changes in the rate will depend on the components of the corporation tax system, such as capital allowances and any tax credits available for research and development. When investing, it is likely that firms will take into account both their overall tax rate (the average effective tax rate) as well as the rate on the particular investment project they are considering (the marginal effective tax rate). The statutory, or headline, rate is also important in terms of the signals it sends to overseas investors.

Principles underpinning the bill

Villiers outlined the government's 'overarching principles' relating to tax devolution, in that this must:

- encourage genuine economic activity in Northern Ireland;
- be attractive to business and ensure that any administrative burden is proportionate;
- satisfy EU state aid rules; and
- ensure that the cost to the Northern Ireland executive remains proportionate and is kept to a minimum.

Villiers estimated that a Northern Ireland rate would affect '34,000 companies of all sizes, including 26,500 SMEs'. But she added: 'The burden will vary greatly depending on their size, existing tax arrangements, whether they have any Northern Ireland-based trading activity in a given year, and whether their activity is wholly based in Northern Ireland.'

Also, it has been argued for many years that the Irish Republic has attracted substantial foreign direct investment thanks to its lower rate of corporation tax, and that Northern Ireland has suffered from this disparity.

Eligibility

The bill devolves power to the assembly to set by resolution the Northern Ireland rate, charged on the profits of certain trades and activities of companies there. This may be set independently of the UK main rate. The bill details what trades and activities fall within the scope of the Northern Ireland rate, if one is set. The rate will be applied to trading income only, with other sources of income remaining chargeable at the main rate of corporation tax.

The rate, in general, will apply to all of the trading profits of a company if that business is a micro, small or medium-sized enterprise (SME), and its employee time and costs fall largely in Northern Ireland. The rate will also apply to the profits of large companies that are attributable to a Northern Ireland trading presence, defined as a Northern Ireland regional establishment (NIRE). The trading profits attributable to the NIRE are computed using internationally-recognised principles with some modifications and adaptations.

The bill deals with SMEs (using the EU definition, see ***Table***) and large companies (non-SMEs) separately.

Table – SME definition under EU Regulations

The main factors determining whether a company is an SME are:

1. number of employees and
2. either turnover or balanace sheet total.

Company category	Employees	Turnover or	Balance sheet total
Medium-sized	250	€50 m	€43 m
Small	50	€10 m	€10 m
Micro	10	€2 m	€2 m

These ceilings apply to the figures for individual firms only. A firm that is part of a larger grouping may need to include employee/turnover/balance sheet data from that grouping too.

SMEs

The bill requires SMEs with employees in Northern Ireland to establish whether they are a ‘Northern Ireland employer’. If they are, all the profits will be subject to the Northern Ireland corporation tax rate. The SME will be a Northern Ireland employer if the Northern Ireland workforce conditions are met for the relevant accounting period or the previous 12 months. These will be met if at least 75% of its staff time and costs relate to work carried out in Northern Ireland. This is a simple in/out test and those failing it will not be eligible for the Northern Ireland rate.

R&D tax relief will be adjusted so as to maintain the same overall benefit as with the rest of the UK

Large companies

Large companies are required to identify whether they have a regional establishment in Northern Ireland – broadly, similar to the permanent establishment (PE) rules. It will meet the criteria if it has a fixed place of business in Northern Ireland through which it wholly or partly carries on its business, or if it carries on its business there through a dependent agent. The large company must then, if it has a presence in both NI and the rest of the UK, apply rules similar to those governing the allocation of profits to a PE, in effect treating the Northern Ireland trading activity as if it were a separate business from that in the rest of the UK, and apportion profits between the two. The existing transfer pricing and permanent establishment rules, together with their ongoing evolution under the OECD BEPS discussion papers, will clearly be in point.

The bill also includes specific rules in relation to how certain tax reliefs and capital allowances will be dealt with in relation to companies that qualify for the Northern Ireland rate on trading profits.

Trades excluded from the Northern Ireland corporation tax rate altogether include:

- lending and investing activities;
- asset management;
- long-term insurance (mainly life insurance);
- reinsurance of both general and long-term insurance; and
- profits subject to the oil and gas regime ring-fence and activities of oil and gas contractors working on the UK continental shelf.

Companies with excluded trades and activities other than those relating to oil and gas or long-term insurance may make a one-off election for their back-office functions of those activities to qualify for the NI regime.

There are several other changes to CTA 2009, CTA 2010 and CAA 2001 to enable a Northern Ireland rate.

Practical implications

There are many practical implications that will evolve as the legislative changes are worked through. Some of the most likely, including their common implications, are as follows:
One of the most significant implications will be for companies and groups that do business throughout the UK. These will need to be able to identify the profit properly attributable to activity in Northern Ireland. It will be increasingly important that businesses can show that supplies of goods, services and financing between operations in Northern Ireland and the rest of the UK are undertaken on an arm’s-length basis.

Having a sub-region with a different rate of tax will cause complications in the transfer of assets, or business activities, between Northern Ireland and the rest of the UK operations of a business or group of companies.

The offset, or transfer, of commercially incurred tax losses between Northern Ireland and rest of the UK activities will become more difficult because there will be amendments to legislation to facilitate a potential rate differential.

Unincorporated businesses are likely to be asking themselves whether to incorporate. Fundamentally, the nature of the business entity adopted is a commercial and governance question and will be based on a range of factors – not just the corporation tax rate. However, a reduction in the rate of corporation tax is likely to provide an additional incentive for businesses to incorporate.

For owner-manager businesses that are already incorporated, there will be an impact on remuneration strategies. A lower rate of corporation tax means that the value of the tax deduction associated with a bonus payment is reduced. Hence, an owner-manager is likely to give preference to a payment of a dividend rather than a bonus.

To the extent that there is a dual rate of tax, with passive (ie investment) profits subject to a higher rate, companies will need to focus on properly identifying investment income and costs to ensure that such profits are charged at the correct rate.

The bill includes specific rules in relation to how some tax reliefs and capital allowances will be dealt with in relation to companies that qualify for the Northern Ireland corporation tax rate on trading profits. For example, a concern had been that a reduced corporation tax rate, the benefit of R&D tax relief for SMEs would be diminished. Villiers quelled these concerns, confirming that R&D tax relief in such cases would be adjusted upwards to maintain the same overall benefit as the rest of the UK. The bill makes similar provision for other reliefs and incentives.

There will be implications for HMRC, which will need to police any new corporation tax regime. Given the obvious implications of a different, potentially lower tax rate in Northern Ireland, it is expected that HMRC will deploy additional resources to, and put a greater focus on, businesses operating in Northern Ireland.

The above examples indicate that, although it is only the corporation tax rate setting power that has been the subject of the devolution discussions, it is likely that many aspects of UK tax legislation will need to be amended to ensure compatibility with any Northern Ireland corporation tax regime.

Conclusion

The Stormont House Agreement and the Corporation Tax (Northern Ireland) Bill is not the end of it. There are still important questions to be resolved and much work needs to be done with the Northern Ireland executive, the UK government and the Irish government before the agreement is implemented. The agreement gives the devolved executive a chance to refocus and work together with renewed confidence for a more prosperous, stable, secure future for the people of Northern Ireland, and the Corporation Tax (Northern Ireland) Bill is an important step in this process.