Aligning Corporation Tax and Income Tax – as a prelude to radical reform

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by

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Summary

There are many reasons for aligning the main rate of corporation tax with the basic rate of income tax (currently 20 per cent). Any one of these reasons alone would be sufficient to justify reform. Together they make an overwhelming case:

- The tax bias against equity causes companies to leverage more than they would prefer if decisions were not distorted. This issue was identified in the recent ICB report.
- The tax bias against equity distorts investors' decisions.
- Lower rates of corporation tax (whether or not tied to the basic rate of income tax) would reduce taxes paid by investors which has direct advantages for pension funds, beneficiaries of unit trusts etc., as well as indirect effects in making the economy more capital intensive in an environment in which capital mobility is sensitive to international corporation tax rates.
- Aligning the main rate of corporation tax would significantly reduce tax compliance costs and reduce the size of the tax code. Unlike some of the changes in the 2011 budget, this would actually involve an area of taxation that affects large numbers of individuals and companies.
- Given the government's plans to reduce the rate of corporation tax and given the dynamic benefits from its reduction, tying the corporation tax rate to the basic rate of income tax would not have substantial revenue implications.
- After two decades of ever-increasing complexity in the tax system – a level of complexity that has made the system incoherent – tying the main rate of corporation tax to the basic rate of income tax would be a strong signal that the government wanted to make the UK tax system simpler and more coherent.
- In the long term, there should be radical reform of the corporation tax system which might involve abolishing the tax altogether.

Background

The high level of corporation tax rates in the UK is an important issue for several reasons which will be outlined in the next section. The coalition government has signalled a reduction in the rate of corporation tax in the coming years. Both this reduction and the manner of the implementation (a coherent deliverable programme) are important for efficient business decision- taking. However, even at the end of that process, corporation tax will remain above the basic rate of income tax and will not be particularly low by international standards. This paper proposes a reduction in corporation tax rates to the basic rate of income tax and also proposes maintaining the link between the basic rate of income tax and the corporation tax rate as a basic principle of the tax system until the system is reformed entirely.

In the long term a wholesale review of the corporation tax system along the lines proposed in the Mirrlees Review recently published by the Institute for Fiscal Studies or using an alternative approach discussed below would be desirable. Meanwhile, the proposals discussed below would encourage economic growth, remove distortions in the tax system and reduce compliance costs.

Problems caused by high rates of corporation tax

The recent report of the Independent Commission on Banking (ICB) discussed the problems caused by the differential tax treatment of equity and debt. In a speech before the election, George Osborne also raised the same problem. Curiously both the ICB and George Osborne talked about a *tax bias in favour of debt*. In fact, debt interest is treated exactly how we would expect it to be treated in a soundly-based tax system – debt interest is taxed in the hands of the recipient at the recipient's marginal income tax rate. On the other hand, equity finance is *discriminated against* because, in almost all cases, the returns to equity (company profits) and the distributions arising from those returns (dividends) are taxed at least at corporation tax rates. This means that for some investors (non-taxpayers such as charities) the tax paid on equity returns is 26% and the tax paid on returns to debt capital is zero (as is supposed to be the case for non-taxpayers). Capital gains tax complicates the situation a little (though does not change the basic argument) and can raise the effective tax rate on equity capital even further. The magnitudes of these distortions are different for people with different marginal income tax rates and they will, of course, be reduced significantly for basic rate taxpayers[1] by the government's current proposals. This tax discrimination against equity was greatly exacerbated by the withdrawal of dividend tax credits by Gordon Brown.

This tax discrimination gives rise to a number of direct problems:

- It distorts investors' decisions so that they take investment decisions on the basis of their tax position rather than on the underlying suitability of the investments.
- As a result of this, the tax regime distorts company finance decisions in favour of debt. This might be regarded as a particular problem in financial institutions in which equity capital provides for greater stability given its legal status.
- Complexity is created as companies try to design ways of circumventing the problem by designing special financing structures.
- Similarly, investors can try to circumvent the problems by investing in an optimal way from a tax perspective and then using derivatives to achieve the desired economic exposure.
- The need for the corporation tax rate to be consistent with the income tax rate for small levels of profits (generally for small firms) means that there has to be a special regime for smaller profits and a way of withdrawing that special treatment. This is discussed further below.
- The need for different investment funds to be treated on a consistent basis means that those investment funds that are regarded as corporations for tax purposes (such as life insurance companies, unit trusts and mutual funds) need special corporation tax rates and regimes applying to them.

The extent to which companies will issue debt rather than equity as a result of tax discrimination will depend on a number of factors including the preferences of those who own company shares and debt instruments. It is notable that pension fund investment in UK equities has fallen from 56% to 24% since 1993. This is not wholly due to the increased tax discrimination against equity resulting from Gordon Brown's 1997 decision but this has been an important contributory factor. It is also notable that investment in foreign equities has increased from 25% to 30% in the same period – foreign equities were not affected by the decision, of course.

Furthermore, there are specific problems with high corporation tax rates in terms of their effect on economic growth and the capital intensity of the economy. This problem is particularly acute when capital is mobile and for small open economies such as the UK. This problem is discussed in the next section.

1 The class of basic rate taxpayers does not only include personal taxpayers who are not large holders of equity investments but also life insurance and investment funds that have special regimes applied to them so that they, in effect, are treated like basic rate taxpayers.

Who pays corporation tax?

There seems to be a myth that prevails in popular discourse that corporation tax is somehow paid by ‘companies’. Ultimately, however, the burden of all taxes falls on households. In the case of company taxation, the direct burden falls on those households that own the company. In some cases, this will be overseas households, but it will also include UK savers who have indirect financial interests in shares through life insurance companies, mutual funds, unit trusts, investment trusts and pension funds. Corporation tax has a direct effect on such households. The higher the level of corporation tax, for example, the lower the level of the pension that individuals will receive from a given level of contributions. This is not a trivial point. For example, academic work suggests that the withdrawal of tax credits from pension funds by Gordon Brown reduced the pension received from a given level of contributions by about ten per cent. Insofar as this burden was reduced by changing investment policy, there would be other undesirable side effects. A decrease in corporation tax therefore benefits savers directly – some of these savers will be UK households but others will be overseas households.

Important academic work on corporation tax also points out that there are very serious effects of corporation tax arising from the tendency of capital to be mobile and therefore for its owners to respond quickly to a change in corporation tax. The effect of a higher rate of corporation tax is therefore to reduce the capital intensity of the economy, reduce the productivity of labour and therefore reduce the level of wages. This is no esoteric point, nor is it a point made by ‘Tea party’ activists and their academic supporters. The leading work on this was done by Professor Joseph Stiglitz. Important UK work has been undertaken by Professor Devereux at the University of Oxford who has estimated that the cost to workers, in terms of lower wages, of UK corporation tax, may well be greater than the corporation tax yield – though the mechanism explored by Devereux is somewhat different.

UK corporation tax rates by international standards[2]

In 2010, corporate income tax rates for the 31 member countries of the OECD ranged from 39 per cent (Japan) down to 12 per cent (Ireland), with a median of 26 per cent (Sweden). The UK's rate is 26 per cent, which is above the median and significantly closer to the highest rate than to the lowest rate. Capital is particularly mobile within the EU and thus UK rates relative to other EU rates would be expected to be important in the context of the considerations above. The EU average corporate tax rate in 2009 was 23 per cent. Clearly, current government reforms will take us to the EU average, but this is still not impressive given the fact that the size of the state is greater in most EU countries – relatively speaking we tax owners of corporations more than in the rest of the EU.

Given this, the government's current proposals are welcome and will significantly improve Britain's position by international standards. However, the dynamic benefits of reductions in corporation tax continue to be gained as the rate is cut further.

When considering the tax burden on equity capital, we should not only look at corporate tax rates. When a company makes a profit, it will usually pay at least some of the profit to shareholders who may then suffer tax on the dividends they receive. If we look at the total tax suffered by higher rate taxpayers on equity returns after allowing for personal tax, the UK has very high rates by international standards – the third highest in the world - and, even after the planned reduction in corporation tax rates, the total tax burden imposed upon higher rate taxpayers will be above the average (assuming no change in other countries).

2 See 'How Competitive is the UK Taxation System', Richard Baron, Institute of Directors, London, UK, 2010.

Corporation tax and tax simplification

Between 2007 and 2014, it is planned that the main rate of corporation tax will be reduced from the former level of 30 per cent to 23 per cent. The rate charged on lower levels of profit has generally been consistent with the basic rate of income tax now at 20 per cent. Thus the gap between the basic rate of income tax and the main rate of corporation tax has been narrowing.

National Insurance complicates matters considerably, but if that issue is set to one side, the convergence between corporation tax and income tax ensures that a person trading as a sole trader and paying tax at the basic income tax rate is, in principle, in the same position as one trading through a limited company with profits taxed at the lower rate:

- Ignoring personal allowances and any other income, a sole trader with profits of £20,000 will pay income tax of £4,000 at 20 per cent, leaving him with £16,000.
- If the profits are earned in a company, corporation tax of £4,000 will be paid and the balance may be taken out as a dividend without further tax liability, so he is still left with £16,000.
- Alternatively, the full amount of £20,000 may be paid out of the company as salary. In this case, the company has no taxable profits and so pays no corporation tax. The recipient of the salary pays income tax of £4,000, so is again left with £16,000.

It is because of the ease with which individuals can switch between the income and corporation tax systems that the small profits rate of corporation tax has to exist and be close to the income tax rate. The lower 'small profits' rate applies for a company with 'augmented profits' of up to the 'lower limit', which is in principle set at £300,000 (CTA 2010, s. 18). The figure of £300,000 is reduced if the company has any 'associated companies' as defined (s. 24). It is also reduced if the accounting period is less than 12 months.

Complex calculations are needed if a company has profits between the lower limit and the upper limit, which is five times the lower limit (so normally £1,500,000, but again subject to adjustments in various circumstances) (s. 19). A specific regime and set of regulations is necessary to 'dovetail' the main rate of corporation tax to the small-profits rate. If a company has profits at the upper limit, there is an effective marginal tax rate for profits between the lower and upper limits of 27.5 per cent for the current financial year (FY 2011).

Example

First £300,000 of profit @ 20% = £60,000.
Next £1,200,000 @ 27.5% = £330,000.
Total tax on £1,500,000 is £390,000, which is equal to the main corporation tax rate of 26 per cent.

Also, there are provisions to ensure that the small profits rate is not available if the company is not resident in the UK or if it is a close investment-holding company (s. 18). A different small profits rate applies for ring-fence profits (FA 2011, s. 6(1)).

As noted above, the figure of £300,000 on which the small-profits rate is charged is reduced if there are associated companies. Once again, a whole set of regulations is necessary to administer this provision.

The small company regime introduces a level of complexity that has a negative impact on large numbers of businesses and on most accountants. Any limited company that is making profits of at least £300,000, or that has associated companies and is making profits of even much lower figures, will have to grapple with the complexities. All but the smallest accounting firms will have at least some clients in those categories.

The complexity can cause real difficulties. An article in Taxation magazine dated 28th July 2011 lamented the complications and uncertainties and ended with a heartfelt plea to the tax authorities to ‘rid us of the hypocrisy of claiming that small companies are being given fiscal incentives, while the small print is intended to impede entirely legitimate claims’.

The case of *Reddleman Properties Ltd v Revenue & Customs* [2011] UKFTT 395 (TC) was just one recent example of uncertainty over one aspect of the rules.

In terms of legislation, the Corporation Tax Act 2010 devotes much space to the special rules. Part 3, entitled ‘Companies with Small Profits’ contains 17 sections covering the rules for companies with small profits. Most or all of this legislation could be repealed, subject to deciding what to do about the rules for ring-fence profits (which, however, are relevant only to far fewer businesses).

Another complication arises for certain companies where it is considered necessary to tax them at income tax rates for reasons discussed above. For example, the rate of corporation tax for open-ended investment companies, authorised unit trusts and most funds within life assurance companies is set at the income tax rate for the tax year starting on 6th April in the year concerned (CTA 2010, s. 614 and s. 618 respectively). These special rules would not be needed if the rates of corporation tax and income tax were linked.

Furthermore, the difference between the small profits and main rates of corporation tax can lead to a distortion of business decisions. A successful small company may wish to launch a new company alongside the successful company. In simplistic terms, this will lead to an immediate problem if the first company has profits above £150,000 as it will have to pay higher rates of corporation tax:

Example

Widget Ltd makes profits of around £280,000 each year. At the small profits rate of 20 per cent, it pays tax of £56,000.

The same owners decide to set up a new business alongside, different enough to justify a new company but still using some of the existing contacts etc. The new company makes profits in year one of £50,000 but the profits of the first company drop to £230,000 because of management time being focused on the new business.

Overall profits are therefore still £280,000. However, the overall tax bill has now risen to £62,000, a rise of £6,000. This increase is entirely due to the distortion caused by the small profits rules, which can thus act as a disincentive to grow new businesses.

Are small-profits and the main rate of corporation tax justified on grounds of "progressivity"?

Putting aside the cases for and against progressive tax rates in general, it simply does not make sense on grounds of creating 'progressivity' in the tax system to have separate rates of corporation tax for small and large profits. The beneficiaries of a company's profits (whether retained or distributed) are the shareholders or the beneficiaries of investment funds. There is no reason at all to suppose that the shareholders of companies that make larger profits are better off in general than the shareholders of companies that make smaller profits (indeed, the opposite is likely to be the case, as smaller companies are more likely to be owned by single individuals). Progressivity is, in any case, ensured by the system of taxing dividends.

Reform

The proposal of this paper is to reduce the main rate of corporation tax to the basic rate of income tax and tie the two rates together. This would simplify the tax system and not arbitrarily tax holders of equity more than holders of debt – except for tax-exempt investors or investors using tax-exempt funds.

The government should also consider long-term reform. This could be along various lines. For example, the Mirrlees Review suggested a general exemption from tax for interest and investment returns but the payment of some form of profits tax on the excess of profits over the risk-free return on capital. Alternatively, individuals could pay tax at their marginal tax rate on the *earnings per share* (not the dividends) that accrued to the shares they owned. This would involve a company paying no tax directly on profits but individuals paying tax on the profits attributed to them according to their tax status. Both of these approaches would remove the problems that exist within the current system of company taxation. Neither would be particularly difficult to implement from the administrative perspective.

Nevertheless, progress could be made and many of the problems of the company taxation system relieved by aligning the main rate of corporation tax with the income tax rate.

The fiscal cost

According to the calculations published by the Treasury, a reduction of one per cent in the main rate of corporation tax would lead to reduced revenue of about £2.4 billion. However, it should be borne in mind that the Treasury's models are static and they take no account of the benefits from increased investment to which a reduced rate of corporation tax would lead. As noted above, in the long term such increased investment would also increase income tax revenue. Furthermore, a number of corporation tax allowances could be reduced to pay for the change.

It is not necessary, however, to reduce the rate of corporation tax to the basic rate of income tax immediately. Business plans will be affected by a coherent and credible statement of intent. We therefore propose that, by the end of the Parliament, the two rates become unified.

Conclusions

There is a strong case for low corporation tax rates in general – a lowering of rates can be almost self-financing. There would be additional advantages from the corporation tax rate being tied to the basic rate of income tax in terms of reduced tax compliance costs, reduced administration costs for the Treasury and the removal of distortions in business finance decisions.

The differential between corporation tax rates and the basic rate of income tax will be just three per cent from April 2014. As such, the important simplifying principle of aligning the two rates is within grasp and the loss of revenue would not be that great. A further reduction in corporation tax of three per cent would go a long way towards making the UK corporation tax system competitive as well as making it coherent with other aspects of the tax system. Merging the main rate of corporation tax with the rate for companies with small profits would represent a modest but worthwhile simplification of the tax system. It would remove some unintentional pitfalls and many uncertainties over grey areas. If the (single) rate of corporation tax were then locked in to the basic rate of income tax, that would remove further distortions and problems.

The ideal outcome would be that all decisions as to business structure should be driven by factors other than tax. These moves would represent a significant step in the right direction.

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