



# UK Tax – Getting More Competitive?

IoD POLICY PAPER



In association with







# UK Tax – Getting More Competitive?

IoD POLICY PAPER



In association with



Copyright © Institute of Directors and BDO LLP, November 2011

Published by the Institute of Directors  
116 Pall Mall, London SW1Y 5ED

COPIES AVAILABLE FROM:

Policy Unit  
Institute of Directors  
116 Pall Mall  
London  
SW1Y 5ED

Tel: 020 7451 3103  
Fax: 020 7839 2337  
Email: [policy-unit@iod.com](mailto:policy-unit@iod.com)  
Web: [www.iod.com/policy](http://www.iod.com/policy)

This paper was written by the Institute of Directors and BDO LLP.

The Institute of Directors (IoD) was founded in 1903 and obtained a Royal Charter in 1906. It is an independent, non-party political organisation of 40,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum, from media to manufacturing, e-business to the public and voluntary sectors. Members include CEOs of large corporations as well as entrepreneurial directors of start-up companies.

BDO LLP is the award-winning UK Member Firm of BDO International, the world's fifth largest accounting and business advisory network employing almost 47,000 people in 1,082 offices in 119 countries. It operates from 14 offices in the UK with some 3,000 partners and staff. BDO remains focused on helping its clients navigate ever-changing economic and market conditions by providing high quality advice and service on a consistent basis. Its wide advisory offering includes:

- \* Audit services
- \* Tax services
- \* Business Services and Outsourcing
- \* Business restructuring
- \* Corporate finance
- \* Forensic accounting
- \* Fraud and financial crime
- \* Investment management
- \* Technology risk, business risk and internal audit
- \* Technology advisory services
- \* Valuations

BDO's commitment to knowledge and best practice sharing means that expertise is easily shared across the network and common methodologies and IT platform ensure effective and efficient service delivery to all its clients.

# Contents

Foreword by Stephen Herring of BDO LLP	2
Executive summary	3
1 Why tax competitiveness matters	4
2 The overall burden	5
3 Corporation tax	6
3.1 The main corporation tax rate	6
3.2 The overall rate on companies and individual shareholders	6
3.3 The regime for multinational businesses	7
4 Other business tax burdens	8
5 Personal tax	9
5.1 The tax burden on average earners	9
5.2 The tax burden on high incomes	10
5.3 VAT	10
6 Certainty	12
7 Administration	14
7.1 The overall administrative burden	14
7.2 Simplicity in the rules	14
7.3 Relationships between HMRC and taxpayers	15
8 The prospects for improvement	18
9 How could the UK progress towards a flatter tax system? <i>by Stephen Herring and Thomas Story of BDO LLP</i>	19
9.1 Introduction	19
9.2 Business taxation	21
9.3 Personal taxation	24
9.4 Some conclusions	26

## Foreword by Stephen Herring of BDO LLP

This second annual report by the Institute of Directors on the competitiveness of the UK's tax system makes an important contribution to the debate on the tax reforms necessary to reduce fiscal barriers and thereby increase the United Kingdom's competitiveness and boost its economic growth and prosperity.

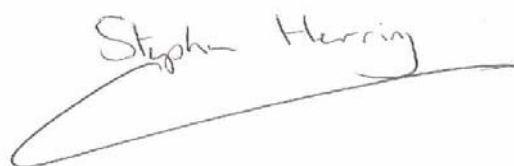
The report correctly focuses upon the overall tax burden in the context of the UK economy as a whole, and provides useful insights into the specific burdens placed upon both business and individual taxpayers. It rightly acknowledges that the short-term scope to reduce the UK's overall tax burden is, regrettably, very limited in view of the Coalition Government's understandable imperative to reduce the fiscal deficit to sustainable levels. Nevertheless, we consider that the initial focus for tax reforms upon substantial listed international groups now needs to be broadened to both listed SMEs and entrepreneurial businesses. The needs of these companies must be properly addressed by the tax system, so that they can make their major contribution to employment growth and the UK's future economic success.

Within this context, we strongly endorse a target to reduce the rate of corporation tax to 15% by 2020. A bold commitment of this nature is essential if the Government is to achieve its ambition of fashioning "the most competitive corporation tax system in the G20". In our experience, the headline rate of tax is invariably *the* key factor when international businesses compare potential locations for foreign direct investment. We anticipate that there would be widespread support across almost all business sectors for achieving this corporation tax rate as soon as possible, even at the price of phasing out certain overly targeted corporate tax reliefs.

More broadly, the report identifies a number of concerns with the growing complexity of the UK tax system and the increasing administrative burden this imposes upon all taxpayers, but particularly upon businesses. We consider that movement towards a much flatter tax system with lower rates and fewer complex reliefs is overdue to reverse this trend.

Accordingly, we were very pleased to be given the opportunity to contribute an article which considers how the UK ought to progress towards a simpler and flatter tax system, in the context of tax reforms introduced by the UK's major competitors for foreign direct investment.

We concur with the report's conclusion that important first steps have been made by the Coalition Government in a number of important tax areas, but no one can doubt that more far-reaching reforms are imperative if the UK is to enhance its fiscal attractiveness in comparison to its key international competitors.

A handwritten signature in blue ink that reads "Stephen Herring". The signature is written in a cursive style and is positioned above a long, horizontal, slightly wavy line that serves as a decorative underline.

**Stephen J Herring**

**Senior Tax Partner,  
BDO LLP**

## Executive summary

- Tax competitiveness matters. If the UK does not maintain a strongly competitive position, it will lose investment and jobs.
- The UK's overall tax burden places the country in the middle of the pack of OECD countries.
- The UK's main corporation tax rate is slightly below the OECD median, and planned reductions should leave it higher than the rates in only one third of OECD countries. A reduction to 15 per cent would leave the UK beaten only by Ireland, and ahead of the rest of the OECD.
- The UK's overall tax rate on companies and their shareholders is markedly uncompetitive.
- The regime for multinational businesses is in reasonably good shape
- The total tax burdens on business are much higher than the corporation tax rate would suggest. A typical medium-sized business might suffer a total tax rate of 42.9 per cent.
- Personal tax rates affect the cost of employing a workforce. The total tax cost of employing people on average earnings is higher in the UK than in one third of other OECD countries, the 40 per cent income tax rate applies at a lower level of income than in the past, and only three OECD countries have higher top tax rates than the UK's 50 per cent.
- The UK does reasonably well in letting businesses have certainty on tax liabilities.
- Administrative burdens imposed by the tax system remain substantial. Relationships between officials and large businesses are generally good, but not perfect. There is serious concern about relationships between officials and businesses when officials enquire into the tax affairs of businesses.

### Article by Stephen Herring and Thomas Story of BDO LLP

- Significant reforms would be needed in order to move towards a simpler, flatter tax system, but such reforms are feasible, even on a revenue-neutral basis.
- It would be possible to have a single corporation tax rate, to align taxable profits with accounting profits, and to make significant simplifications to the taxation of groups and of lending arrangements.
- Priorities in relation to personal tax include changes to tax rates and thresholds, the alignment of income tax and national insurance, changes to the taxation of share incentives, the merger of CGT and IHT, and the simplification of savings taxation.

# 1 Why tax competitiveness matters

This is the second edition of an annual report on the competitiveness of the UK's tax system. Last year's report concluded that the UK was in the middle of the pack of competitor nations, and that while the Coalition Government was heading in the right direction, there was a long way to go.<sup>1</sup> This year, we will review the progress that has been made, and assess the prospects for further improvement.

One thing that has not changed is the importance of tax competitiveness. Groups can put their capital investment where they like, and in practically any country they will find the labour force that they need. They can also put intermediate holding companies, for example European holding companies of American groups, where they like. If a group has a choice between two countries that are equally good on the basis of non-tax considerations, such as the language, the level of education of workers and the general business environment, the group has a duty to its shareholders to choose the lower-tax country. This imperative can have direct effects on the prosperity of the UK in two ways.

- When a group decides where to place its large-scale operations, such as its research facilities, its factories and its distribution centres, it will favour countries where the total tax liability is low. Not only the corporation tax rate, but tax burdens on employment, will matter. These large-scale operations bring jobs to the host country, not only within the groups themselves, but also in local suppliers of goods and services and in local shops where the employees spend their money.
- When a group decides where to place its group holding company, it will consider the regime for receiving profits from subsidiaries and paying them out to shareholders. In particular, it will not want extra tax charges to arise at the holding company level, and it will not want tax charges on profits that have been made in subsidiaries but that have not yet been paid up to the holding company level. Groups do not often announce the detailed reasons for their corporate location decisions, but there have been enough high-profile groups choosing holding companies in Switzerland, or preferring Ireland to the UK, to make it clear that tax burdens can be a strong influence. This matters to the UK economy, even though the numbers who are directly employed in holding companies may be small. Group holding companies tend to use local service providers, such as banks, lawyers and accountants, so they can bring more business to their host countries than may at first appear. Furthermore, directors will be familiar with the laws and business environment of the country in which they work, so they will tend to favour that country over others when it comes to locating substantial investments. It therefore pays a country to attract group holding companies.

It is not only in relation to multinationals that competitiveness matters. A system that is competitive internationally is one that is likely to help purely domestic businesses. Rules on the taxation of profits made in other countries will not matter directly to such businesses, but all of the other features of an attractive tax system – low tax rates, certainty, transparency, simplicity and low administrative burdens – will benefit them just as much as they benefit multinational groups.

---

<sup>1</sup> *How Competitive is the UK Tax System?* by Richard Baron, Institute of Directors, 2010.

## 2 The overall burden

Most countries impose a wide range of taxes, and all taxes are ultimately burdens on individuals, one way or another. Since it is individuals who decide how much to work, or where to invest their money, all taxes are potentially burdens on business. It therefore makes sense to start with the ratio of total tax revenue to GDP.

Not all taxes imposed by a given country will be potential burdens on all businesses active in that country. Foreign investors in a business, for example, will not suffer that country's tax on dividend income, or will only pay a modest withholding tax on profits extracted, although they may also be liable to tax on dividends in their own countries. And even within one country, some taxes will be much more direct burdens on business than others. At one extreme, corporation tax takes a slice directly out of profits, reducing returns to investors.<sup>2</sup> At the other extreme, a tax on the occupation of private housing will primarily fall on the occupiers of existing housing stock, although there will be some effect on the construction industry because the tax on the occupation of substantial homes may lead people to prefer smaller, cheaper houses.

Despite these reservations, the ratio of total tax revenue to GDP is important. It shows whether the state is a heavy or a light burden on the economy. A high tax burden reduces economic growth.<sup>3</sup> And even if some taxes have little or no impact on some businesses, the trend in the ratio from one year to the next can still show whether things are getting better or worse.

OECD data on total tax revenue as a percentage of GDP are now available for 33 OECD countries for 2008.<sup>4</sup> The range runs from 21 per cent (Mexico) up to 48.2 per cent (Denmark). The UK's figure is 35.7 per cent. 18 countries had lower percentages than the UK, and 14 had higher percentages than the UK. This represents a marginal slippage down the rankings as between 2007 and 2008. Data for the same 33 countries for 2007 showed that 17 countries had lower percentages than the UK, and 15 had higher percentages than the UK. We should not read much into this. Several of the percentages are close together, so minor fluctuations can change rankings by one or two places. Moreover, the financial crisis has put new pressures on governments, requiring changes to fiscal plans and disrupting trends in tax burdens. Even so, we should note that the UK remains in the middle of the pack. It is not a low-tax country.

Data for more recent years, and projections, are available for the UK.<sup>5</sup> The precise percentages may not be directly comparable with the OECD percentages, but the trend is the important thing. Taxes were 34.9 per cent of GDP in 2009-10. This rises to 35.6 per cent in 2010-11 and is expected to be 36.4 per cent in 2011-12. It is expected to stay within 0.1 percentage point of this level right through to 2015-16, the end of the forecast period. While the large deficit makes it unsurprising that reductions in the burden are not foreseen, we must record the fact that the UK looks set to stay in the middle of the pack for the next five years. If the UK is to be seen as markedly competitive, it needs to do something striking on the taxes that are most directly relevant to businesses, and to set out some bold plans for the period from 2015 to 2020.

---

<sup>2</sup> It is, however, worth noting that employees bear a fair proportion of the burden of corporation tax, because it means that wages have to be held down in order to offer a sufficient return to attract investors. Estimates of the proportion of the burden that falls on employees vary widely. The proportion could easily be between one quarter and three quarters, depending on economic specifics. For a survey of the theory and of empirical studies, see Jennifer C. Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis*, Congressional Budget Office Working Paper 2010-03.

<sup>3</sup> A recent survey stated that "The most recent studies find a significant negative correlation: An increase in government size by 10 percentage points is associated with a 0.5 to 1 percent lower annual growth rate": Andreas Bergh and Magnus Henrekson, *Government Size and Growth: A Survey and Interpretation of the Evidence*, Research Institute of Industrial Economics Working Paper number 858, 2011, also available in *Journal of Economic Surveys*, online doi: 10.1111/j.1467-6419.2011.00697.x and forthcoming in the print edition.

<sup>4</sup> *Revenue Statistics 1965-2009*, OECD, 2010, page 19. Estonia is the member that is not covered.

<sup>5</sup> *Economic and fiscal outlook*, Office for Budget Responsibility, March 2011, table 4.6, page 101.

## 3 Corporation tax

### 3.1 The main corporation tax rate

In 2010, the UK's main corporation tax rate was, at 28 per cent, above the OECD median. 21 of the current 34 members had lower rates, one had the same rate and 11 had higher rates. In 2011, the UK rate is 26 per cent, and this has led to a small improvement. 17 countries have lower rates, one has the same rate and 15 have higher rates. If the UK's rate reaches 23 per cent by 2014, as the Government plans, and other countries do not change their rates, only 11 countries will have lower rates, and 22 will have higher rates.<sup>6</sup>

As with total tax burdens, the UK is very much in the middle of the pack. Moreover, tax rates are bunched around the middle. In 2011, the lower quartile rate is 20 per cent and the upper quartile rate is 29.4 per cent, while the range runs from 12.5 per cent (Ireland) up to 39.5 per cent (Japan). This means that modest tax rate reductions by a reasonable number of countries can rapidly push a middle-ranking country down the rankings.

Now suppose that the UK had a more ambitious target, a rate of 15 per cent by 2020. If other countries did not change their rates, that would put the UK in second place, behind Ireland, with the next four countries all trailing four percentage points behind. Given that there are already four OECD countries on 19 per cent, and another five on 20 per cent, an ambitious target like 15 per cent is needed to give the UK any chance of being outstandingly competitive.

The UK's rather mediocre showing is confirmed by a study of effective corporate tax rates within the G20.<sup>7</sup> Effective tax rates take account of allowances, in particular allowances for capital investment. The UK is placed ninth out of the 19 countries in respect of its effective average tax rate in 2011, and fifteenth in respect of its effective marginal tax rate.<sup>8</sup> A significant part of the explanation for the UK's poor showing, when it ranks seventh out of the 19 countries for its headline tax rate, is the lack of any allowance for the cost of industrial buildings, apart from a deduction from the amount received when they are eventually sold.<sup>9</sup> The proposed reduction in the UK's main rate to 23 per cent, and accompanying changes to capital allowances, will move the UK up to fifth place in respect of the effective average tax rate, and to fourteenth place in respect of the effective marginal tax rate.<sup>10</sup>

### 3.2 The overall rate on companies and individual shareholders

Tax tilts the balance between risk and reward against business investors. The tax system reliably takes a slice of profits, but relieves only some losses. Corporation tax will affect all investors in UK companies. In addition, most will be affected by tax on the dividends that they receive on their shareholdings. (Dividends paid by one company to another are not taxed, but at the top of the chain, dividends will be paid out to individuals, and will then be taxed.) The overall tax rate, at the corporate level and at the shareholder level, is our best guide to the extent to which the tax system tilts the balance and discourages enterprise.

<sup>6</sup> All data are from the *OECD Tax Database*, table II.1.

<sup>7</sup> *G20 Corporate tax ranking 2011*, by Katarzyna Bilicka, Michael Devereux and Clemens Furst, Oxford University Centre for Business Taxation, 2011.

<sup>8</sup> *Ibid.*, pages 11 and 13. There are 19 countries in the G20, because the European Union is a member but not a country.

<sup>9</sup> *Ibid.*, pages 15-18.

<sup>10</sup> *Ibid.*, page 20.

There is no single figure for this total burden, in relation to companies in a given country. Shareholders in different countries will pay different rates of tax on dividends. But we can compare the total burdens in different countries, when a company and its shareholders are assumed to be in the same country (for example, UK shareholders in UK companies).

The overall rate in the UK for someone on the highest income tax rate (50 per cent), owning shares in a company that pays the main corporation tax rate (26 per cent), after adjusting for the tax credit on dividends, is 52.7 per cent. For someone paying 40 per cent income tax, it is 44.5 per cent. If profits are taken by shareholders in the form of capital gains, taxed at 28 per cent but with no tax credit, the overall rate is 46.7 per cent. Overall, roughly half of profits made and paid out in dividends never reach the shareholders who have put their capital at risk. It is true that pension funds avoid these personal tax burdens, but then pensions paid out are taxable income of the pensioners.

Data on overall rates for individuals paying the top income tax rates are available for 2011 for the 34 members of the OECD.<sup>11</sup> 22 of them have overall rates that are below the 44.5 per cent that applies in the UK when the individual pays income tax at 40 per cent. 31 of them have overall rates below the 52.7 per cent that applies in the UK when the 50 per cent income tax rate applies. These are pretty much the same rankings as in 2010. The UK is markedly uncompetitive on this measure.

### 3.3 The regime for multinational businesses

There have been substantial changes to the UK tax regime for multinational businesses in recent years. The trend has been to make the UK a more competitive location. A tax exemption for intra-group dividends received from abroad has been introduced, and the process of amending the regime for controlled foreign companies (CFCs) has been started. There are some developments to report since this time last year.

- Perhaps most importantly for the UK's competitiveness, the Government has explicitly backed away from making interest payments non-deductible.<sup>12</sup> Had it made that change, other very substantial adjustments would have been needed in order to maintain the UK's international attractiveness.
- Plans for the final shape of the CFC regime have now been set out.<sup>13</sup> The rules will, very sensibly, be focused on profits that are at high risk of being diverted from the UK. Monetary assets and intellectual property are recognized to be the most likely sources of such profits. But there will be a partial exemption for intra-group financing income, recognizing the fact that group finances are often managed on a worldwide basis for perfectly good commercial reasons, and a special regime for patent income is being introduced.
- There is now an optional exemption for foreign branches of UK companies, allowing them to be taxed in a similar way to foreign subsidiaries.<sup>14</sup>

Changes such as these are not quantifiable, and cannot be compared with the position in other countries as easily as tax rates. They are, however, changes that should help to maintain the UK's competitiveness. Indeed, competitiveness was a recurrent theme throughout the policy development process.

---

<sup>11</sup> *OECD Tax Database*, table II.4.

<sup>12</sup> *Corporate Tax Reform: delivering a more competitive tax system*, HM Treasury and HMRC, November 2010, paragraph 3.6, pages 13-14.

<sup>13</sup> *Consultation on Controlled Foreign Companies (CFC) reform*. HM Treasury and HMRC, June 2011.

<sup>14</sup> *Finance Act 2011*, section 48 and schedule 13.

## 4 Other business tax burdens

Corporation tax is by no means the only tax that is likely to deter business activity, or encourage investors to consider countries other than the UK. Not only do the owners of unincorporated businesses suffer income tax and class 4 national insurance on profits made, at rates that are higher than corporation tax rates. Businesses of all types suffer substantial burdens that are imposed in the form of employers' national insurance contributions,<sup>15</sup> business rates and fuel duty on business transport. There are plenty of other taxes, but these are the most significant ones.

Different countries tax businesses in such a range of different ways that aside from straightforward taxes on profits, which are almost universal, it is hard to compare countries in relation to specific taxes. The sensible comparison is one in terms of the ratio of total tax revenue to GDP, as set out in section 2. But we can assess the current position in the UK. Sadly, the picture is not one of great competitiveness.

An IoD report found that a medium-sized business can expect to part with 42.9 per cent of its pre-tax profits in the taxes that most obviously affect business decision-making, including corporation tax, national insurance, business rates, fuel duty and stamp duty land tax. The modest improvement since the previous year, when the proportion was 44 per cent, is mainly explained by the reduction in the corporation tax rate.<sup>16</sup>

---

<sup>15</sup> Employers' national insurance contributions are singled out here because they are the ones most likely to strike business decision-makers as an additional burden. It is natural to think in terms of the gross wage that must be paid, plus the extra cost. But as is noted in the next section, employees' national insurance contributions should also be taken into account, as forming part of the additional cost of paying a given net wage.

<sup>16</sup> *Tax – the weighty burden 2011* by Richard Baron, Institute of Directors, June 2011, page 6.

## 5 Personal tax

Personal tax rates, including national insurance rates, matter to the international competitiveness of a country in two different ways.

- Each person in a workforce will require a certain level of net pay, after deducting all taxes and national insurance. The higher the rates of income tax, employees' national insurance and employers' national insurance, the more expensive it will be to provide that level of net pay. The main rates of these impositions are what matter here.
- Highly paid and highly mobile workers will be sensitive to the top rate of income tax, and the cost of giving them net pay that is enough to persuade them to work in one country rather than another will also be increased by employers' national insurance. (Employees' national insurance is generally capped, or, as in the UK, reduced to a very low rate at high incomes, so it is less significant.) Entrepreneurs who are choosing countries in which to set up businesses are likely to be similarly sensitive to top tax rates, except when they can obtain their returns by selling shares, paying capital gains tax on the proceeds.

### 5.1 The tax burden on average earners

We can measure the overall burden on the workforce in general by the tax wedge. Consider an employee on a certain percentage of average earnings. Compute the total cost  $T$ , that is, gross wages plus employers' national insurance contributions. Compute the net pay  $N$  that the employee takes home, after deducting income tax and national insurance, and after adding cash transfers such as the UK's tax credits. Then the tax wedge, as a percentage, is  $100 \times (T - N)/T$ . It is the percentage of the total cost that does not reach the employee's pocket.

The OECD has computed tax wedges for 2010 for its 34 countries.<sup>17</sup>

- For a single employee on average earnings and with no children, tax wedges ranged from 55.4 per cent (Belgium) down to 16.9 per cent (New Zealand). The UK's tax wedge was 32.7 per cent, which meant that ten countries had lower tax wedges and 23 had higher tax wedges. In 2009, the UK's tax wedge was 32.5 per cent, and the OECD computed the data for 30 OECD countries. Then, ten countries had lower tax wedges than the UK and 19 had higher tax wedges.
- For a married couple on 1.33 times average earnings (divided as average earnings for one partner and 33 per cent of average earnings for the other), and with two children, tax wedges ranged from 42.9 per cent (the Netherlands) down to 7.2 per cent (New Zealand). The UK's tax wedge was 25.1 per cent, which meant that 11 countries had lower tax wedges and 22 had higher tax wedges. In 2009, the UK's tax wedge was 24.6 per cent, and the OECD computed the data for 30 OECD countries. Then, ten countries had lower tax wedges than the UK and 19 had higher tax wedges.

There has therefore been hardly any change in the UK's competitiveness as measured by the tax effect on the cost of employing a workforce, either in absolute terms or relative to other countries. This is not surprising. Income tax and national insurance are the UK's

---

<sup>17</sup> *OECD Tax Database*, table S.1.

two largest sources of tax revenue. Large changes to the rates of these imposts would have very large effects on total revenue, and there is no slack in government finances at the moment. We should, however, be very concerned that there is such a large gap between what it costs to employ someone, and what the employee receives. If we look at the 32.5 per cent tax wedge on a single person on average earnings as a proportion of the net pay, we see that the money paid to the state is  $100 \times 32.5 / (100 - 32.5) = 48$  per cent, or nearly half, of the money that is paid to the employee.

We also need to be concerned at the direct disincentive effect of the fact that the UK's higher income tax rate of 40 per cent (42 per cent when one includes employees' national insurance) applies at ever-lower points on the income scale. A pay rise of £1,000 for someone in this bracket is worth only £580 in the pocket. This will deter some people from seeking promotion or from working overtime.

The level of income at which the rate starts to apply has fallen because of the way that the (highly desirable) policy of increasing the personal allowance has been implemented. The intention is to restrict the benefit to basic rate taxpayers, so when the personal allowance is increased by £1,000, the level of income at which the higher rate starts to apply is reduced by considerably more than £1,000. Thus in 2010-11, the personal allowance was £6,475 and the higher rate started to apply at total income of £43,875. In 2011-12, the corresponding figures are £7,475 and £42,475. HMRC predict that the number of taxpayers liable to tax at the 40 per cent rate (including those who are also liable to the 50 per cent rate) will jump from 3,385,000 out of a total of 30,500,000 in 2010-11 to 4,048,000 out of a total of 29,900,000 in 2011-12.<sup>18</sup>

## 5.2 The tax burden on high incomes

Turning to the highly paid, the main concern is with the marginal rate that they suffer. How much of a performance bonus, or of a reward for additional work, will be taken in tax?

Here, the UK does badly. In 2011, only three of the 34 OECD countries have higher top tax rates than the UK's 50 per cent: Sweden, Denmark and the Netherlands. A further three, Austria, Belgium and Japan, also have 50 per cent rates. The remaining 27 countries have lower top rates.

If the UK had kept its top rate at 40 per cent, the picture would have been dramatically different. 21 other OECD countries would have had higher top rates, two would have had an equal top rate and ten would have had lower top rates.

It is quite clear that the UK could make itself a lot more competitive on this measure by abolishing the 50 per cent top rate of income tax. And the evidence is that it raises very little revenue, if any.<sup>19</sup> It would seem that only politics stands in the way of this easy way to move the UK up the ranks of developed economies.

## 5.3 VAT

Finally, we need to note that taxes on income are not the only factor that increases the cost of employing people. Employees do not expect a certain amount of net pay in itself, but a certain standard of living, and therefore a certain amount of net pay relative to the cost of living. One important element in the cost of living is the level of taxes on

---

<sup>18</sup> *Income Tax Liabilities Statistics*, HMRC, April 2011, page 16.

<sup>19</sup> The evidence is analysed in *Budget Submission 2011*, Institute of Directors, March 2011, chapter 1.

consumption, and in particular VAT, the tax that applies to the majority of spending in the UK.

The UK is, as on other measures, in a middling position. 33 OECD members have a VAT or general sales tax in 2011 (the exception is the USA). The UK's rate is 20 per cent. 11 countries have higher rates, six other countries have the same rate and 15 countries have lower rates.

While the fiscal reasons for the increase in the rate of VAT from 17.5 to 20 per cent in January 2011 are perfectly clear, we should note that it does increase pressure on wages, increasing the cost of employing people, and that it does therefore have an impact on UK competitiveness. A 17.5 per cent rate would be beaten by only nine other OECD countries.

## 6 Certainty

Those who run businesses like to have certainty about as many things as possible. In particular, they like to know what the tax consequences of given transactions will be, and what the tax due on profits of a given size and type will be.

Last year, we noted that the great majority of UK businesses can reliably predict the relationship between their investments, their profits and their tax liabilities.<sup>20</sup> There were, however, a few areas of concern. There have been significant developments since last year's report in three areas.

- A general anti-avoidance rule (a GAAR) is now under active consideration. The Government set up a group of experts, chaired by Graham Aaronson QC, to look at the options. Mr Aaronson's report was published in November 2011. If the idea is taken further, the next stage will be a formal Government consultation.

The great fear about a GAAR is that it may lead to huge uncertainty. There is, however, a very helpful counter to the temptation that tax authorities may feel to generate uncertainty by introducing a vague GAAR. If a GAAR might or might not catch a given transaction, the courts will tend to give the taxpayer the benefit of the doubt. Thus a vague GAAR is likely to be useless to the tax authorities.

If, on the other hand, the eventual outcome of the current work is a GAAR that has a very clear focus, on the tax avoidance schemes that are manifestly abusive, that may not add much to business uncertainty. Mr Aaronson's report recommends such a clearly-focussed GAAR. It would, however, be important to establish that the impact of a GAAR really was clear. The opinions of tax practitioners would not demonstrate this. We would need to test any prospective GAAR by taking several tax avoidance schemes, and then asking a significant number of lawyers, all working without communicating with one another, to say which schemes would be defeated by the GAAR. We could only have confidence that the impact of the GAAR was clear if there was very little variation between their answers.

Even if a GAAR did pass that test of certainty, we could not be sure that it would give certainty in practice until it had been in use for several years. Any GAAR should therefore be accompanied by a full clearance procedure, which would allow taxpayers to ask HMRC in advance whether they might use the GAAR against a piece of tax planning. HMRC answers would have to be supplied quickly, and they would have to be binding on HMRC unless the taxpayer had failed to disclose material facts.

- A new framework for policy development has now been published.<sup>21</sup> It sets out five stages, from setting out the objectives and identifying the options, through to reviewing and evaluating changes after implementation. Consultations are promised at key stages, and a large proportion of the process will be public. The framework is a good one. But we should not only consider its impact on the quality of the policies that are created. We should also consider its impact on certainty. If a company is considering a major investment, the returns on which will be enjoyed over a period of several years, and will be affected by changes to tax law within that period, will this new framework reduce or increase the business uncertainties?

---

<sup>20</sup> *How Competitive is the UK Tax System?* by Richard Baron, Institute of Directors, 2010, page 16.

<sup>21</sup> *Tax Consultation Framework*, HM Treasury and HMRC, March 2011.

The effect should be positive overall. The potentially drawn-out nature of the process might be thought to reduce certainty, but the alternative would be changes that suddenly came out of the blue. At least under the new framework, businesses can have a good idea a year or so in advance of which changes are likely, and can look at detailed specifications of policy changes before they come into effect.

One useful addition to the new framework would be a published rolling five-year programme for the whole of the tax system, with a timetable for any planned changes. (A rolling programme would straddle general election dates, but a government could state that it was committed to a programme subject to its winning the next election.) Such a programme has been published for the corporate tax system, although it is a programme for the fixed period to 2014, not a rolling programme with regular updates.<sup>22</sup> It would be good to see a more comprehensive programme.

- We now have greater clarity on the circumstances in which new policy may be made rapidly, outside the framework. The usual cause of such rapid policy-making is tax avoidance. The Government becomes aware of a scheme, and announces that with effect from the date of the announcement, the law will be changed in order to ensure that the scheme no longer works. Legislation to achieve this is then included in the next finance bill. A protocol on this type of change has now been published.<sup>23</sup>

The protocol commits the Government to giving enough technical detail for tax specialists to be able to understand the changes that are to be made in the next finance bill. It also limits such announcements to cases where there would be a significant risk to the Exchequer. So while the known risk of surprise announcements of changes to the law that come into effect immediately is bound to lead to some uncertainty, the protocol does at least limit that risk to special circumstances in which taxpayers can be aware that they run the risk – in particular, the use of aggressive tax planning schemes.

Overall, we can say that the level of certainty available to taxpayers has remained fairly stable over the past year. There is, however, room for improvement. We note some results related to large businesses in section 7.3.

---

<sup>22</sup> *Corporate Tax Reform: delivering a more competitive system*, HM Treasury and HMRC, November 2010, page 17.

<sup>23</sup> *Tackling tax avoidance*, HM Treasury and HMRC, March 2011, pages 19-20.

## 7 Administration

The competitiveness of a tax system is primarily a matter of how much money it takes from taxpayers. But administrative simplicity can help too. Business people work more effectively when they can concentrate on their businesses, and are not distracted by administrative burdens. There have been several developments in the past year. We will consider them under the same three headings as were used in last year's report.

### 7.1 The overall administrative burden

The Government has launched a significant new initiative to seek to reduce the overall administrative burden. In the March 2011 Budget, it was announced that the Government would look at merging the operation of income tax and national insurance, the two separate taxes on employment income that employers must apply through the PAYE system. This announcement was followed by an exercise to gather evidence from employers and others on where burdens arose and how a merger might help.

While we can welcome this initiative, it exposes a limit on the Government's thinking that threatens to impose severe constraints on what may be achieved. The Government is only interested in merging the operation of the two taxes, not in merging income tax and national insurance themselves. It is by no means clear that a merger of the two taxes would be a good idea. There are arguments for and against. But it is pusillanimous to rule out in advance a reform that would deliver huge administrative savings.

We must also be concerned at the lack of progress on targets for the reduction of administrative burdens on taxpayers. A set of targets covered the five years down to March 2011. Eight months later, a replacement set of targets had not been announced, even though it was known well in advance that the old targets were due to expire. It is not easy to work out what new targets should be put in place, especially since the targets need to be quantified, and tough but realistic. But the new targets should still have been announced in the March 2011 Budget.

We do have data on how large businesses perceive the burden, and these data emphasize how important it is that tough new targets should be set. A survey conducted in autumn 2010 found that 78 per cent of the largest businesses, those whose affairs were handled by the Large Business Office, thought that the administrative burden of tax compliance had increased in the preceding 12 months, and 69 per cent thought that the overall cost of tax compliance had increased in the preceding 12 months. Action should be taken to get the burden to fall, not rise.<sup>24</sup>

### 7.2 Simplicity in the rules

The Office of Tax Simplification has published a report on tax reliefs, and an interim report on the taxation of small businesses (including the personal service company rules known as IR35). It is now working on the ways in which taxable profits are computed for small unincorporated businesses, on tax administration, and on disincorporation relief, and it is starting to work on the taxation of pensioners and of share schemes.

All of this work has the potential to be valuable. But the item most likely to improve the attractiveness of the UK to international investors is the work on share schemes, which

---

<sup>24</sup> *Large Business Panel Survey: businesses' experience of HMRC*, HMRC Research Report 142, 2011, prepared by IFF Research for HMRC, page 34.

have grown to be an important way to incentivize both executives and the generality of the workforce. As with income tax and national insurance, it will be essential for the Government to give serious consideration to policy changes, as well as to administrative improvements. Mere changes to administrative systems, without changes to the policy of the tax system, will not reduce burdens by as much as they could be reduced.

### 7.3 Relationships between HMRC and taxpayers

In February 2011, HM Revenue & Customs (HMRC) published its *Change Plan*. The plan outlined a programme of work to improve services, within a diminishing resource budget, over the period from 2011 to 2015. The developments mentioned in the plan that will have the greatest impact on the business competitiveness of the tax system are the development of the skills of HMRC staff so that they work more effectively with large businesses, closer and better-managed relationships with large businesses, and various improvements to data quality and information technology.<sup>25</sup>

These are all worthwhile pieces of work that hold out the prospect of real improvement. In particular, the further development of good relationships between HMRC and large businesses is to be welcomed, because the use of HMRC customer relationship managers has already proved to be a success. It will, however, be a while before we can tell whether the plans now set out do make things better. Meanwhile, we can consider some evidence of taxpayers' current experience, and whether there are signs of improvement.

In June 2011, the HMRC Large Business Panel Survey was published.<sup>26</sup> It reported on a survey, carried out in the autumn of 2010, of the experience of 426 businesses that are dealt with by the Large Business Service and 1,344 smaller, but still substantial, businesses. Since the attractiveness of the UK tax system to the largest businesses is key to the international competitiveness of the UK, we here give results for businesses that are dealt with by the Large Business Service. The views of the other businesses were generally a little less favourable to HMRC.

- An astonishingly high 89 per cent of businesses reported that their experience of dealing with HMRC was good, and only 2 per cent reported that it was poor. Moreover, 25 per cent reported that it had improved over the previous year, while 11 per cent reported that it had worsened.<sup>27</sup>
- 91 per cent thought that HMRC actively sought a co-operative relationship, while 3 per cent thought they did not.<sup>28</sup>
- Rather less satisfactorily, only 76 per cent thought that HMRC had the necessary level of technical expertise, while 9 per cent thought they did not. There was only a tiny improvement on the previous year, when the percentages were 75 and 10 respectively.<sup>29</sup> Moreover, only 69 per cent thought that HMRC had a good understanding of the taxpayer's business, while 13 per cent thought that they did not. The corresponding percentages for the previous year were 62 and 16 respectively, suggesting that there has been progress in the understanding of businesses.<sup>30</sup>

---

<sup>25</sup> *Change Plan*, HMRC, 2011, pages 6 and 9.

<sup>26</sup> *Large Business Panel Survey: businesses' experience of HMRC*, HMRC Research Report 142, 2011, prepared by IFF Research for HMRC. This survey was compiled in a different way from the previous year's survey, reported in *Large Business Customer Survey*, HMRC Research Report 102, 2010, prepared by TNS-BMRB for HMRC. We therefore refer to data for previous years as reported in the 2011 survey, since those data incorporate any necessary adjustments to ensure comparability, rather than referring back to the 2010 survey.

<sup>27</sup> *Large Business Panel Survey*, page 57.

<sup>28</sup> *Ibid.*, page 59.

<sup>29</sup> *Ibid.*, page 60.

<sup>30</sup> *Ibid.*, page 60.

- Standards of service matter to hard-pressed tax professionals. Sadly, only 76 per cent agreed that HMRC responded to queries within an agreed timeframe, and 13 per cent disagreed. The corresponding percentages for the previous year were 79 and 12 respectively, showing that performance may be getting worse.<sup>31</sup> As to the quality of responses, 81 per cent agreed that HMRC provided a reliable response to queries, and 6 per cent disagreed (82 and 6 in the previous year).<sup>32</sup> Concerns here are doubtless connected with concerns about technical expertise.
- Certainty is greatly valued by taxpayers, and long-running disputes are to be avoided. 73 per cent agreed that HMRC provided certainty in tax affairs, while 11 per cent disagreed. The corresponding percentages for the previous year were 54 and 20 respectively, so there has been a marked, and very welcome, improvement.<sup>33</sup>
- Having said that, when disputes arise, the process of resolution is not wholly satisfactory. Only 56 per cent agreed that HMRC demonstrated commercial understanding in resolving disagreements, while 24 per cent disagreed. And only 59 per cent agreed that HMRC resolved disagreements within agreed timeframes, while 20 per cent disagreed.<sup>34</sup> 46 per cent agreed that HMRC had improved the process of resolving disagreements, while 15 per cent disagreed.<sup>35</sup>

Given these results, the top three priorities for improvement are not surprising. They are quicker responses to queries, more knowledgeable and better-trained staff, and more commercial understanding.<sup>36</sup> But we can also ask about the overall effect of the relationship between HMRC and taxpayers on the UK's competitiveness.

22 per cent of the largest businesses considered HMRC's administration of the tax system to have an effect that was mainly positive, while 36 per cent considered it to have an effect that was mainly negative. Worryingly, the corresponding percentages for the previous year were 33 and 30, indicating a marked deterioration.<sup>37</sup> Furthermore, of the businesses that had considered relocation to another country, 22 per cent cited the cost of tax compliance as one of the reasons for considering relocation.<sup>38</sup> HMRC have made some improvements, but there is clearly much to be done, and it needs to be done sooner rather than later.

The need for improvement is underlined when we look at a wider range of businesses. An area of particular concern is how HMRC officials behave when they enquire into taxpayers' affairs. Nothing is likely to damage a business's perception of HMRC more, or distract from running the business more, than an excessively heavy-handed, guilty-until-proved-innocent, attitude by officials. The senior management of HMRC understand this well, and the declared aim of HMRC is to help those who want to get their tax right, while dealing firmly with those who do not want to get it right. A recent study by BDO found that all was not yet well in this area.<sup>39</sup>

The study considered a range of different types of situation. Aggressive artificial tax avoidance meets with a combative HMRC response, and it would be hard to object to that. Unfortunately, reasonable tax planning to limit costs can meet with a similarly confrontational response, and sometimes to unnecessary litigation that benefits no-one. Even when there has been no unusual tax planning, HMRC officials can show a lack of understanding of the complexities of modern business, and the many ways in which

---

<sup>31</sup> *Ibid.*, pages 60-61.

<sup>32</sup> *Ibid.*, page 61.

<sup>33</sup> *Ibid.*, page 67.

<sup>34</sup> *Ibid.*, page 70. Comparative figures for the previous year are not available.

<sup>35</sup> *Ibid.*, page 71.

<sup>36</sup> *Ibid.*, page 19.

<sup>37</sup> *Ibid.*, page 76.

<sup>38</sup> *Ibid.*, page 77.

<sup>39</sup> *Tax Challenges: an Imperative to Discriminate*, BDO, 2011.

decisions can be taken, leaving records that, while they make perfect sense to the business, are not easily understood by officials who have been brought up to expect traditional minutes and detailed records of reasons for decisions. The conclusions of the report, which reflect practical experience in helping businesses to cope with enquiries, show that there is plenty of scope for officials to acquire a more realistic attitude to businesses. In particular, they should recognize that business must be conducted in the ways that get results, which may not be the ways that best suit civil servants.

## 8 The prospects for improvement

The UK is not particularly competitive on the overall tax burden, the corporation tax rate, the combined rate on companies and individual shareholders, or tax burdens on the incomes of individuals. The UK is nowhere near being the first choice on tax grounds as a destination for internationally mobile capital. In a globalized world, we need to do better.

There is, unfortunately, little prospect of dramatic improvement in the near future. The Government has to focus on reducing the deficit. Tax rate reductions can stimulate growth, improving tax receipts and making it easier to balance budgets, but one can understand how a Chancellor might hesitate before committing to tax rate reductions, at a time when there is precious little margin for error.

There is more hope of a commitment to a long-term plan to reduce tax rates. If the Chancellor would like to give business confidence a boost, this is one of the best things he could do. Any such commitment would of course be subject to the outcome of the next general election, but that would be clearly understood by all.

Finally, there is plenty of scope to improve the ways in which HMRC works with major taxpayers, at little cost. The relationship is already good, but technical expertise, business understanding and the handling of disputes could all be improved.

# 9 How could the UK progress towards a flatter tax system?

by Stephen Herring and Thomas Story of BDO LLP

## 9.1 Introduction

Both businesses and individual taxpayers instinctively state that they would welcome a simpler tax system which enabled them to make investment decisions without being unduly concerned about the tax treatment of these decisions. Both economists and politicians from across the mainstream political spectrum talk favourably of a broad tax base, lower tax rates and the removal of tax distortions created by overly focussed tax exemptions and reliefs. Incoming governments invariably state that they intend to simplify taxation and ensure that the United Kingdom provides a tax framework which is attractive to both global businesses and entrepreneurs, and which promotes foreign direct investment into the UK.

So why is it then that the UK's tax legislation now (in 2011/12) includes over 38,400 pages of primary legislation, statutory instruments and HMRC statements of practice, codes of practice and guidance notes? The reasons are complex, contradictory and open to debate. They certainly include the following.

- Competing government priorities (for example, the incentives for green energy)
- Perspectives upon fairness (for example, the loss of the personal allowance for taxpayers earning over £100,000 a year)
- Perceptions of special cases for particular industries (for example, North Sea oil and property investment)
- Keeping pace with competing economies (for example, controlled foreign companies reforms and the proposed patent box tax regime)
- The strength of vested interests supporting the continuation of highly targeted tax reliefs (note, for example, the reactions to many of the proposals suggested by the Office of Tax Simplification)
- The willingness of tax advisers to promote tax arrangements which attempt, often unsuccessfully in recent years, to exploit perceived inconsistencies in the tax legislation
- The interface between UK tax legislation and the UK's obligations to ensure 'freedom of establishment' and 'freedom of movement' within the European Union
- The lack of a clear vision for overarching tax policy reforms
- Suspicion within HM Treasury and HM Revenue & Customs towards what they perceive to be simplistic tax policy frameworks.

This is a daunting list (and probably incomplete!), but that does not mean that the desire for a simpler tax system should be ignored. Indeed, to do so would be a tacit acceptance that the UK's tax legislation will, inexorably, grow in size and complexity regardless of the impact upon the economy, the problems of enforcement and, most importantly, the views of taxpayers.

A key initiative by the Coalition Government to reduce unnecessary complexity in the UK tax system was the establishment of an independent Office of Tax Simplification (the OTS). The most high-profile initiative undertaken by the OTS to date has been to recommend to HM Treasury tax reliefs which could be simplified or abolished. The OTS recommended the outright abolition of 45 reliefs and simplification of a further 17. However, most of these reliefs are obscure and, while this may well have been a worthwhile exercise, it will impact on relatively few business or personal taxpayers. A bolder approach is called for if significant progress is to be made towards achieving genuine tax simplification.

We consider that a move towards a flatter tax system in the United Kingdom should be underpinned by the following principles:

- Broadening the tax base to enable tax rates to be lowered
- Successfully resisting lobbying that seeks to secure excessively focussed tax reliefs or exemptions
- Testing existing taxes to establish whether they justify their existence in terms of either tax revenues raised or an overriding imperative for fairness
- Simplifying tax compliance for both business and individuals (and, incidentally, simplifying enforcement by HMRC)
- A more discriminating approach to tax enquiries by HMRC, focussing upon combating artificial tax schemes rather than attempting to identify tax traps into which genuinely commercial transactions may have stumbled.

We consider that it is important to understand that a simpler and flatter taxation system need not carry with it a particular political viewpoint. There is no reason why the Conservative, Liberal Democrat and Labour parties cannot embrace most of the principles stated above. By way of example (and using 2011-12 projected tax receipts), if corporation tax receipts must remain around £50 billion a year, this could be achieved with a lower rate of corporation tax applied to profits reported under UK Generally Accepted Accounting Principles (UK GAAP) or International Financial Reporting Standards (IFRS), with no accelerated reliefs for capital spending on plant and equipment or intellectual property. Similarly, if income tax receipts must remain around £160 billion, this could be achieved by abolishing higher tax relief for personal allowances but increasing the basic rate tax band to remove a substantial number of taxpayers from the current 40 per cent marginal rate (which is higher if national insurance contributions are included).

We are certainly not talking in this paper about the overnight (or even protracted) implementation of a flat tax system out of adherence to any rigid and prescriptive economic hypothesis. We are unconvinced that a complex developed economy such as the United Kingdom can learn much from the implementation of the, more or less, flat tax systems in countries such as the Russian Federation, Bulgaria and the Baltic states. The vision we are promoting is that there are sound reasons for the UK to move *in the direction of* a flatter tax system and that there are areas of tax law which can be highlighted where progress can be made in the short to medium term which would be entirely consistent with the Coalition Government's stated objectives to reduce the fiscal deficit, create a more competitive tax regime and simplify taxation.

The following sections suggest some areas of tax law for both businesses and individual taxpayers where progress to a flatter tax system might be made over, say, a two to five year time horizon.

## **9.2 Business taxation**

As stated above, we have made the prudent assumption that, in broad terms, changing the business tax system towards a flatter tax system must be achieved against the backdrop of there being little or no scope for net tax reductions and, specifically, that the amount collected from corporation tax must remain around £50 billion. If there were to be room for modest tax reductions, progress could be achieved on a more favourable basis and more speedily.

The suggestions below would all simplify corporation tax, but all would mean that there would be winners and losers. Accordingly, we have noted some areas where a more protracted transitional period would be required.

### ***A single corporation tax rate***

For many years, a fundamental aspect of complexity in the corporation tax system has been the different tax rates applied to companies with small and large profits. In recent years, chancellors have not considered it necessary to reduce the small profits rate of corporation tax (formerly called the small companies rate) *pari passu* with reductions in the main rate of corporation tax. Similarly, the small profits rate upper limit has been fixed at £300,000 for almost ten years, thereby substantially eroding its real value.

Currently, the small profits rate of 20 per cent applies on taxable profits up to £300,000 with the full rate of 26 per cent applying on taxable profits over £1.5 million. Between those two points, profits are taxed at the anomalously high marginal rate of 27.5 per cent.

These thresholds are modified for groups and other connected party situations by dividing by the number of associated companies; in many cases it is not straightforward to determine the number of associates and perform these calculations. In fact, even businesses controlled by entrepreneurs and their families often need to establish more than one company for commercial reasons and, accordingly, often do not benefit from the small profits rate.

With the full rate due to fall to 23 per cent by 2014, the question arises as to whether a differential of only 3 per cent warrants the complexity of retaining two principal corporation tax rates, with the computational complexity that follows.

In our view, the Chancellor should seek to accelerate the reduction in the main rate of corporation tax to 20 per cent by 2013, by which time a simple corporation tax system with a single rate of tax would have been achieved.

To promote entrepreneurial businesses, we consider that alternative tax reliefs should be enhanced. For example, the annual investment allowance, which provides 100 per cent tax relief for a fixed annual level of capital expenditure, should be somewhat more appropriately targeted and preserved at £100,000 a year, rather than implementing the scheduled reduction to £25,000 from April 2012. This would be more beneficial and would encourage entrepreneurial business activity where further investment in plant and equipment is needed. In our view, this would be a more focussed and valuable incentive to entrepreneurial businesses than retaining the complexities of the small profits rate once the main rate falls to 20 per cent.

### ***Aligning taxable profits with financial statements***

In our view, the corporation tax position should, as far as possible, follow the treatment adopted in the financial statements as this ought, in principle, to align tax liabilities with the underlying commercial position; whilst either UK GAAP or IFRS might not always be perfect, they are clearly a better measure of underlying profitability than business

taxation computations under the current system. Such a change would significantly reduce the tax adjustments required to prepare and file tax returns and computations.

The UK corporation tax system remains highly focussed upon calculating the profits and gains arising from each business activity and, only then, combining the outcomes to arrive at the corporation tax return and computation for the company as a whole (group tax issues are discussed separately below). In our view, this is an outdated approach to company taxation. There are very strong grounds for permitting companies to elect to treat their trades and other business activities as a single composite business. This would simplify corporation tax and remove the anomalous position whereby a company might have made an overall loss but is still required to pay corporation tax, for example, if the trade which made the loss had not been carried for the whole year or if the company made an overall loss in one year but commenced an additional trade in the following year.

Another fundamental step in this direction would be to replace the current system of capital allowances for tax relief on capital expenditure on items such as plant and machinery by aligning relief with commercial depreciation in the accounts. The proviso would be that the depreciation satisfied the criteria set out in UK GAAP or in IFRS.

It must be acknowledged that any such move would require adequate transitional measures which, in the short term at least, might marginally increase the complexity of the system. We would only support an abolition of the capital allowance system if a simple, sufficient and equitable transitional system were to be implemented. One approach would be to allow companies to continue to claim capital allowances on existing capital assets but claim depreciation on future acquisitions. However, in many cases, in our opinion, companies would immediately elect to adopt depreciation immediately and the resulting simplification would both benefit taxpayers, and reduce HMRC's review procedures.

### ***Simplifying group taxation***

The corporation tax system requires each company within a group to prepare a separate tax return. It is generally possible to transfer unused losses between group companies, and a parallel system of elections applies to capital gains and losses. The end result of this process is normally tax liabilities that are broadly in line with group results, but anomalous results can sometimes arise that do not reflect the commercial position.

Even for relatively small groups, this process imposes complexity upon the tax compliance process. For larger groups, the logistical challenges of retaining records of the taxation position and the history of claims and elections for each individual group company should not be underestimated.

Furthermore, the system of group relief only applies to offset profits and losses arising in the current year. This can often lead to losses being stranded in one company as future profits arise elsewhere in the group. Often tax planning can mitigate these issues but it would seem that management time would be better focussed on driving the business forward rather than undertaking tax planning merely to ensure that properly incurred business costs obtain appropriate tax relief.

To reduce the compliance burden for groups, we consider that an option to file a single corporation tax return on a group-wide basis should be introduced. This is already possible for VAT purposes and, more importantly, variations of consolidated tax systems apply in a number of the UK's competing G20 countries, including the US and Germany.

### ***Safe harbours for finance deductions***

One of the most complex and uncertain aspects of the UK corporation tax system is the extent to which interest and other finance costs qualify for tax relief. The relevant legislation includes a motive test (the so-called unallowable purpose test), the resolution of which can often be uncertain and contentious.

It is understandable that transfer pricing rules also apply to restrict tax relief for interest deductions on connected party debt funding to what would be available if borrowing from a bank or other unconnected lender. However, the lack of any safe harbours setting out the quantum available means that this is often an area of tax uncertainty for many businesses.

The requirement for companies to self-assess the level of debt funding and market interest rates for their particular business and retain documentation to support the position represents a costly compliance burden and the disputes with HMRC that frequently arise are an unwelcome distraction.

In our view, a simple statutory safe harbour, set according to easily calculated business metrics such as debt:equity ratios or, possibly, EBITDA (earnings before interest, tax, depreciation and amortisation) would provide welcome certainty and simplicity. For example, Germany operates a relatively straightforward restriction of interest relief to, broadly, 30 per cent of EBITDA, noting that interest in excess of this limit may be set off in future periods subject to the same criteria. We would not, however, advocate restrictions on interest paid to entirely unconnected parties (which the German system can require) as this should be left to the market to determine.

We would welcome a debate on a simple and equitable safe harbour of a similar nature. If set at an appropriate level, it would also offer scope to abolish some or all of the range of other anti-avoidance provisions in this area (for example, the worldwide debt cap, the unallowable purpose provision, the anti-arbitrage rules and the provisions on acting together) in a revenue-neutral manner. A safe harbour, such as is proposed above, could well discourage businesses from attempting to introduce excessive intra-group or connected party debt as they would forgo the protection of the safe harbour.

### ***Introduce a comprehensive participation exemption for holding companies***

For many years, countries such as the Netherlands, Luxembourg and Spain have operated holding company regimes that are widely regarded as more appropriate – and, indeed, more favourable – for cross-border investment than the UK.

A key aspect common of these holding company systems is a wide-ranging and simple participation exemption, which typically ensures that no corporate tax arises at the holding company level on dividend income and capital gains from subsidiaries.

It should be acknowledged that both this Government and its predecessor have made progress in this area. The UK corporate tax system now contains an exemption for capital gains known as the substantial shareholding exemption and a general exemption for most dividends, whether from UK or non-UK companies.

However, the substantial shareholding exemption regime is both unduly complex and restrictive in comparison to many other systems. For example, it cannot apply to subsidiaries that are regarded as investment businesses rather than trading businesses. This continues to make the UK uncompetitive as an international holding company location in important sectors, including financial services and property investment businesses.

A simple rule, such as the Luxembourg exemption for almost all capital gains and dividend income arising from all shares above a minimum ownership threshold of 10 per cent and after a minimum ownership period of one year, would be very welcome. In our view, this would be self-financing as it would attract substantial business activity to the UK, outweighing the relatively low fiscal cost of introducing such a measure.

### **9.3 Personal taxation**

Even more than business taxation, the taxation of individuals is, inevitably, a highly charged, politically sensitive area. Any government would wish to be confident that any tax reforms affecting individuals could be properly argued to be equitable. There are many instances in recent years of personal tax reforms becoming far more contentious and far more complex to implement than was anticipated by the Chancellor at the time. The ten per cent income tax rate and the abolition of capital gains tax taper relief come to mind.

Nevertheless, we consider that there are strong arguments in personal taxation as well as business taxation for moving in the direction of a flatter tax system; however, the tax reforms to achieve this must satisfy the criteria of fairness and simplicity. It is important to emphasise that it has been assumed that all of the proposals identified below must be capable of being implemented on the basis that there is no material reduction in the overall tax take, that is, that income tax should continue to collect around £160 billion, national insurance around £105 billion, capital gains tax around £3 billion and inheritance tax around £3 billion.

#### ***Pensions tax relief***

When examining the potential benefits of a flatter tax system, in the personal tax context, it must be acknowledged that by far the most costly targeted relief is that which applies to pension contributions. Therefore, a significant restriction (or even abolition) of pension tax relief would represent a substantially flatter tax system.

Restricting tax relief on pension contributions to the basic rate would be one possible approach. This would, of course, be widely opposed by many higher-rate taxpayers and by the investment industry on behalf of its pension savers. An interim position, such as providing a fixed tax relief of 25 or 30 per cent might, however, be considered as an alternative approach.

On the other hand, the very substantial savings to the Treasury from such a measure would enable significant progress to be made towards achieving other fiscal goals that would be highly beneficial, including some or all of the following:

- Accelerating the increase in the personal allowance to the Coalition Government's target of £10,000 or higher
- Raising the basic rate band so that the 40 per cent higher rate does not apply to taxpayers earning less than twice average earnings
- Reducing the internationally uncompetitive 50 per cent top rate of income tax, which is considered to deter both globally mobile executives and entrepreneurs from locating in the UK.

We would welcome a balanced debate to consider whether the undoubted disadvantages of withdrawing higher-rate tax pension tax relief for higher-rate taxpayers would outweigh the benefit of a flatter tax system with lower marginal personal tax rates for many taxpayers.

### *Alignment of PAYE and NIC*

The Treasury is currently examining a range of options to align the income tax and national insurance systems, but it has been stated that these will not be introduced during the course of this Parliament and will, understandably, maintain the contributory principle for entitlement to retirement pension and other contributory benefits.

However, in our view, there is no insurmountable reason why a single set of rules and parameters could not be devised to calculate the quantum of remuneration which is subject to both income tax and national insurance. This would significantly reduce the administrative burden for employers running payroll and benefits systems and, more importantly, make the rules more transparent and understandable for individual taxpayers.

Furthermore, a full alignment of bands between the two systems and calculating national insurance on an annual basis would increase understanding for taxpayers.

Such alignment would remove many of the anomalies which arise from the existing divergence between the two systems.

### *Overhaul the taxation of share incentives*

The current tax system is a significant disincentive for companies to establish appropriate share incentive arrangements.

The general rules can often lead to significant tax liabilities for both companies and individuals, before any cash is realised by employees. This is a significant barrier to increasing share ownership by employees, and is an obstacle to the alignment of employee remuneration with the longer-term profitability of the company.

While there are a number of tax-advantaged share option schemes available which provide a range of statutory tax benefits, these all have a complex range of conditions which restrict the commercial suitability and practical benefits of these schemes.

We consider that an alternative framework can be devised that would be easier for companies to administer, would be more attractive to employees and would remain affordable for the Treasury, as follows:

- Employers could grant share options to any employee, at any price, without limits on how many options could be granted.
- The grant of share options would not be taxed unless the option was made available at a discount to the market price, in which case employees would be liable for the tax at their full marginal rate when the options were granted.
- The exercise of an option would have no tax impact, but the sales of the underlying shares would trigger a capital gain, meaning that the employee would pay capital gains tax at the prevailing rate on the gain arising.
- There would be no income tax or national insurance to pay as any profit on the exercise of an option is not remuneration, but an investment return.
- To put these reforms on a broadly tax-neutral footing, corporation tax relief relating to the grant and exercise of options would be abolished.

### ***Merger of CGT and IHT***

To achieve authentic tax simplification, radical measures are required which would eliminate the need for whole chapters of tax legislation or, in this case, an entire tax. Capital gains tax (CGT) and inheritance tax (IHT) currently collect around £6 billion in aggregate and, in our view, it should be challenged periodically whether these two taxes in their present form justify the complexities introduced within the tax system and the distortions created in response to these taxes which affect commercial and financial decisions made by individuals and entrepreneurial businesses.

Currently, no capital gains tax arises on death but, instead, inheritance tax arises on the value of the deceased's estate (and certain gifts made within seven year of death). In our view, it would be both simpler and more equitable if the two taxes were merged. This could be achieved by a charge to capital gains tax arising on assets held at death above a fixed and reasonably generous threshold, where the probate value exceeded the acquisition cost incurred by the deceased. We consider that a full relief would be needed for trading businesses, like the exemption for inheritance tax that is currently provided by business property relief. This would ensure that privately owned businesses would not be burdened by the requirement to fund a substantial liability on a shareholder's death.

An increase in the incidence of capital gains tax as described above would enable inheritance tax to be repealed in its entirety at little or no cost to the Exchequer.

Such a system would also counter the common complaint that inheritance tax is fundamentally inequitable as it applies to amounts that have often already been taxed as income or gains.

### ***Simplification of savings taxation***

One simple reform which would very substantially reduce the number of taxpayers required to complete self-assessment returns would be to introduce an annual exemption of, say, £10,000 for interest, dividend and other savings income which would no longer be taxed or be reported on income tax returns (except by checking a box to confirm that total savings income was below this figure). Savings income from both savings accounts and dividends above this level would be taxed at a flat rate of, say, 35 per cent.

## **9.4 Some conclusions**

We are firmly of the view that there is scope for progressing to a simpler, flatter taxation system which would be better understood by taxpayers and could be achieved without making the system less equitable. Both the Coalition Government and the previous Labour Government have introduced tax reforms under the banner of simplifying taxation, but no authentic progress has been made to date in reducing the size and complexity of tax legislation. To achieve this outcome, a more radical approach is needed. A flatter tax system with fewer reliefs and lower tax rates represents a potential framework which we commend.

Stephen Herring  
Tax Partner, BDO LLP

Thomas Story  
Tax Director, BDO LLP

*Note: The views expressed in this article are the views of the authors and do not necessarily represent the views of either the Institute of Directors or BDO LLP.*

