Tax is vexing as Britain finds itself among the dearer domiciles

By Vanessa Houlder
Published: October 16 2006 03:00 | Last updated: October 16 2006 03:00

Britain's corporate tax regime is under siege. Companies say the complexity, unpredictability and scale of the tax burden is unsustainable. It is, according to the CBI, the employers' body, "damaging the prospects of the UK as a place to do business".

Most British businesses have no choice about where they pay tax. But some international companies are voting with their feet. Two insurers have recently decided to switch their domicile to low-tax Bermuda. GUS, one of the UK's largest companies, has just spun off much of its business to Ireland, where its effective tax rate will be nearly one-third less.

Intensifying tax competition from European neighbours, such as Ireland and the Netherlands, could make others follow suit. It could also erode inward investment: for the past two years, most senior tax advisers have warned international groups against choosing the UK for their European holding companies.

In London the Treasury takes these concerns seriously: it is conducting detailed discussions with big businesses about the changes they want to see. But its attitude is coloured by concerns about the impact any moves would have on public finances and on other parts of the tax system.

Multinationals object to three aspects of the British tax regime: the level of its tax rates, a deteriorating relationship between companies and the tax authorities and, perhaps most important of all, the treatment of foreign earnings.

Judged by its headline corporate tax rate, the UK now looks expensive. Bringing the UK's 30 per cent rate down closer to the European Union average of 25 per cent would stifle some of the criticism and might be affordable. Each percentage point cut would cost the Treasury about £1.5bn ($2.8bn, €2.2bn) - a relatively small amount given that corporate tax revenues have grown from £32bn to £48bn over the last five years.

But a modest cut would not stop multinationals from moving their domicile to genuinely low-tax jurisdictions - Ireland has a 12.5 per cent rate. Large cuts in tax rates can create substantial value for shareholders. Ken Lee, a Citigroup analyst, says: "From now on, I think you will find more investors asking companies: 'What are the options to take advantage of tax competition in the EU?' Up to now they have taken the tax rate as a given."

This kind of pressure could force huge cuts in corporate tax rates. Chris Wales, former chief adviser on tax policy to Gordon Brown, chancellor of the exchequer, predicts that most EU countries' corporation tax rates will end up at about 15 per cent.

Such a drastic reduction might stimulate stronger growth and investment, ultimately increasing tax revenues, although many economists say that this is an unlikely outcome in a large economy such as the UK. The Treasury might try to claw back some of the lost revenues by abolishing corporate tax reliefs, such as on interest costs, although that would tend to disadvantage less profitable companies.

Tax rates do not tell the full story about a country's competitiveness. Its appeal also depends on other aspects of the tax system factors such as the size of its markets and the quality and cost of its labour force. The UK scores highly on most of these. But on one crucial factor - the business-friendliness of its tax administration - its reputation is under fire. Relationships between companies and Her Majesty's Revenue & Customs have suffered as the government has adopted a harder line on tax avoidance.

Resentment at the government's approach has been particularly acute when it comes to its treatment of companies' foreign earnings. As British companies become more international in their outlook, they are increasingly unsympathetic

to the idea that the Treasury has a moral claim to a share of their worldwide earnings. John Cullinane, president of the Chartered Institute of Taxation, says: "There's too much of a Maginot line mentality in endlessly trying to protect our tax borders."

In practice, companies pay little tax on overseas profits to the UK Treasury. But the rules on foreign earnings are complex, inhibit tax planning and are widely loathed by businesses. Some tax experts think it is time to abandon the principle of worldwide taxation, which dates back to the introduction of income tax in 1799 to pay for the war against the French forces under Napoleon. They want to move to a "territorial" system, which taxes only domestic profits. This system, which is used in the Netherlands and some other European countries, makes it easier for multinationals to minimise the tax bills of their overseas subsidiaries.

The case for such a change has been heightened by a recent ruling by the European Court of Justice that has made it harder to stop businesses moving profits outside the UK tax net.

But scrapping the taxation of foreign profits could have an unwanted side-effect. The Treasury fears it could erode the tax base because companies would have a greater incentive to borrow in the UK - making use of generous rules on deducting interest costs against tax - in order to invest overseas. That raises the threat that the government might decide to clamp down on tax relief for interest costs, which would be hugely unpopular with domestic as well as international companies. A similar German proposal this year provoked a storm of protest.

Not everyone sees a need for drastic reforms. Despite the complaints, the UK tax system still has many of the attributes most prized by multinationals. Inward investment statistics remain impressive. Moving a holding company is difficult, expensive and poses reputational risks: companies are likely to do so only as part of a broader restructuring. Moreover, there is no statistical evidence that globalisation has eroded the ability of governments - even in high-tax European countries - to raise tax revenues. László Kovács, the EU tax commissioner, says fears about tax competition are exaggerated, maintaining: "I do not believe there is a race to the bottom."

But this is uncharted territory. The Organisation for Economic Co-operation and Development warned last week that the damage inflicted on public finances by European tax competition might take several years to materialise. The UK Treasury, which depends on a relatively small number of large companies for much of its corporate tax revenues, has reason to be fearful. But its response is difficult to calibrate. It has to judge what is best for the UK as a whole. Tax competitiveness is worthwhile only if it leads to more jobs and stronger growth.

In the end, there may be limits to how far the government should go in making the UK attractive to multinational holding companies. But if it balks at the changes they demand, it should not be surprised if more companies pack up their headquarters and leave.

Vanessa Houlder