Lowering Northern Ireland's Corporation Tax:

Pot of Gold OR Fool's Gold?

By Richard Murphy

SPECIAL REPORT

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Preface

We live in an era of tremendous social and economic change and opportunity, with the economic crisis effecting every home, office and business. Times like this should inspire new and original thought about how we can craft an economy which serves society, rather than the other way around. Unfortunately, powerful and vested interests in Northern Ireland seem stuck in a groove, like a scratched vinyl record. Their solution to the underperformance of the Northern Ireland economy is simple – cut Corporation Tax and investment will flow into our private sector and this will remove our dependence upon the public sector.

This is a blunderbuss approach to a complex matter. Congress has argued for many years that this is too simple. It does not take into account many of the underlying problems with the balance of our economy, such as the fact that the public sector is not too large, rather it is the private sector which is too small, and is largely comprised of small businesses, most of which pay the lower rate of Corporation Tax, and would benefit little from cutting it.

There are fewer than ten PLCs in NI, ten firms account for over 50% of NI exports and the region has the second-lowest level of business formation in the UK . Most private sector economic activity is carried out by companies that pay the reduced rate of Corporation Tax. Only 4% of NI companies pay the full rate, although this sector dominated the Industrial Task Force, which commissioned the 2006 'independent study' that found, among other claims that 180,000 new jobs "could" be created by 2030 and that growth "could" be doubled. This analysis is also based on a profound misreading of the economy of the Republic of Ireland, an analysis which was flawed in 2006 and is largely irrelevant now.

The case for cutting Corporation Tax was demolished by the Varney report of 2007, and yet the same individuals returned with largely the same pitch in early 2010, this time under the guise of a think-tank called the Economic Reform Group Northern Ireland. The ERGNI argument is debunked in this report by Richard Murphy of Tax Research UK, one of the most important thinkers on this subject. This report, commissioned by the ICTU and the TUC, forms the basis for our joint submission to the House of Commons Northern Ireland Select Committee's inquiry into the economy of Northern Ireland.
We are publishing it here for distribution to politicians, opinion formers and 'ordinary' citizens to read an argument which is shamefully underreported here.

This is an important debate, and there are two sides to it. As you read this side of the debate, we think you will agree with us that new and original thought is more necessary than ever to achieve our shared goal of a prosperous Northern Ireland.

Peter Bunting
ICTU Assistant General Secretary

Summary

A suggestion that Northern Ireland should reduce its corporation tax rate to 12.5% to match that of the Republic of Ireland has won widespread support in Northern Ireland. The Coalition Government has promised a review of this issue and it is expected that parliamentary hearings on the proposal will take place in both Stormont and Westminster during the autumn of 2010.

The proposal has strong support amongst the political parties of Northern Ireland. They have based that support on ideas emanating from the Belfast offices of the Big 4 firms of accountants, local academics, local big businesses and from right wing campaign groups who support low tax rates in general, such as the Taxpayer's Alliance.

This paper considers three issues. The first is the claim made that Northern Ireland could compete with the Republic of Ireland to attract foreign direct investment if it cut its tax rate to 12.5%. The second is the belief that Northern Ireland could legally cut its tax rate independently from the UK. The third is the idea that it would be economically advantaged by doing so. In each case this paper finds the claims made to not just be weak, but likely to be fundamentally wrong.

The idea that the Republic of Ireland simply uses a low tax rate to attract foreign direct investment is shown to be one of the many myths that contribute to the cult of the Celtic Tiger. That rate is undoubtedly totemic, but low tax is a much more complex matter than just offering low rates. The Republic also has no controlled foreign company laws or thin capitalisation rules, a relaxed approach to the taxing of foreign dividends and to transfer pricing regulation, relatively easily achieved corporate secrecy and (perhaps crucially) membership of the Euro to add to its appeal.

Northern Ireland will not be able to match any of these arrangements meaning that, as this report concludes, tax collected in Northern Ireland will always be higher than tax collected in the Republic of Ireland on identical commercial operations even if the tax rate is equalised. Indeed, if, as is the case for many companies the Republic actually offers the chance to pay almost no tax at all then no tax rate that Northern Ireland can now offer can out-do the offering that the Republic currently makes available. Put another way, Northern Ireland cannot compete with the Republic of Ireland on tax and win.

As this report shows the assumption that Northern Ireland can legally reduce its tax rate to 12.5% may well also be wrong. Although this reduction appears to be theoretically possible within the laws of the European Union, the

obstacles to doing so are enormous. For example, the very fact that a new law to let it happen will be required at Westminster may in itself be a complete legal obstacle to such a reduction being acceptable to the EU.

Even if that could be overcome it also seems likely that Westminster would have to agree to Northern Ireland having its own independent tax authority, quite distinct from HM Revenue & Customs. The likelihood of that being agreed is remote.

Finally, even if these problems with the EU could be overcome, the reduced rate of tax could not be applied to finance and intra-group service companies under EU laws and these are the very companies to which the Republic is most attractive, even if they bring it remarkably little in the way of new net investment or employment now, as the report also shows.

Then there are economic objections to the proposal. First amongst these are the enormous obstacles that would be placed in the way of trade between the UK and Northern Ireland because much of it would then be subject to cumbersome and costly transfer pricing rules to prevent tax leakage from the rest of the UK. The second economic problem would be that Northern Ireland would lose at least £200 million a year in subsidies from the Westminster government as a result of adopting this proposal, and maybe rather more. At a time when Northern Ireland is already likely to suffer above average cuts in government spending this appears a pressure too far for the economy of the Province.

The conclusion is obvious: whatever Northern Ireland's pressing needs (and they are considerable) they cannot be met by reducing its corporation tax rate to 12.5%. Far from solving its problems such a tax rate could only increase the isolation, uncertainty and cost of trading from Northern Ireland.

1. Introduction

The Republic of Ireland has had low corporate tax rates since 1957. From 1981 until 2003 it offered a 10% rate to manufacturing companies and companies located in the Shannon Free Zone and Irish Financial Services Centre in Dublin Docks. When that tax rate was ruled unacceptable by the EU it was replaced by a tax rate of 12.5% generally available to all Irish resident companies, wherever they are and almost whatever they do.

Amongst the many myths that have contributed to the tale of the 'Celtic Tiger' the supposedly mystical power of these low tax rates to attract business to Irish shores has been a powerful narrative that has lured many with its apparent simplicity.

The politicians of all the main political parties in Northern Ireland have now been attracted by the power of this myth[i]. Seemingly at their behest the Conservatives included a promise in their 2010 election manifesto that if elected to office they would establish an inquiry into the future corporation tax rate in Northern Ireland[ii].

In June 2010, following George Osborne's emergency budget, Northern Ireland Secretary Owen Paterson said[iii]:

"*Working closely with the Northern Ireland Executive, we will publish a consultation paper in the autumn. This will look at mechanisms for giving NI a different rate of corporation tax and other economic reform options."*

The consultation paper is expected to be published in the autumn of 2010[iv].

The Northern Ireland Affairs Committee at Westminster has also said it will hold an inquiry into the rate of corporation tax in Northern Ireland[v].

These are not the first such consultations. The previous Government considered such a measure in the Varney report published in 2007. The report concluded that a reduced rate of corporation tax for Northern Ireland would cost almost £300 million a year in lost tax receipts and could also displace existing businesses from the rest of the UK[vi]. For these reasons the proposal was rejected at the time.

In 2010 the political climate is different: the Coalition government is committed to cutting corporation tax for the UK as a whole. And for the first time there appears to be widespread political interest in establishing a separate corporation tax rate for Northern Ireland at Stormont.

2. The Republic's 12.5% tax rate

The Republic of Ireland has used low corporation tax rates as part of its strategy for encouraging foreign direct investment (FDI) into the country since 1981[vii], and in some earlier forms since 1957[viii].

The current Irish corporate tax rate of 12.5% is the second lowest in a mainstream European Union country – being beaten only by the 10% tax rates offered in Bulgaria and Cyprus, neither of which can be considered serious competitors to Ireland for international business.

The rate is, of course, notionally higher than that offered by many tax havens. The UK Crown Dependencies do, for example, offer international businesses that use their facilities tax rates of zero per cent for all but finance activity and ten per cent if they are engaged in the financial services sector. However, as this paper notes this difference may not be as serious as it seems: for many international businesses Ireland now offers an opportunity to set up wholly or largely tax free structures through which they can let their profits flow.

The Northern Ireland Economic Reform Group, which has campaigned for a lower tax rate, says in support of their case that[ix]:

"...as the Republic's Government acknowledges, Ireland's very competitive corporation tax regime played a crucial role in attracting such investors and it has made clear that, notwithstanding the current pressure on the public finances, this competitive advantage will be maintained. The transformation was such as to merit the description of 'economic miracle'.

"The story of how successive Irish governments transformed the country's tax system, turning Ireland into one of the world's best performing economies, has been extensively documented. But the evidence is so strong and convincing that it is worth recounting again, to show just what could be possible in Northern Ireland."

They also claim:

The real reason for the Republic's astonishing success has been a very low rate of corporation tax for most manufacturing sectors since the late 1950s. This attracted a large in-flow of investment in plant and machinery, much of it by US multi-nationals in high value-added sectors.

Unfortunately this ignores a number of key issues. The first is that the policy did not work from 1957 until 1994, after which the real growth in the Irish economy took off. This fact has been ignored by those who make claim for the miraculous impact of this policy, and yet it suggests that it cannot have been low tax rates by themselves which created the phenomena they wish to attribute it.

The second is that they undoubtedly underestimate the benefit of the long term investment in Ireland by the European Union which had to reach critical mass before any such growth could occur, such was the poor state of Irish infrastructure until the 1990s.

Third, they ignore, most importantly, some crucial further issues little mentioned in discussion of the Celtic Tiger phenomenon but which are key to the growth that occurred in Ireland. These are addressed next in this report. What consideration of these issues suggests is that whilst the 12.5% tax rate in Ireland has proved to be a remarkable marketing tool for Ireland (a fact this briefing does not dispute) it is unjustifiable to suggest that the supposed benefits flowing from that tax rate can be replicated in Northern Ireland.

3. The real key to the Republic's success and why Northern Ireland can't beat it

The real reasons for the Republic's apparent economic success from the mid 1990s until 2008 are substantially more complex than any of the reasons given by those promoting a low corporate tax rate for Northern Ireland. This paper argues that the following have been critical to this process:

a. The role of the International Financial Services Centre;
b. Membership of the Eurozone;
c. Irish rules on the taxation of subsidiary companies;
d. Irish rules on the taxation of dividends;
e. Irish rules on 'thin capitalisation';
f. The availability of corporate secrecy in Ireland;
g. Irish legislation's willingness to turn a 'blind eye'.

These are explored, albeit briefly, in turn in the rest of this section before conclusions are drawn.

a. The role of the International Financial Services Centre

The work of Jim Stewart at Trinity College Dublin has revealed the importance of the IFSC to inward investment in Ireland. As he argued in 2008[x]:

Total foreign direct investment reached a peak in 2003 and has since fallen. Total foreign investment in the IFSC continues to rise and in 2006 is roughly 14 times the size of foreign direct investment, [as this table shows]:

The growth of the IFSC in Dublin: Total foreign Investment in Ireland € millions

	2003	2004	2005	2006
Direct investment	176,435	152,446	138,626	118,900
Portfolio investment	542,200	720,952	1,025,902	1,224,126
Other	389,807	443,796	556,906	670,968
Total	1,108,442	1,317,194	1,721,434	2,013,994
IFSC part	813,336	975,357	1,300,223	1,562,750
IFSC %	73.3%	74.0%	75.5%	77.6%
Direct investment %	15.9%	11.6%	8.0%	5.9%

Direct investment is, of course, that which gives rise to manufacturing and other employment. This was fading rapidly long before the financial crisis of 2008 hit Ireland.

Portfolio investment and, in this case 'other' investment, is investment in the financial assets of banks and related financial services activities. As the data shows this was largely due to the IFSC.

As is also apparent from this data, Ireland's attraction to very much foreign direct investment bar financial capital was rapidly diminishing after 2003 in absolute and proportionate terms.

The consequence has been that the low tax policy has not delivered sustained employment opportunities: many companies such as Dell has already closed major facilities in Ireland[xi]. 40,000 people left Ireland because of a lack of work in 2009 and this rate is expected to rise[xii].

Other companies such as Waterford Wedgewood[xiii] have failed, and their production, under new owners, moved to cheaper locations[xiv] whilst as Jim Stewart has also shown, the median number of employees engaged in an IFSC subsidiary of a foreign multinational corporation was from 1999 to 2003 an astonishing zero! In other words, many of these operations were brass plate activities of a pure tax haven nature run by local lawyers and accountants but otherwise generating no employment at all in the Irish economy. The corporation tax policy is not now attracting new employment: it is now in the main hot money seeking an opportunity for low or no tax which creates no employment on its passage through a Dublin bank account.

A report in the Irish Times[xv], quoting Irish Revenue Commissioners internal briefings has confirmed this. As the Irish Times noted in September 2010:

About 20 multinational companies have relocated their corporate headquarters to Ireland over the past year because they are able to pay "little or no tax" here, according to the Revenue Commissioners.

They added:

The firms, which are mostly US- and UK-owned, have been moving their main holding companies away from places like Bermuda and the Cayman Islands because of plans by a number of governments to clamp down on tax havens. The very limited amount of tax paid by some of these firms indicates they do not have any meaningful presence here in terms of investment or jobs.

This is hardly encouraging for anyone proposing to replicate such a regime in Northern Ireland, and in any event there is no chance that Belfast could host the next International Financial Services Centre. London already fulfils that role for the UK. But the reality is that in that case nor will Northern Ireland attract the foreign direct investment it dreams of, or the new jobs for anyone but lawyers and accountants that go with it, by offering a low tax rate.

On the other hand, having noted these facts it is all too obvious why accountants are so keen to promote low taxes for Northern Ireland. They are now amongst the few to be benefiting from them in the Republic – a point they fail to mention in their report arguing for low rates in Northern Ireland.

b. Membership of the Eurozone

If Ireland is not now the home of foreign direct investment that it once was it has become something else instead, and that is to be the conduit for foreign direct investment that moves on to elsewhere.

This is especially true of funds from the USA – for whom as the OECD has said[xvi]:

Membership of the European Union, including monetary union and the single market, was crucial in making Ireland a gateway to the single European market.

Of course this does not explain all that happened by itself, but the importance of the being in the EU and the Euro cannot be understated in the case of Ireland.

Ireland's recent role in foreign direct investment activity is explained in this table[xvii]:

Table 1. Developed countries: FDI flows of selected countries, 2009-2010, by quarter (millions of dollars)

	FDI inflows					FDI outflows				
	2009:Q1	2009:Q2	2009:Q3	2009:Q4	2010:Q1	2009:Q1	2009:Q2	2009:Q3	2009:Q4	2010:Q1
Australia	3 471	3 610	7 735	6 775	5 199	6 118	3 684	3 940	4 470	574
Austria	2 474	877	3 408	228	5 814	2 938	- 4 031	3 387	2 584	2 584
Belgium	- 13 104	29 382	8 028	9 781	8 775	- 3 544	5 357	- 11 746	- 9 677	1 188
Canada	- 418	- 2 104	15 287	7 134	14 557	1 833	3 735	24 445	10 339	829
France	4 598	28 898	8 988	15 708	4 058	35 615	42 919	27 710	40 848	19 036
Germany	4 868	12 748	8 188	10 038	9 478	17 740	21 921	24 687	- 2 741	44 311
Iceland	- 128	122	124	- 214	86	148	- 382	858	733	- 74
Ireland	1 011	12 277	- 8 378	20 318	5 920	2 062	8 572	8 012	5 515	6 887
Italy	6 692	9 516	7 448	6 858	7 453	2 538	34 188	10 403	6 887	10 966
Japan	3 908	2 872	4 835	439	958	19 013	16 714	23 839	15 069	9 885
Netherlands	4 667	2 788	28 591	- 9 167	- 3 621	22 714	- 2 180	13 647	- 18 588	18 488
Norway	- 808	5 623	- 1 713	2 182	482	1 691	9 972	11 013	10 419	6 459
Sweden	17	7 788	3 908	- 1 083	2 107	3 178	7 081	16 939	3 772	6 686
Switzerland	5 944	1 844	2 258	- 757	- 4 294	6 593	4 118	6 082	- 642	282
United States	4 738	30 328	54 561	40 255	46 098	39 968	58 980	73 187	78 038	86 979

It will be noted that in five quarters in 2009/10 Ireland had inward investment of $31.1bn. Outward investment in that period was $31.0bn. In other words, Ireland is not the location in which foreign direct investment is taking place.

In this context being a member of the Euro is vital: much of the onward investment and the resulting flows of income that will consequentially flow back from Europe to the USA will all be Euro denominated. US corporations using Ireland as an entry point for their investments in Europe therefore reduce their foreign exchange risk considerably as a result, compared to locating those investments and sales in a sterling zone. The use of Northern Ireland would involve two foreign exchange risks. In Ireland there is only one. That would make Northern Ireland very unattractive by comparison as a result.

The same is also true to some extent of the distance selling operations that are now such a feature of the Irish economy. Companies such as Microsoft, Apple and Google use Ireland as a European (and sometimes worldwide) sales hub. These companies can do this because the value added in their sales comes from the sale of software, which can be downloaded or used at the point of sale but with that sale being recorded virtually at will wherever the multinational corporation wishes. Ireland's use of the Euro does, again, reduce foreign exchange risk for any multinational corporation using it in this way. Northern Ireland has no response to that competitive advantage.

c. Irish rules on the taxation of subsidiary companies

Understanding Ireland as a conduit for foreign direct investment rather than a destination for it is vital if its current economic function in the world economy is to be properly appraised.

When a country is used as a conduit for foreign direct investment then a company located in that place will have subsidiary companies located in other countries, by definition. For many European (and other) countries this creates a considerable tax challenge. They operate under what is called a 'residence basis' for taxation meaning that the worldwide income of any company resident in their country is subject to tax there even if the income arises somewhere else in the world. So, for example, a UK company with a branch in India will be taxed in the UK on the profit of that Indian branch, although any tax paid in India will be taken into account when calculating the UK liability so that double taxation does not take place.

In practice this rarely poses a major problem if the onward investment is into a country like India which operates a tax rate broadly equivalent to that of the country in which the parent operation (the UK in this case) is located. But it can give rise to considerable problems when subsidiary companies are located in low tax locations, such as tax havens, which is increasingly commonplace.

In many cases, the intellectual property of companies (e.g. the patents of pharmaceutical companies and the registered trademarks of major brands) are registered in tax havens with royalty income then being paid to those subsidiary companies. This then gives rise to dispute in countries such as the UK as to where the income of the tax haven subsidiary really arose – with the UK tax authorities frequently trying to argue that at least part of that income should be taxed in the UK even though it is recorded in a tax haven. To allow the tax authorities to charge such tax, the UK and many other countries have what is called 'controlled foreign company' (CFC) legislation that lets them deem a tax haven subsidiary of a parent company to be resident for tax purposes in the UK.

As an Irish firm of accountants has said on its web site when explaining why the Republic of Ireland is so attractive as a location for FDI[xvii]:

Approximately 26 OECD countries currently have controlled foreign companies regulations. These rules seek to tax companies on the passive income *(e.g. royalties, rents, interest etc) earned by foreign companies they control, where those companies are located in tax haven countries.*

Ireland does not have controlled foreign companies regulations and therefore an Irish holding company will not be taxed on the imputed income of a foreign subsidiary, even if that subsidiary is located in a tax haven.

The decision by Ireland not to have CFC legislation cannot be chance: it must be deliberately designed to attract FDI. And it does. There can be no doubt that this form of tax relief adds immensely to the attraction of Ireland to tax minimising IT and pharmaceutical companies in particular.

There is little doubt that Northern Ireland could not replicate this exemption for itself within the UK tax system. As such it could not offer this enormous advantage to companies seeking to undertake foreign direct investment that the Republic can offer. Given that foreign direct investment conduit business now represents almost all the foreign direct investment the Republic receives the attraction of Northern Ireland in comparison might be very small indeed.

d. Irish rules on the taxation of dividends

The rules on controlled foreign companies are not the only special exemptions from normal international taxation arrangements that Ireland has to offer companies using it as a conduit for foreign direct investment that Northern Ireland could not replicate. The next that it offers, and which the UK has not yet come near to replicating, is its lenient treatment of dividend income received from foreign subsidiaries.

In general dividends received by a parent company based in Ireland from its trading subsidiaries based in other locations are in principle in most cases subject to the standard Irish corporate tax rate of 12.5%. However, generous reliefs are available to ensure that little or no additional tax is usually paid so that tax already paid on the profits in another location cancel the tax due in Ireland in most cases, whether or not Ireland has a double tax agreement with that other location or not. The reality is that as a result in most cases dividends are not taxed on receipt by a parent company based in Ireland.

In particular, and quite unlike arrangements that operate in the UK, if tax at more than 12.5% is paid in one location from which dividends are received by an Irish parent company then the excess tax paid in, for example, the UK where a subsidiary may have paid tax at 28%, can be used to cancel tax due on the receipt of a dividend from another location where little or no tax may have been paid on the profits out of which another dividend received in Ireland was paid. This means that dividends from tax haven subsidiaries received by an Irish parent company can often be received tax free in Ireland.

There is no equivalent arrangement for tax on foreign dividends to be ‘pooled’ like this in UK law meaning that any dividends received by a Northern Ireland parent company from a tax haven subsidiary would be subject to additional tax on receipt meaning that any new tax regime in Northern Ireland would suffer a competitive disadvantage on this issue when compared to the arrangements in the Republic.

e. Irish rules on 'thin capitalisation'

So called 'thin capitalisation rules' are another area where Ireland has rules considerably more lax than those available in the UK.

Thin capitalisation is a complex issue, and basically refers to the way in which a foreign parent company structures the capital invested in a subsidiary located in another country. There is considerable advantage to a multinational corporation in subscribing for as little share capital as is possible in that foreign subsidiary and to financing as much of its activity as possible in that subsidiary through the making of intra-group loans to it.

These intra-group loans would be charged to interest at as high a rate as possible and be granted by other subsidiaries of the multinational corporation located in low or not tax jurisdictions. The result is that tax relief is given on interest payments that effectively strip profits out of the taxing jurisdictions with OECD average (or thereabouts) tax rates where parent companies or trading subsidiaries are located but the income is received tax free in the low or not tax jurisdiction, so achieving an overall tax saving for the multinational corporation. The UK and many other countries stop this abuse by using thin capitalisation rules which limit the amount of capital that can be provided by way of loans and requires that part of any subsidiary's capital be provided in shares. These rules would undoubtedly apply in Northern Ireland.

Ireland has no such rules[xix]. This has two consequences. The first is that Northern Ireland could not compete with Ireland on this issue and would, therefore, lose out to it again, even if it had a 12.5% tax rate. The second is that Ireland loses substantial tax revenues as a consequence of not having such a rule and seemingly is indifferent to doing so.

In combination the result is that once again Northern Ireland has no chance of replicating the appeal of the Republic of Ireland even if its tax rate is lowered.

f. The availability of corporate secrecy in Ireland

It is widely claimed that secrecy is a major attraction to any multinational corporation wishing to avoid tax. Some feel that secrecy is now so important to the tax avoidance industry that what are colloquially called tax havens are now defined by those who protest at their activities as secrecy jurisdictions[xx].

They define secrecy jurisdictions as places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. It is also argued that to facilitate its use, secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so.

The Irish Times argued in its reports on internal briefings of the Irish Revenue Commissioners in September 2010, some companies seem to treat the Republic of Ireland as a tax haven[xxi], or as that paper put it, “a flag of convenience”. The BBC reported in May 2009[xxii] on broadly similar lines:

Ireland and the Netherlands are two countries which could fall foul of President Obama's plan to crackdown on tax havens.

For many years, some of the best-known American companies in the world, including the software giant Microsoft have maintained large operations in European countries with low corporate tax rates.

The Seattle Times claimed there was good reason for this reporting in the same month[xxiii]:

Google would have had an effective tax rate of 45.2 percent instead of 27.8 percent last year if it hadn't been able to capitalize on lower rates overseas, according to the company's annual report. Without the lower foreign rates, Google's 2008 tax bill would have been $1.02 billion higher.

Work undertaken by Tax Research UK for the Sunday Times claimed Ireland was key to this saving of tax by Google, using some of the mechanisms noted above.

Work also undertaken by Tax Research UK, this time in association with the Wall Street Journal[xxiv] in 2005, argued that Microsoft achieved substantial tax savings by using Ireland as a major centre for its worldwide sales operations.

FinFacts in Ireland claimed that further use was then made of secrecy in Ireland noting in December 2007[xxv]:

US software giant Microsoft has taken steps to shield from the public, the value of Tax Haven transactions of two Irish-registered subsidiaries that have enabled it to save billions of dollars in US taxes.

The company applied to the Irish Companies Office on Monday to re-register its Round Island One and Flat Island Company subsidiaries as companies with unlimited liability. Unlimited companies have no obligation to file their accounts publicly. The two companies operate from the Dublin offices of corporate lawyers Matheson Ormsby Prentice.

In theory Northern Ireland might be able to offer the same opportunity – but there are restrictions on the circumstances under which an unlimited company in the UK can avoid filing accounts and whilst there are loopholes that can be exploited, these can be hard to use. Ireland offers the opportunity to avoid the filing of accounts for public inspection without any such fuss. It is unlikely that Northern Ireland can replicate this situation with any such ease and as such this is another reason why a low tax rate is unlikely to be nearly so advantageous for Northern Ireland as it is for the Republic.

g. Irish legislation's willingness to turn a 'blind eye'

If the whole of Ireland's economic strategy is based on having a low tax regime that is used to lure business into Ireland then it would make no sense at all for the Irish tax law to alienate those companies that the government has spent so much time and effort bringing into the country.

Evidence supports this idea. The low taxes actually paid by many companies in Ireland suggest that not only does Ireland not have the necessary arrangements (as described above) to capture much of the income of the subsidiaries of multinational corporations located in its domain, it might also have a light touch regime on issues such as transfer pricing.

A transfer pricing arrangement occurs whenever two or more businesses (whether corporations or not) which are owned or controlled directly or indirectly by the same person (whether a company or individual) trade with each other. The term transfer pricing is used because if the entities are owned in common they might not fix prices at a market rate but might instead fix them at a rate which achieves another purpose, such as tax saving.

If a transfer price between related companies can be shown to be the same as the market price then it is always acceptable for tax. What are not usually acceptable for tax purposes are transfer prices which increase the cost or reduce the sales value in states which charge higher tax rates and increase the sales value or reduce the costs in states with lower tax rates. These arrangements shift profits from high tax jurisdictions to low tax jurisdictions and unsurprisingly high tax jurisdictions are not keen on that.

If Ireland does take a relaxed view on this issue, especially with regard to the payment of royalties for the use of intellectual property to tax haven locations, then it reduces the profits available for taxation in Ireland but increases the potential flow of income through Ireland - which has always been its ultimate aim.

It is highly unlikely that the UK's HM Revenue & Customs would allow a similar relaxed view on transfer pricing to be taken in Northern Ireland, whatever tax rate applied in the Province, and as such this additional competitive advantage that the Republic enjoys could not be replicated in Northern Ireland. Nor can HM Revenue & Customs afford to take a relaxed view in Northern Ireland. The only regional data on the tax gap published by HM Revenue & Customs relates to duty evasion, where the evidence that evasion rates are higher in Northern Ireland than in the rest of the UK as a result of it having the UK's only land border is compelling[xxvi]. If, rather than turning a blind eye the tax service in Northern Ireland was provided with greater resources with the revenue those greater resources might bring in – estimated to be at least thirty times the cost of employing each investigator by the Association of Revenue and Customs, the senior staff trade union at HM Revenue & Customs, being thirty times the cost of employing a member of staff being returned to Northern Ireland then the resources to fund the necessary specific investment to reflate the Northern Ireland economy could be made available without any of the problems noted in this briefing arising.

h. Summary of this section

This section has explored issues that give the Republic a competitive advantage with regard to tax that they exploit to bring business to their country which it is highly unlikely that Northern Ireland could replicate.

The core issue is a simple one, expressed in a formula that explains how much tax is collected in any tax system, which is:

Tax collected = Tax rate x income subject to tax

The proposal that has been made to reduce the corporation tax rate for Northern Ireland to 12.5% concentrates solely on the tax rate element of this equation. The reality is that whilst this is the totem that attracts business to Ireland, the matters described in this section – many of which reduce the income subject to tax in Ireland - are at least as important to those companies that are seeking a location for their foreign direct investment. Northern Ireland cannot replicate these advantages for the reasons noted. As such tax collected in Northern Ireland will be higher than tax collected in the Republic of Ireland on identical operations.

As such two important conclusions can be drawn. The first is that it is wrong to claim that Ireland's growth has been solely dependent on its low tax rate. That is simply not true. Many other factors relating to tax and other issues have also been just as, if not more, important. Second, Northern Ireland cannot compete with the Republic by simply offering a 12.5% tax rate because that by itself will simply not be enough for it to create a level playing field within the island of Ireland.

A third important conclusion can then be drawn. If the Republic actually offers the chance to pay almost no tax at all then no tax rate that Northern Ireland can offer can out-do the offering that the Republic currently makes available. Put another way, Northern Ireland cannot compete with the Republic of Ireland on tax and win.

4. Consequences for Northern Ireland if it were to offer a 12.5% tax rate

For reasons made clear in the previous section, Northern Ireland cannot replicate the Republic of Ireland's tax offering to multinational corporations even if it had a 12.5% corporation tax rate. This reasoning, by itself should be sufficient to persuade those considering this issue not to pursue this course of action. Just in case it is not, there are additional, powerful reasons why such a policy would be a mistake for Northern Ireland. These are:

a. The EU's requirements will create considerable difficulties for Northern Ireland in achieving this objective;
b. The difficulty for Northern Ireland's companies wanting to trade with the UK will be considerable;
c. The cost of meeting the EU's requirements for this tax rate cannot be justified.

Other matters could be mentioned: the above three should, however, be sufficient to explain the near insurmountable obstacles such a policy will place in the path of economic growth for Northern Ireland.

a. The EU's requirements will make this a costly exercise for Northern Ireland

Northern Ireland can in principle, and subject to changes in the law, have a different tax rate from the rest of the UK. This was determined in 2006 in a case relating to a tax scheme in the Azores, which is, of course a part of Portugal. Those proposing a reduced tax rate for Northern Ireland have relied heavily on this decision in making their case[xxvi].

In so doing they have emphasised the fact that the EU has agreed differential tax rates are possible but they have ignored the fact that the obstacles to achieving this goal are considerable. The European Commission has said such rates could only be set if three conditions were met[xxvii]:

- The decision must have been taken by a regional or local authority which had, from a constitutional point of view, a political and administrative status separate from that of the central government;
- It must have been adopted without the central government being able to directly intervene as regards its content; and finally,
- The financial consequences of a reduction of the rate for undertakings in the region must not be offset by aid or subsidies from other regions or central government, the regional or local authority must assume the political and financial consequences of such a measure.

It is important to note that:

i. It is not clear if the first two conditions can be met in the case of Northern Ireland, especially given the history of devolved government in Northern Ireland and the capacity of the Westminster government to resume direct rule on occasion. To proceed without certainty on this issue would be rash in the extreme;

ii. It has been estimated that the third condition would give rise to a loss of revenue on the part of the Northern Ireland government of at least £300 million per annum, according to the Varney report of 2007[xxix].

There would seem to be significant obstacles to achieving these goals:

- If the UK parliament had to legislate to devolve taxing powers to Northern Ireland, then the UK parliament would seem to be explicitly engaged in a series of events to achieve a goal it had pre-ordained might happen. That would seem to contravene the EU's requirements that setting a rate of tax must be an independent action of an independent regional government, so removing any chance a lower tax rate in Northern Ireland might be considered legal for some time to come;
- It would seem that Northern Ireland would not just need the power to set its own tax rate, it would also seem to need its own separate and independent tax service to administer that tax to remain within European law. Administratively and politically there seems no prospect of the Westminster parliament devolving all tax authority including the power to assess and collect tax to Stormont and to do so would be prohibitively expensive anyway. As such there does, again, seem to be no prospect of such a tax being legal in Northern Ireland for this reason.

These issues appear to present massive obstacles to any progress on this matter.

There is, however, a further issue which those proposing a lower corporation tax rate for Northern Ireland have ignored. The 2006 decision[xxx] of the European Court of Justice that ruled that a region can establish a differential tax rate within a member state of the European Union also upheld a previous decision of the European Commission on this matter relating to the Azores, which was that such a reduced rate could not create a subsidy to business that applied to undertakings carrying out financial activities or supplying intra-group services .

This has an obvious impact if Northern Ireland wishes to cut its corporation tax rate to compete with the Republic of Ireland because, as the above analysis has shown, the vast majority of the activity the Republic now attracts as a result of its lower corporation tax rate is either financial services activity or of an intra-group nature. But quite specifically Northern Ireland cannot secure a benefit from attracting these businesses using a lower corporation tax rate under EU law. In that case it is hard to see what benefit might arise from that lower rate.

b. The difficulty for Northern Ireland's companies wanting to trade with the UK will be considerable

In addition to the fact that a 12.5% corporation tax rate in Northern Ireland may not achieve its desired objectives, may have limited scope and may not even be legally possible there are other difficulties that it would pose.

The issue of transfer pricing has been referred to above with regard to transactions between companies under common control. This was in the international context in which the matter usually has relevance, but it is important to note that in theory it has relevance to all transactions between companies under common control – including those within the same country. In practice this fact has largely been ignored because almost no tax consequence would arise from enforcing arms length internal transfer prices within any EU member state. This situation would, however, completely change if Northern Ireland were to have a different tax rate from the rest of the UK. In that case each and every item traded between Great Britain and Northern Ireland would need to be correctly priced in accordance with the arm's length transfer pricing principle.

No supermarket would ever again be able to transfer baked beans from its warehouse in Scotland to its supermarkets in Northern Ireland without having established a procedure to set an arm's length price for the transaction, which is no straightforward matter. The resulting cost for UK business would be considerable.

Ultimately this additional cost would have to be reflected in the cost of trading in Northern Ireland, and local prices in the Province. That some companies might then simply withdraw from trading in Northern Ireland would have to be considered a real possibility.

The impact on inflation in the Province should not be ignored. Nor should the additional administrative burden on all companies located in the Province and trading into the UK be ignored either.

Put simply, doing business to and from Northern Ireland would become a lot more expensive. This is a serious obstacle to the very economic activity that the lower tax rate would be designed to encourage.

c. The cost of meeting the EU's requirements for this tax rate cannot be justified.

Those who are proposing a reduced tax rate for Northern Ireland do not dispute it will have an initial cost. They estimate that this initial cost in terms of lost subsidies for Northern Ireland to match lost tax revenues will be at least £200 million a year[xxxii]: the Varney report of 2007 suggested a figure of £300 million a year.

Those proposing the tax cut suggest that this is only a short term issue and that the tax cut will generate such substantial growth in business activity that the loss in tax revenue will be made good by growth in taxes raised from employment in a relatively short period. There are an enormous range of assumptions implicit in this claim.

The first is that the tax cut will work, despite all the evidence noted to the contrary in this briefing. The second is that the tax cut can apply to the types of business likely to be attracted to Northern Ireland, which is unlikely given the nature of the European Commission ruling on the Azores which precludes any subsidy to financial services or intra-group service companies. The third is that the EU will allow increased payroll taxes arising in Northern Ireland to be offset against a loss in corporation tax when calculating the amount of subsidy to be withdrawn. This is unlikely: they strictly partition consideration of personal and corporate taxes when considering such issues, as they did for example when promoting the EU Code of Conduct for Business Taxation[xxxiii].

The fourth is that there will be gains after the additional administrative burden of trading in Northern Ireland are taken into account following the introduction of a reduced tax rate and all the consequent transfer pricing arrangements that will have to be put in place.

Finally, at a time when Northern Ireland is already predicted to face the prospect of above average cuts in government spending[xxxiv], it has to be economically risky, to say the least, to opt for an additional, cut in government spending.

Each of these issues poses enormous questions to be considered in Northern Ireland before any decision could be taken on this issue. What has to be stressed though is that in each and every case there is considerable uncertainty. The modelling presented by those making a case for this tax cut is not just simplistic, it is naively simplistic and based on assumptions that, as this briefing shows, have little credible basis in fact, law and tax practice.

To proceed in the light of these uncertainties with a change in the tax rate for which there is as yet no successful precedent in Europe would be an act either of considerable courage or foolhardiness. The evidence suggests it might well be the latter.

This paper was written for the ICTU and TUC by Richard Murphy.

About the author

Richard Murphy is a chartered accountant and graduate economist. He was senior partner of a London firm of accountants for more than ten years. He has also been a serial entrepreneur.

Since 2000 Richard has worked mainly on taxation policy. He is director Tax Research LLP and advises the Tax Justice Network (of which he was a founder), the UK Trade Union Congress and many other organisations on tax policy issues. He has been a consultant to the World Bank and a visiting fellow in tax and political economy at a number of UK universities.

According to the Accountancy Age Financial Power List for 2009 Richard is the 25th most influential person in UK finance.

Richard writes a daily blog at **www.taxresearch.org.uk/blog**.

He is co-author of 'Tax Havens: How Globalization Really Works' published by Cornell University press in January 2010.

Endnotes

[i] http://www.bbc.co.uk/news/uk-northern-ireland-10791157
[ii] http://news.bbc.co.uk/1/hi/uk_politics/election_2010/northern_ireland/8617837.stm
[iii] http://www.bbc.co.uk/news/10381730
[iv] http://www.ukbudget.com/EmergencyBudget/business/EmergencyBudget-business-Corporation-tax-Northern-Ireland-reform.cfm
[v] http://www.bbc.co.uk/news/uk-northern-ireland-10791157
[vi] ibid
[vii] http://en.wikipedia.org/wiki/Taxation_in_the_Republic_of_Ireland
[viii] http://ergni.org/reports/report_corporation_tax_may_2010.pdf
[ix] http://ergni.org/reports/report_corporation_tax_may_2010.pdf
[x] http://visar.csustan.edu/aaba/Stewat2008.pdf
[xi] http://business.timesonline.co.uk/tol/business/industry_sectors/technology/article5472924.ece
[xii] http://www.irishtimes.com/newspaper/frontpage/2010/0728/1224275616744.html
[xiii] http://www.huffingtonpost.com/2009/01/05/waterford-wedgewood-colla_n_155198.html
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[xv] http://www.irishtimes.com/newspaper/frontpage/2010/0903/1224278128273.html
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[xvii] http://www.unctad.org/Templates/Webflyer.asp?docID=13647&intItemID=3198&lang=1
[xviii] http://www.brensonlawlor.ie/doingbusiness.php
[xix] ibid
[xx] http://www.secrecyjurisdictions.com/
[xxi] http://www.irishtimes.com/newspaper/frontpage/2010/0903/1224278128273.html
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[xxiii] http://seattletimes.nwsource.com/html/nationworld/2009173947_taxes05.html
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[xxv] http://www.finfacts.ie/irelandbusinessnews/publish/article_10005150.shtml
[xxvii] http://ergni.org/reports/report_corporation_tax_may_2010.pdf
[xxviii] http://ec.europa.eu/dgs/legal_service/arrets/03c088_en.pdf
[xxix] The original press release relating to this issue has been deleted from the HM Treasury web site by the current UK government. The matter is quoted now from secondary sources – including those promoting the current change in tax rates in Northern Ireland.
[xxx] http://curia.europa.eu/jurisp/cgi-bin/form.pl?lang=EN&Submit=rechercher&numaff=C-88/03
[xxxi] http://ec.europa.eu/dgs/legal_service/arrets/03c088_en.pdf
[xxxii] http://ergni.org/reports/report_corporation_tax_may_2010.pdf
[xxxiii] http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm
[xxxiv] http://www.guardian.co.uk/politics/2010/apr/23/david-cameron-paxman-squeeze

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