Corporation tax reform

At the same time as the 29 November Office of Budget Responsibility report the government announced details of some of the reforms to corporation tax. Among the changes announced is a plan to make corporation tax more "competitive." This comes on top of other significant changes already announced, such as using iXBRL for filing corporation tax returns next year and proposed changes to the rules on connected companies.

The UK competes with other countries in terms of the corporation tax regime. The government "wants to send out the signal loud and clear that Britain is open for business." It has already reduced the rates of corporation tax for both large and small companies. However, its rates of 21% and 27% tax still compare unfavourably with the 12.5% offered by the Republic of Ireland. Even in its recent austerity package, the Irish government made clear that it would not increase this rate as countries have been calling for it to do. The UK had the tenth lowest corporation tax rates in the 27 present EU states in 1997. By 2010, it had fallen to 20th.

The proposals have five objectives:

- reducing rates but removing tax breaks, to maintain revenue
- maintaining stability, by avoiding constant changes
- being aligned with business practice, to reflect new accounting standards
- avoiding complexity, and
- maintaining a level playing field, not advantaging one group at the expenses of other groups.

TERRITORIALITY

The first significant change is a move away from taxing UK companies on global profits to taxing them on UK activities only. This change will particularly affect close foreign companies and foreign branches.

Up to now, UK tax law on controlled foreign companies (CFCs) has concentrated on preventing tax revenue being diverted to low tax countries. The government now recognises that these rules, largely introduced 25 years ago, go further than is needed and are now restricting UK companies in the current global markets. Some interim reforms are already planned for 2011. The government plans further reforms in 2012.

The broad thrust of the proposals are:

- to target more precisely artificial profit-shifting to low tax countries
- to exempt from UK tax foreign profits where doing so does not erode the UK tax base
- not to tax profits from genuine economic activities undertaken offshore.

This means that a CFC will only be taxed on UK-earned profits plus profits that have been artificially diverted from the UK. There will be special provisions for finance companies.

The further changes to the law regarding CFCs will consider separately issues relating to monetary assets, intellectual property, insurance, banking, and property.

These proposals sound eminently fair, but the issue to watch is the system for catching artificially diverted profits. The problem with putting down any trap is that it can catch animals you don't want to catch. We shall watch this aspect with particular care and can advise you when further details become known.

The government wishes to give UK companies the greatest freedom to manage its monetary assets in the way they regard as most beneficial. Equally the government recognises that financial instruments can be used as a means of diverting taxable profits from the UK. There are already rules on thin capitalisation to deal with some of these issues.

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Proposals being considered would tax companies according to their debt to equity ratio (also known as gearing). The solution is simple and pragmatic. Under such a scheme, the government would allow a minimum debt to equity ratio of 1:2. This would mean that two-thirds of the interest paid would be attributed to equity and be tax exempt. Another way of looking at this is the tax on debt interest is one third of the corporation tax rate. Inevitably such a proposal will come with extensive anti-avoidance rules that will need careful watching.

The government has already rejected the idea of trying to trace how funds are used. It believes that this would be too complex and self-defeating. Instead it proposes extending existing rules for finance companies to all companies. This would deal with issues of "swamping" where large amounts of funds are transferred to CFCs that perform a funds management function. Under such arrangements, interest would not be taxed in the UK up to a certain point (determined by the debt to equity ratio) and any excess taxed as if it was earned by a finance company.

For foreign branches, the government proposes to introduce an "opt-in exemption" from corporation tax on profits earned by foreign branchers of UK companies. As with most tax options, significant sums can be saved by understanding the option and exercising it appropriately.

Further details are expected to be known in the spring of 2011. Draft legislation is expected in autumn 2011 for inclusion in Finance Act 2012. As further details become known, we can advise you whether this option is worth taking.

INTEREST PAYMENTS

There was a fear that the government could end the tax-deductibility of interest payments on borrowings. It has decided not to do so, as most other countries allow such payments and doing so conforms with accounting standards.

It should be remembered that not all interest paid by a company is tax-deductible. We can advise you on whether interest you pay is deductible.

INTELLECTUAL PROPERTY

The taxation of intellectual property (IP), particularly patents, has been identified as an area that needs reform. The main driver is, again, preventing diversion of UK profits to low tax countries. Some provisions already apply, including transfer pricing.

Details have already been announced of proposals for a "patent box". Under this, profits derived from exploiting a patent will be given tax advantages. Further details will be published in spring 2011, with draft legislation in autumn, and final legislation in Finance Act 2013 (not 2012).

A first step is to exempt IP profits earned overseas with little UK connection. In the longer-term, proposals include identifying high-risk businesses and then assessing whether excess profits have been earned overseas.

If your business involves exploiting patents or similar innovative work, we can advise on how the patent box may be able to help your business. This would involve splitting off "excess profits" and then identifying how much is artificially diverted profit. The proposals again suggest using the debt: equity ratio. It is recognised that the many legitimate ways of managing IP makes this a complicated issue.

IR 35 ISSUES

One running sore in the tax system is the arrangement commonly known as "IR 35" about personal management companies. This is when a person works for his or her company and sells his or her services to clients on a basis that would otherwise regard the person as an employee. In short, it seeks to tax the self-employed on the basis that they are avoiding tax they would pay if they were employees. Commentators have observed that this is like taxing people for walking to work because they avoiding excise duty and VAT by not buying petrol to drive to work!

In practice, it is often far from clear whether someone is within the scope of IR35. The new Office of Tax Simplication has been given the task of simplifying this as its first priority. Details will be made known in time for the 2011 Budget. It is difficult to see what simplification there can be other than scrapping it.

In the meantime, the IR 35 rules remain in place. We can advise you on whether an arrangement made by you or by a supplier could be caught by these rules and, if so, what you should do.

ADMINISTRATION

The plans also give details of simplifying the administration of tax. This involves avoiding the constant change in tax laws, much of which is either trying to tell people how to run their businesses or closing loopholes found from previous changes. These proposals are welcome except that we have heard it all before.

The government has already set up two new bodies: the Office of Budget Responsibility (OBR) and the Office of Tax Simplification (OTS). Both have recently reported. The OBR gave the government a clean bill of health and gave more optimistic views for the country's economic future. The OTS has identified more than 1,000 tax breaks, which it has listed. It now starts the process of deciding whether they are all needed and whether those that are can be provided more effectively.

It is now planned to create another new body: The Corporate Tax Reform Liaison Committee to provide strategic oversight to corporation tax reform. This will include eight business representatives. They will be looking at the issues mentioned above, among others.

WHAT YOU SHOULD DO

Some of these issues are already with us. In particular, you should consider discussing with us:

- how to set up businesses overseas in a tax-efficient manner
- whether your distribution policies for a CFC are adequate
- claiming the special capital allowance for research and development
- considering how best to structure a business that exploits a patent
- checking whether one-man suppliers are caught by IR35 rules
- the most tax-efficient way of financing your business from debt and equity.

There are separate developments on corporation tax on which you should be aware, of which the most significant are:

- adopting iXBRL in computer filing of tax returns from 2012
- whether to use the new rules on national insurance holidays
- considering the structure of associated companies (which currently can include companies that have no connection with your business but are simply run by a close relation).

You also need to follow developments as they unfold of:

- changes to the territoriality of CFCs and foreign branches
- further changes to tax on exploiting patents
- changes to the rules relating to interest payments.

On all these matters, among others, we can provide you with advice and assistance.