

More on corporation tax as a tax on transactions - and ...

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I wrote [a blog yesterday](#) suggesting that despite the impression given by law and practice direct taxes, such as corporation tax, are not in fact taxes on profits, as is implied by their description, but are in fact taxes on specific transactions. The inevitable adverse reactions were received, suggesting that I had, as usual, got everything wrong. Since this is, however, the inevitable reaction of those with a vested interest in the existing system on every occasion that was to be expected, but in practice the comments made suggested to me that if anything my theory is closer to the truth than I had expected.

As example, let's just look for a moment at the potential sources of revenue for a UK company. This diagram helps:

The revenue of the company, by no means all of which will be reflected in its turnover, but all of which will, eventually, contribute to its profit, can come from a wide variety of sources, some of which are noted above. And, as this simplified diagram notes, quite a range of those revenue sources can, even though they give rise to what are described as realised profits (that is, cash in the bank) give rise to no UK tax liability.

I stress, that is not because the profit is outside the scope of tax: it is because the source of income is outside the scope of tax. So, for example, dividends received by one UK company from another UK company are not taxed, and this now applies to intra-group dividends received from companies outside the UK. Similarly, the proceeds of sale of significant shareholdings by one company in another company are not subject to any tax, even though they can give rise to significant capital gains. Most tellingly, revenue now earned by an overseas branch of the UK company is also outside the scope of UK tax.

Many of these exemptions (or loopholes, if you like, for that is what they are) are recent innovations and only a very few (such as the receipt of dividends from other UK

companies) have any obvious theoretical justification. The distinction between realised and unrealised gains is also new: this aberration, which has fundamentally undermined the reliability of all financial statements, basically dates from the adoption of International Financial Reporting Standard as the de facto accounting standards for the UK in 2005.

The reality is that when corporation tax was introduced I think it was, as the law describes, intended to be a tax on profits. The fact is that this is no longer the case: we now have a tax on specific transactions undertaken by companies, less the costs that are allowed by law to be offset against them. That is something very different indeed but what it does do is open the opportunity for those with an interest in tax policy design to ask some very relevant questions. These include the very obvious ones, such as why have we chosen to exempt those types of income for the currently untaxed, and should we reform that approach? Likewise, the opportunity to ask about the costs that should be offset against taxable revenues is now very clearly within the scope of policy debate.

Once the linkage between profit and tax is broken, as I think it has been in the case of corporation tax, and to some extent income tax, then we need to look at the whole basis of tax design again. It is something I intend to do because the opportunities that this opens for the taxation of what might be described as 'bads' whilst exempting those transactions that we think to be of benefit to society is one that is too important to miss.