

## Corporation Tax - what does the future hold?

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Good evening and may I start with a warm note of thanks to you for asking me to give this lecture. I know that this is an important occasion for you, and it marks a major anniversary in your long history.

Thank you also for giving me such a provocative title to talk about. Corporation tax -- what does the future hold?

Perhaps I should start with a note of caution. Maybe with a reference to something provocatively known as Murphy's Law. With a name like mine I am familiar with this, but just in case you are not, a succinct summary might be "if it can go wrong it will go wrong". Of course, that might be an accurate description of all I forecast, but it also seems an apt description of all attempts to reform corporation tax in the last decade or so.

I am struggling to think of a successful corporation tax initiative in that period, but the list of the problems is almost endless. We started with the reform of advance corporation tax, struggled to comply with the requirements of the European Union, have had ongoing problems with foreign profits, have seen rate falls which have appeared to please no one, saw the absurd 0% starting rate for small businesses, then its repeal and now the increase in the small-business rate, which again has pleased no one, the attack

on income shifting which is at present in limbo, IR35 which is now back on the agenda, and no doubt everyone present can add some more to the list. It's not a pretty picture but it does make this a good time to talk about the future of corporation tax.

So let me set out my stall in advance: I believe very strongly that companies must be taxed on the basis of a broad, clear and unambiguous tax base. I also believe that is possible if we're ambitious and that is what I'm going to talk about.

So let me also be clear: this will not happen without a radical review of our corporation tax system. The reason why all attempts to reform corporation tax have failed is easy to explain: the system is broken, and no amount of tinkering will get round that fact. We have to go back to basics to work out where to go from here. Piecemeal reform is not going to work.

Before going further though let me mention one reform that I think unacceptable and which will not, in my opinion, ever work. I am aware that the Institute for Fiscal Studies has published a recent report suggesting the abolition of corporation tax in its entirety and its replacement by VAT. I have three objections to this proposal.

First, the burden of tax on ordinary people in this country is already high. This proposal would increase the VAT rate in the UK to more than 28%, and might require that it be charged on food as well. This would make the UK tax system massively more

regressive than it already is, significantly encourage tax evasion and the cash economy, and increase the gap between rich and poor with resulting harm for everyone in the UK. As such I can see no chance that any politician will do this.

Second, when the International Accounting Standards Board is now recommending the adoption of the entity perspective for corporate accounting which recognises that companies are quite distinct from their members I can see no reason for accepting this recommendation that corporation tax be abolished, which is based on the idea that companies are mere extensions of their shareholders. Only one of these opinions can be right. With all due respect to any economists present, I think we accountants are nearer the truth on this one, and corporation tax should survive. The accountant's entity perspective is right, the economists are wrong.

Third, we've seen some extraordinary events in the last week or so, with the biggest nationalisation in history. But as this proves, we are all dependent upon government. If that is the case there is a clear and unambiguous duty on corporations to pay tax for they too, indeed they especially, are enjoying the protection the state right now.

So, if we're going to have this tax, but it doesn't work in its current form I think it's important to go right back to the basics of taxation if we're to have a clear picture of what the future should hold.

There are five reasons for taxation. The first and most obvious is to raise revenue. The other four reasons also conveniently start with the letter R. The second reason to tax is to re-price goods and services for social reasons, the third to redistribute income and wealth, the fourth to raise representation because tax is the consideration in the democratic relationship between people and their government; and finally tax is used to reorganise the economy, which for those old enough to remember it is good old fiscal policy of the Keynesian variety.

Now, I'll be honest: having rejected the replacement of corporation tax with VAT I can see little role for corporation tax in the repricing of goods and services because this is an indirect tax issue.

I will also be quite clear: without a doubt the primary purpose of corporation tax is to raise revenue, a point to which I will return soon. But what I do want to make clear now is that we cannot ignore corporation tax's role in redistribution, the democratic process or in fiscal policy. Anyone who does forgets why we got the tax in the first place.

Not many of us will remember the introduction of corporation tax. That happened in 1965 and whilst this lecture is meant to be forward-looking and is not a history lesson I do think it's important to remind ourselves of the assumptions that

underpinned corporation tax when it was introduced, and of what was hoped for it.

I would suggest the assumptions on which the tax was based were:

- 1) That the corporate entity is taxed, and the group of which it is a member is (largely) ignored;
- 2) That legal form has priority over economic substance;
- 3) That accounting profits are a reliable basis for taxation;
- 4) The management and ownership of companies are clearly distinguishable;
- 5) That corporate taxation can be nationally based because the movement of capital is undesirable and should be controlled;
- 6) Sufficient information will be available on which to calculate the appropriate taxation charge.

Well I remind you: those assumptions were made in 1965 and this is 2008. The trouble is that despite the enormous changes that have taken place in both political philosophy and the commercial world since 1965 the structure of corporation tax has not changed much over the years.

The sheer number of companies has changed considerably. Companies incorporated in 1965 had numbers beginning 800,000. In 2008 they have numbers beginning 6,600,000. OK, more than 4 million have disappeared over that time, but the scope of the tax has changed enormously.

Groups also contain many more companies now. New companies are formed at the drop of a hat. To consider each as distinct and separate from its parent and associates now makes no sense.

Vast numbers of companies are foreign owned, have foreign subsidiaries or have foreign associates.

It's now assumed that the free flow of capital is a good thing and to be encouraged, even if I'm not so sure that it's always of benefit.

Globalisation has happened. That has meant that the national basis for taxation is harder to define, whilst the assumption that the information needed to calculate profits on that national basis is looking precarious, to say the least.

And let's also remember that in 1965 we hadn't heard of accounting standards in the UK. Now we have International Financial Reporting Standards. Many of us wonder, at least in quiet moments, whether we know much more as a consequence

but what we can be sure of is that the remove between accounting and taxation profit has widened as a result.

Substance is now known to take precedence over form in accounting, and in the case of group accounts it's fair to say that substance is just about all there is.

Perhaps most of all though, we've seen an explosion in the number of small companies in use in the UK. Of course Fred Smith and Sons Limited (and, more occasionally, daughters) existed in 1965. But the casualisation of the professional labour markets, the rise in contracting and the explosion of consultancy have, more than anything, transformed demand for companies. They're still not commonplace with artisans: the painter and decorator does without one now just as he or she did in 1965. But for the person with a laptop a company is now the essential designer accessory.

The trouble is that this shatters another of the 1965 assumptions: when one person is director, sole employee, and sole shareholder of a company is it really reasonable to think that the corporate veil has any meaning for tax? Or that their affairs and those of the company can be clearly distinguished?

Of course each of these points is an abstraction, a simplification of the developments that have taken place, but by now I think you get my drift. If the 1965 assumptions were a business model on which corporation tax was built they no longer hold true, but

the same old model of tax is still being flogged into the market. It's as if Ford were still selling the Cortina, albeit Mark 3, when Ford has actually been through the Sierra and more versions of the Mondeo and than I care to remember since then.

I reiterate my point as a result: I know we're having discussions within the chattering tax classes right now on a wide range of issues with regard to corporation tax, from how to make it fit the small business model to solving the problem of taxing international groups but my message is that all this talk is missing the point. Tinkering at the edges won't do. Fundamental reform is required if the government is serious about achieving its objectives for this tax.

So let's remind ourselves what those objectives might be. First, it does want to raise revenue. No tax is more vulnerable to swings in the business cycle than corporation tax, but in 2007/08 the government collected £46 million from this tax, which was just over 10% of total HM Revenue & Customs income. That's up from £29 million and 9% in 2002/03, by the way.

No government is going to readily give this up. In practice they can't. There are three reasons why this is the case. First, corporation tax, like capital gains tax, is an essential back stop in the tax system. A wicket keeper if you like. Of course income tax is the main revenue collector: it collected more than three times the amount of corporation tax in 2007/08, but without corporation tax the income tax yield would fall substantially. If

you have any doubt about the truth of this look at the desperate measures that Jersey and the Isle of Man are taking to preserve the integrity of their income-tax systems in the face of introducing 0% corporation tax rates and then appreciate that we cannot ever go in that direction. In some ways it's completely fair to see the whole of corporation tax as an anti-avoidance measure.

Second, within what all political parties would wish to appear to be a progressive tax system the government has a duty to make corporate taxes appear to fit the model that the wealthiest pay more. It's why the tax has been charged at two rates for a considerable period, even though my work has shown that as large corporations now probably pay at less than 22% on average and small companies are heading towards paying at more than this on average, this consensus appears to be failing. This is a danger signal for this and any government and a partial reason for the recommendations I will make.

Third the tax collects revenue the government can get its hands on in no other way. The profits of foreign owned entities trading in the UK are captured at source by this tax. The profits remitted by corporations from overseas where lower rates than those payable in the UK have been settled are captured on a residence basis. It's been a jack of all trades. That's its virtue.

It's also its weakness. I don't see how this can continue. I'll put these questions to you:

- 1) Is it really possible to tax small and large companies using one regime when their behaviour is fundamentally different?
- 2) Is it really possible to tax groups as if they don't exist when very obviously that's the basis on which companies make their decisions?
- 3) Is it really possible to use concepts such as legal form and residence to tax when looking at the tax affairs of multinational companies?
- 4) Can we sustain the argument that corporation tax is progressive, and so keep an electorate who still think, by a large majority, that this quality is desirable when the range of incomes covered by corporation tax is so diverse that the term has little objective meaning?
- 5) Can we use a tax mainly paid by companies in the UK as a tool for use in international competition, whatever that is?

I could ask more questions, but my answer to each is “no”.

In that case let me summarise the argument I have been putting to you in one simple sentence. There is no future for corporation tax, at least, not as we now know it.

I'm sorry to say though for those who are already feeling fidgety that I've not finished yet. Nor does it mean that I do in any way agree with the Institute for Fiscal Studies. I'll remind you that I said right at the beginning that I believe very strongly that companies must be taxed. But I never said I thought one tax need fit all companies. So let me come to my main argument of this talk: I do think there's no future for corporation tax, but I do think there's a need for two taxes on corporate income in the future.

There are two natural divides in the UK corporate world: they're large and small and national and multinational. Small and national do not exactly overlap, I know. Nor do large and multinational, I also know. But the world of tax is imperfect and if two taxes will better suit our need in the future, as I'm sure is true, then the line has to be drawn somewhere. Large and small is the best split, I think, the international dimension will be shown to fit into both. So let me share a vision of what I really think we should be doing if we were to build a Mondeo generation tax on corporate profits: a Mondeo Mk 4 tax come to that.

Let me begin with the more important of the two new taxes: that's the one on smaller enterprises. It's more important for three reasons. First more companies are subject to it, second more accountants deal with it and that therefore is of importance for this audience and third this sector is in one heck of a mess.

What is a small company? I know we have a definition in company law, but here we're talking tax, and even so you'll have to excuse me if I skip some of the detail. So let me be bold: I think a small company is, by default, not a PLC, is not owned by a UK based large company and has fewer than ten full time equivalent employees. In addition it's any non PLC that opts to be small.

For these companies I want to make the world a whole lot simpler than it is now. My suggestion is this: I think the profits of the companies should be taxed as if they belong to their shareholders. What is more, I would like the company to designate how that profit is to be shared between the shareholders, with the right to vary it from year to year, just as a partnership can, subject always to a few anti-avoidance measures. The model is, of course, remarkably similar to that we already have in the form of a limited liability partnership.

Let's look at what we could sweep away as a result: all director's PAYE, all benefit's in kind (there will be disallowance in the tax comp instead), all employer's and employees NIC (although Class 4 would apply), all dividend calculations and paper work, all restrictions on director's loans (subject to the need to keep the company solvent), and a great deal of the hassle to do with income shifting. Just imagine the cheer from the Federation for Small Business, the Professional Contractor's Group, the IoD and the CBI for the Chancellor who delivered all that! Think about

the groans from the profession. The loss of business doesn't bear thinking about.

But there is a price of course. I don't believe in free lunches. Shareholders would have to be allocated to three groups: the non-working, the non-executive participants and the executive participants. There would be rules: they'd be backed by targeted anti-avoidance provisions based on common sense. A Commissioner's decision would be final in the event of dispute.

A non-working shareholder could receive a return on their capital. The percentage allowed might be much higher than that paid on a bank account; small business is risky, as we all know, but I'll be honest, the return will still be modest in most cases except for one additional twist. Capital should, I suggest, include the value of assets made available to the business to secure its borrowings. In that way the spouse who lets their home be used for loan security can be paid a return for doing so.

The non-executive director will be allowed a formula based return, subject to a ceiling. No one can dispute non-execs add value to a company. I strongly believe that to be the case. And they should be paid as a result. But we all know they don't get the same pay as execs, and nor should they. I suggest they share 10% of turnover to a ceiling of £20,000 between them. After that the company should make its case based on contribution made. And don't tell me that a contribution to executive activity can't be monitored: just look at the email log or ask the employees.

As for the executives: they can split the income just how they wish.

All of which sounds great, but how is the tax paid? Well, the company would still have to compute its profits. And income tax at basic rate will be paid at source by the company: no ifs or buts, and that captures the non-residents as well. The source basis is alive and well, albeit that a resident person could reclaim the tax paid by the company if it exceeded their eventual personal liability under income-tax rules.

Then having done this the company has two choices: it can tell the Revenue who has shared the income, provide names, addresses, tax codes, NIC numbers or corporate names and that's it, the liability for any higher rate tax then moves to the recipient. If they either can't name the recipient, or if that recipient is a corporation or trust in a location where nominee ownership is commonplace (and let's be clear: we're talking tax havens including the likes of Delaware here) then tax withholding kicks in instead at 35% - the future EU Savings Tax Directive Rate, and the company is liable for this.

I stress: this is EU Code of Conduct compatible because it is the company that makes this choice. Deducting tax at source is also acceptable so long as it applies to everyone, resident or not, and the human rights issue that is inherent in the tax legislation of this sort in the Isle of Man and Jersey is overcome because no

one will have a tax liability without having received the right to income to pay it.

For the company and most taxpayers the arrangement will need be no more onerous than being a member of an LLP, and most small business taxation issues are resolved, with massive simplification and international compatibility thrown in at the same time. I offer the solution for one reason: I genuinely think it's a winner.

But what of the future for the large company, whether that be a private company with a reasonable number of employees who wants to retain profit to finance reinvestment or the multinational corporation? For them this form of “look through” taxation is going to be impossible. The owners will not be known, they'll change many times a year, and the owners are genuinely removed from the management in a great many cases. So let's be clear, these companies are still going to be in a corporation tax regime. The problem is what we have does not work.

And I'll be honest, whilst I've worked through the ideas I've outlined for small business in some detail on my blog, and have had a motion in their favour tabled in parliament, which the Chartered Institute of Tax saw fit to support, my options for big business are at an earlier stage of development. You might call them a work in progress or a contribution to debate. The important point is this though: the issues I'll refer to are the ones

I think we should be discussing. The agenda for debate that the Treasury is promoting is far too narrow right now.

So what I'll do is offer some provocative starters and maybe those who follow would like to take the issues forward.

My first suggestion for a future corporation tax is this: that it is the group that must be taxed. The biggest issues in big business taxation these days are, I suggest, first transfer pricing, second the remittance of profits and third the international treatment of losses. None are relevant if you have one company working in one country: they all reflect the complexity of international groups and the difficulty of allocating group profit (which is what is of real interest to the entity) into individual companies that are nationally located. So any solution to corporation tax has to recognise that earnings are group based and earned internationally.

Second, I'm going to suggest to you that it's now nigh on impossible to relate profit as reported under IFRS to profit as tax authorities want to understand it. If there's one thing fair value accounting is not about it's forming the basis of a tax computation. It can't be: corporation tax is charged on trading results and fair value reports movement in net worth. They're not the same thing. So let me be clear: the days of basing tax liabilities on the reported profits of larger companies are numbered. Something is going to have to take its place.

My third suggestion is that what will take the place of profit for calculating tax is what I might call 'modified funds flow'. At the end of the day cash is king, and it's cash that governments want from companies. I'm not for a minute saying the definition of funds flow is going to be easy: funds are not, as we all know, the same as cash. Some funds are expended for purposes that are not deductible. Funds are used to finance capital spending. 100% first year allowances may not be on the agenda for large companies. And we all know that fund flows can be distorted by provisions, although I have to say that I really do think that, subject to anti-avoidance arrangements provisions are something that tax now needs to live with, having accepted that in larger companies shareholders expectations may impose reasonable restraint upon their excessive use. What will not feature are fair value movements: I see no reason for them doing so.

Now let me offer my fourth suggestion: once calculated a group's 'modified funds flow' will be allocated to national tax bases using a formula based approach. The formula will be broadly that tried and tested in the USA. This would (broadly speaking) allocate profits to a location on the basis of where sales less intra group purchases occur, a labour formula mixing both numbers and remuneration paid in a place and where the fixed capital asset establishment is. The advantage is simple: this allocates taxable profits to the location where their economic substance is likely to have arisen.

Is such a formula perfect? No: of course it's not. But let's be clear, it's better than what we have now when we all know that profit is in effect allocated by negotiation of transfer prices to achieve much the same result. Why in that case can't we be explicit about what we're doing and establish international binding arbitration between states who want to dispute formulas between them and so claim more than 100% of a companies modified fund's flow?

What's the result? Well, for the wholly UK based large company or group I have to admit it's something that will look very much like corporation tax as we know it except that they'll submit one return for the group as a whole and how they allocate it between group members will be up to them. But they're not the real focus of concern, and we all know that. The problem is with the complex multinational, both because of the complexity of what they do and the games they play whilst doing it.

My suggestion does several things for them. First it suggests what I hope will be a more robust method of defining taxable income. Second it says this need only be done once, albeit for the group as a whole (although items such as funds expended on equipment may need national apportionment). Third it will encourage the better reporting of national accounting data, albeit restricted in essence to sales, intra-group transactions, labour data and fixed capital costs, and finally it pushes the onus for resolving international disputes onto the territories who seek to claim more than 100% of income as their own rather than onto the

companies themselves. I know quite a lot of international tax directors who would welcome that. There is opportunity for the UK to pioneer change in this area. We are, after all, one of the biggest financial centres in the world.

So, what else needs attention? First of all tax rates need to be addressed. I have, of course, already done that for smaller companies. They will be tax transparent. As a result they will only pay tax at the marginal income-tax rate of their shareholders, or at income tax basic rate if there is a declared non resident member, or at EU Savings Tax Directive withholding rate if there is a non declared, non resident member. It really is that simple.

It will also be simple for larger companies. Since the amount of tax allocated to the UK may well rise there is no reason for tax rates to increase. However, there is a political imperative that the rate remains significantly above the basic rate of income tax if the ordinary taxpayer is to believe that the system is progressive. Anything much less than the 28% now in operation could not achieve this outcome and as such is to be resisted by any wise politician.

Then there is competitiveness to consider. What I recommend resolves this through the use of transparency. A formula approach is designed to align economic and taxable profits. If money is not made in the UK it should not be taxed in the UK under formula apportionment. If it is made here it should be

taxed here. This creates real opportunity for economic management of the economy. We stop playing games with the tax base and can use the tax rate either for fiscal policy or to attract business, and maybe both. Right now the attractions are very obvious.

So might these ideas work? Let me return to the 1965 assumptions that underpin corporation tax and see how I've changed them.

First I said that it was assumed that the corporate entity is taxed, and the group of which it is a member is (largely) ignored: I have reversed this assumption for larger entities, and for smaller ones have fundamentally changed the rules.

Second I noted it was assumed that legal form has priority over economic substance: again, for the larger entities that cause concern in this area I have reversed the assumption. It is substance, not form, that I would tax.

Third, I challenge the assumption that accounting profits are now a reliable basis for taxation. They aren't, and I recognise that fact.

Fourth, since we all know that in smaller companies the management and ownership are usually indistinguishable I have recognised that reality.

Next, I use a formula basis to deal with international issues because that recognises that in a global world capital moves to where the best rate of returns are to be enjoyed: but it also recognises that tax should be paid where that return is made, and not somewhere else;

Finally because it has become glaringly obvious that sufficient information will never be available on which to calculate the appropriate taxation charge under current rules, including those that relate to transfer pricing, I suggest something radical in their place.

I suggest as a result that I'm using appropriate assumptions for 2008: that alone is a massive step forward.

Is all this possible? That's a good question. We all know California tried and lost at this game, but that was more than twenty years ago. The European CCCTB is a move in this direction: not a perfect move and one that's on the backburner right now, but a certain move all the same. And the UK's not alone in facing a crisis in the management of its tax revenues: many countries are, and the degree of their cooperation in doing so is rising fast. The change that I suggest is radical, and may require international cooperation, but nothing is off the agenda right now.

And remember: I was asked to look at the future of corporation tax. The fact that what I predict won't happen tomorrow is not the point. We live in a global world. We do have global

companies. We do have global tax issues. And we have an enormous number of small entities. This is the reality of 2008. We're no longer in 1965. I expect some will hold out for the Cortina version of corporation tax for a while longer, but that model is past its use by date and in a world where the credit crunch is making almost all financial reform more likely I'll offer this final thought. My vision of the future is wrong because I'm not clairvoyant, but I think it may be not far from what happens.

Ladies and gentlemen: AIA members, thank you for your attention. May we all move into the future of corporation tax with confidence.