The Taxing Wealth Report 2024

Every politician's guide to "How to pay for it"[1]

Corporation tax reforms:

Recreating a significant differential between large and small company rates of corporation tax

Brief Summary

This note suggests that:

- The rate of corporation tax payable by smaller companies in the UK should be aligned with the basic rate of income tax, which is 20 per cent at present. This would increase their current tax rate by 1 per cent.
- That larger companies in the UK should pay corporation tax at a rate 10 per cent higher than smaller companies because:
  - They have higher rates of profitability than their smaller rivals, usually because of their ability to extract monopoly profits from consumers because of their market strength.
  - They have lower costs of capital than smaller companies because they tend to be able to borrow more at lower cost than smaller companies, which ability also allows them to invest more than their smaller rivals which in turn tends to reduce the tax rates that they might otherwise pay.
  - The cost of proper tax compliance is proportionately higher for smaller companies than larger ones, meaning that they should enjoy at least one lower tax rate as a result to compensate them for this.

[1] This note forms a part of 'The Taxing Wealth Report 2024' published by Finance for the Future LLP, which is UK LLP number OC329502, registered at 33 Kingsley Walk, Ely, Cambridgeshire, CB6 3BZ. See https://www.financeforthefuture.com/taxing-wealth/. This note was written by Richard Murphy FAcSS FCA FAIA (Hon), Professor of Accounting Practice, Sheffield University Management School, who is a director of Finance for the Future LLP.

The Taxing Wealth Report 2024 is a joint project between:

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- Smaller companies need to retain more of their profits than their larger rivals if they are to invest, and the rate of return on investment by smaller companies tends to be high for the benefit of the UK economy as a whole.
- Larger companies are larger polluters and pose a greater threat to biodiversity than smaller companies and so should pay more corporation tax as a result when there is at present no other tax to reflect this fact.

- There would be only limited behavioural responses to this proposal because it only applies to UK generated profits and it is increasingly difficult to relocate profits to other countries or tax havens for taxation purposes.
- As a consequence, it is likely that this proposal might raise an additional £6 billion per annum from large companies and more than £1 billion from smaller companies, providing total additional revenues of £7 billion per annum as a result.

The proposal	To change the UK's corporation tax system so that the rate of tax paid by a company, or group of companies, depends upon the rate of profit that it makes, with a progression in the rate paid as the amount of profit increases.
Reason for the proposal	1. To improve the horizontal equity of taxation, which is currently undermined by the low rates of corporation tax payable by larger companies in the UK. This then become a source of subsidy for the growth in the wealth of those with the means to own shares in these larger companies. 2. To increase the prospect of vertical equity of taxation in the UK which is heavily dependent upon the creation of improved horizontal tax equity. 3. To reduce the tax spillover effect that existing rates of corporation tax create when compared to those charged under income tax rules. 4. To reduce the rate of tax avoidance in the UK. 5. To consequently improve the rate of tax compliance in the UK.

	6. To raise additional tax revenues.
Estimated tax that might be raised as a result of the recommendation made	The behavioural response to this recommendation is likely to be small: UK corporation tax rates only apply to the UK profits of UK based groups of companies and as such there will be little incentive for them to relocate as a result of the proposed changes, whilst measures to prevent profit shifting by multinational corporations are now considerably more sophisticated than they were even a decade ago. It is likely that, taking into account the recent increase in the corporation tax rate for larger companies, that this proposal will raise £6 billion of additional tax from larger UK resident companies and more than £1 billion from smaller companies because of the suggested alignment of their tax rate with the basic rate of income tax. Total estimated additional tax revenues are, in that case, £7 billion per annum.
Ease of implementation	Relatively straightforward, not least because the UK had tiered rates of corporation tax until 2015 and they have, to some extent, already been reintroduced meaning that there is considerable familiarity with such a system.
Likely difficulties that might result from implementation	Few.
Likely time required to implement the change	Months in the year preceding the year of actual change.
Consultation period required.	Short, largely because of the familiarity that already exists with multiple rates of corporation tax.

Background

The UK's corporation tax was introduced in 1965 at the same time as the country also saw the introduction capital gains tax. Both taxes were introduced by a Labour government that was anxious to both modernise the UK's tax system and to remove from it opportunities for abuse that existed in the system that they had inherited from the previous Conservative government.

Corporation tax is a tax that is primarily charged on the income, gains and profits of private limited liability companies and public limited companies (PLCs). It can also be charged on the income of some unincorporated bodies, but this is incidental to its main function.

Rates of corporation tax

When corporation tax was first introduced all companies paid tax at the same rate of around 40% on their profits arising during the course of a year.

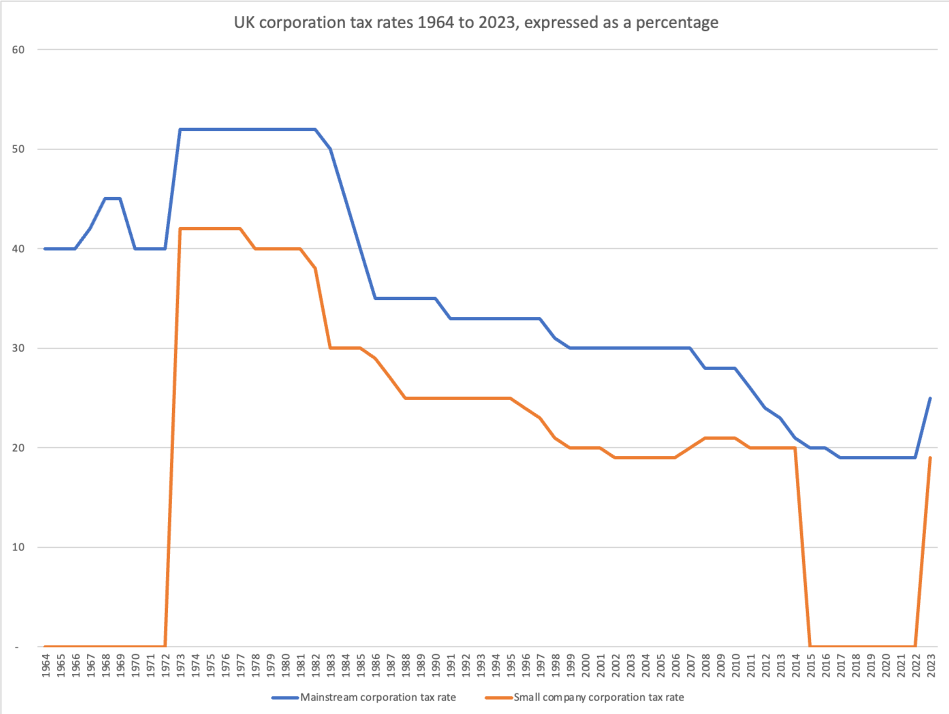
In 1973, that changed. Companies that were defined as being small paid tax at a rate that was usually 10% less than that imposed on large companies.

It should be noted that the difference between a large and small company was based upon the level of profit that was generated by a company for corporation tax purposes during the course of a year. As a consequence, a company with a low turnover but with very high profitability could be defined as a large company, whilst a very large company that made a very small profit could be defined as a small company. Groups of companies were treated as single entities for this purpose to prevent abuse. This definition has persisted to date.

As will be noted from the chart below, opportunity was taken when the small companies rate of corporation tax was introduced to increase the rate of tax charged on the profits of large companies, which in the 1970s exceeded 50 per cent.

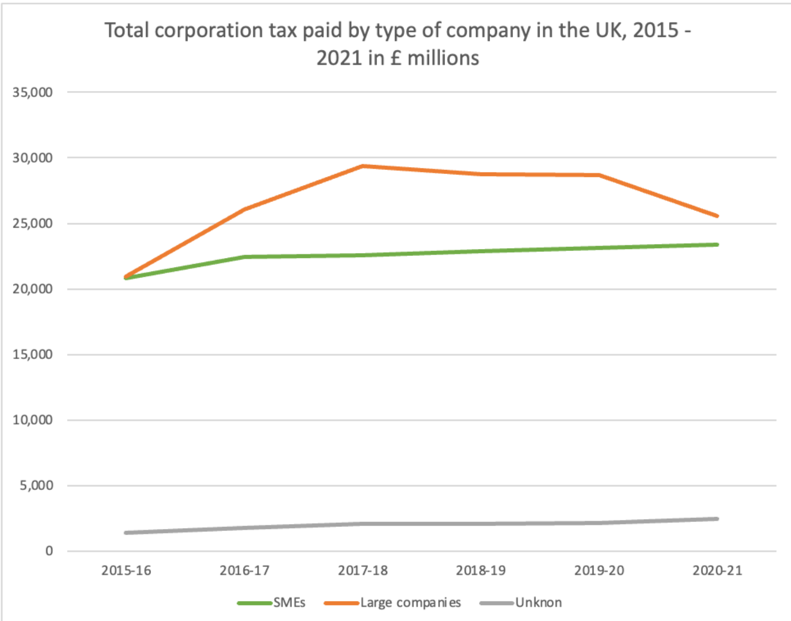
Corporation tax rates fell steadily during the early years of Margaret Thatcher's administration in the 1980s. They then broadly flatlined at between 35% and 30% for more than two decades, until a further steady decline started just before the global financial crisis in 2008, with corporation tax rates reaching their lowest ever level at 19% from 2017 onwards, only recently having been raised again.

It will be noted that from 2015 to 2022 small companies paid corporation tax at the same rate as large companies, i.e. at 19% for most of this period. In 2023 corporation tax rates for large companies have been raised to 25%, but small companies still pay tax at 19%.



Sources: various from data collected by the author over time

In recent years, the estimated amount of corporation tax paid by large and smaller companies, as identified by HM Revenue and Customs to the best of their ability given that these terms had little relevance to liabilities owing during the course of this period, were as follows:



Source: HM Revenue & Customs and author calculations[2]

[2] https://www.gov.uk/government/statistics/corporation-tax-statistics-2022 table 10

To put these numbers in context the number of large and small companies and the average tax liabilities that they settled in each of the years noted were as follows:

	Number of large companies	Total tax paid by large companies	Average tax paid by each large company	Number of SMEs	Total tax paid by SMEs	Average tax paid per SME	Multiple: large to small company tax payments
	Number	£'million	£'million	Number	£'million	£	Ratio
2015-16	18,911	20,960	1.108	1,293,868	20,843	16,109	68.80
2016-17	18,982	26,032	1.371	1,384,777	22,435	16,201	84.65
2017-18	19,576	29,396	1.502	1,434,347	22,561	15,729	95.47
2018-19	19,147	28,733	1.501	1,453,288	22,866	15,734	95.38
2019-20	17,886	28,678	1.603	1,512,888	23,154	15,305	104.77
2020-21	18,432	25,552	1.386	1,461,466	23,365	15,987	86.71

Source: HMRC and author calculations[3]

As this table shows, in most years more than half of all corporation tax payments in the UK are made by a small number of very large companies. This is because of the massive imbalance in their profitability when compared to that of small and medium sized companies that pay tax[4].

Discussion

The idea implicit in the removal of the differential between the tax rates for large and small companies from 2015 to 2022 was that all companies, irrespective of size, should be treated equally within the UK tax system. There are very good reasons for disagreeing with this suggestion.

As is apparent from the data noted above, large and small companies in the UK are very different in their size, as are their resulting tax liabilities.

There are also a number of substantial differences in their trading situations that justify a differential in the corporation tax rates that should be applied to their profits arising during the course of a period.

Firstly, large companies enjoy a number of significant trading advantages compared to their

[3] https://www.gov.uk/government/statistics/corporation-tax-statistics-2022 table 10

[4] See https://taxingwealth.uk/2023/09/22/reforming-the-administration-of-corporation-tax-in-the-uk-might-raise-at-least-6-billion-of-tax-a-year/ This information is based on the companies that do pay tax: evidence suggests that HM Revenue & Customs do not know how many should.

smaller rivals. In particular, many large companies will enjoy the benefits that result from having recognised brands or significant market control, meaning they tend to enjoy higher rates of profitability than lower companies because their trading situations provide them with opportunity to extract what economists describe as economic rent from their customers. That rent might also be described as monopoly profit in some cases because these enterprises often face only limited competition in the localities in which they operate because of their size or familiarity. These additional profits justify the imposition of higher rates of tax on these companies.

Secondly, larger companies also benefit from much lower costs of capital when compared to smaller companies. What this means is that they can borrow more easily and in proportionately larger amount than small companies and that they will usually pay significantly lower rates of interest on those borrowings than will their smaller arrivals. Not only does this increase the rate of profitability of larger companies, it also means that they have access to more funds for the purposes of investment than their small rivals. Given the incentives provided for investment within the tax system this means that larger companies can often reduce their actual tax rates quite considerably as a result of making such investments, whatever the headline rate of tax. As a consequence, a tax differential between larger and smaller companies is justified.

Thirdly, the costs of tax administration in proportion to profits generated are likely to be higher in smaller companies than larger companies, particularly if diligently undertaken. For that reason, a lower tax rate should be applied to smaller companies to compensate them for their higher overall cost of tax compliance.

Fourthly, because of their difficulty in raising capital, and most, especially because it is hard for smaller companies to raise capital from third-party shareholders, most small companies in the UK are dependent upon retaining profits generated to fund their future development and growth. This is not necessarily the case for larger companies[5]. Given that this growth potential in smaller companies is essential to the long-term prosperity of the UK a lower rate of corporation tax for smaller companies is justified because of the potential overall increased return to society that might result from increased investment by smaller companies that are able to retain a larger proportion of their profits.

Finally, there is evidence to suggest that large companies emit proportionately more carbon and cause greater biodiversity loss than do small companies. As a consequence, if net zero is to be achieved it is appropriate that large companies make a more significant proportionate contribution to the costs of climate transition. This can be achieved by them

[5] See https://productivityinsightsnetwork.co.uk/app/uploads/2021/06/PIN-Report-29-6-21-FINAL.pdf

making payment of a higher of corporation tax rate in the absence of other taxes to tackle this issue at present.

Recommendation

Taking all these factors into account, it is suggested that the corporation tax rate payable by small companies in the UK should be aligned with the basic rate of income tax at 20% and that the rate of corporation tax payable by large companies should be 10% more, as was often the case in the past, suggesting that the rate to be used for larger companies should be 30%, which is still comparable to that payable in many other countries, tax havens apart.

Likely revenue implications

Whilst there would be significant objection from large companies to this proposal, in reality, the UK rate of corporation tax is only applied to their profits that arise in the UK in most cases. Since the majority of large companies based in the UK generate most of their profits outside this country this proposal will not reduce the attractiveness of the UK as an international location.

It is also the case that very few large companies pay corporation tax at the headline rate at present because so many tax reliefs and allowances are available to them. This means that in the vast majority of cases their overall tax rates are quite several percentage points below the headline rate, meaning that this suggestion will only leave the effective rate of corporation tax due by these companies at rates comparable to those payable in many competitor nations, tax havens apart.

For these two reasons, it is unlikely that there will be significant behavioural responses as a consequence of this proposed change. In that case, it is reasonable to cautiously extrapolate existing tax yields for both large and small companies for the proposed additions in rate that are suggested in this note. In the case of large companies, this will increase the rate from 25 per cent to 30 per cent, and in the case of small companies it will increase the rate from 19 per cent to 20 per cent. Plausible estimates of revenues arising might be £6 billion in the case of large companies and at least £1 billion in the case of smaller companies. A total of £7 billion is, as a consequence, suggested as the combined revenue yield arising from these proposals.