SUBMISSION FROM CBI SCOTLAND

CBI Scotland welcomes the opportunity to respond to the Scottish Government's paper “Corporation Tax: Discussion Paper Options for Reform”.

We note that the questions contained in the paper are set on the premise that Corporation Tax (CT) will be devolved to the Scottish Government and Scottish Parliament. However, this assumption is hypothetical and, therefore, our response does not attempt to answer the questions but deals with the general and specific issues of concern to our members.

CBI Scotland is Scotland’s leading business organisation, speaking for some 26,000 businesses across all sectors of the economy that together employ around a third of the private sector workforce. As part of the UK CBI and with offices across the UK as well as representation in Brussels, Washington, Beijing and Delhi the CBI communicates the UK business voice around the world.

General

CBI Scotland recognises and shares the Scottish Government’s ambition to grow Scotland’s economy and improve the lives and opportunities of the people of Scotland. We also share the Scottish Government’s view regarding the benefits that would accrue to business and the economy from a lower rate of CT.

The discussion document has an apparent bias in favour of devolving CT to Scotland. The arguments in favour, together with supporting quotes, are selective and do not include the principal counter-arguments or the quotes of those who are opposed to, or questioning of, such a policy. The paper does point to certain challenges associated with devolving CT to Scotland but these are not developed to any real degree of sophistication. Moreover, the paper refers to a growing consensus in favour of devolving CT to Scotland, but offers no evidence to support such an assertion.

Any potential benefit to Scotland of a different rate and/or structure of CT needs to be weighed against the impact of the certain costs, complexities and risks that would arise from devolving the tax. However, there is little analysis of this in the paper, including the burden for companies in having to deal with two separate CT regimes. It must also be borne in mind that the current or a future Scottish Government and Scottish Parliament could decide to increase CT above the UK rate.

For example, the current Scottish Government in the last session of the Scottish Parliament offered businesses no transitional rate relief from the adverse effects of the 2010 quinquennial revaluations of properties. Also, the current Scottish Government attempted to increase the rates bills of Scotland’s larger retailers by an annually recurring £30m charge but was defeated in their attempts to do so by a majority vote of other parties against such a policy. In future, this Scottish Government, or a Scottish Government of other parties, could use a devolved CT system or rate to discriminate against large firms or certain sectors of the economy.
The paper only explores the cutting of CT to support certain sectors or business activity but the opposite could emerge in reality. Indeed, whilst Northern Ireland is cited in the paper as an example where CT could be devolved, the Northern Ireland Executive is currently consulting on its proposals to increase the Regional Business Rate on large retail properties by around £7m a year up to 2015.

The CBI has long argued for a lower rate of CT across the UK. The proposal to devolve the powers to set the structure and/or rates for CT to Scotland, with the ambition to reduce the rate, would nonetheless mean abandoning the UK’s unitary tax system, which would conflict with the UK Government’s tax simplification agenda, another longstanding CBI objective, not to mention overall reduction of the UK CT rate. It should also be borne in mind that devolving CT would be a long-term element of constitutional change and, as stated above, there is no guarantee that the current Scottish Government’s objective of lower CT would be fulfilled or held by other future devolved administrations. Indeed, for most of the period of devolution so far the Scottish Parliament endorsed a position whereby the tax paid by businesses in the form of non-domestic rates were higher in Scotland than in England by some £200m a year.

The CBI has long believed that the interests of the UK, including Scotland, are best served by a unitary CT tax system, especially given the mobile nature of the underlying tax base. This provides the simplest environment for UK and foreign businesses and investors to operate in, and minimises the potential for distortion of economic activity through artificial profit diversion. In addition, if CT were devolved, the ability to shift profit to Scotland from the rest of the UK (RUK), or at some future time, vice versa, could lead to an overall reduction in the CT yield in the UK, although the direct costs and tax foregone would be borne primarily by Scotland through application of the ECJ Azores ruling, assuming ongoing block grant adjustments would fully reflect any increase in the level of profit shifting. The consequences for Scotland’s devolved public finances could be considerable compared to Northern Ireland, for example, due to the relative size of Scotland’s CT base.

If CT were devolved to Scotland, there could then be pressure from other UK countries and regions to adopt a similar level of control over the tax, with a similar impact on overall UK revenues, although again borne primarily, at least in theory, by the countries and regions concerned. However, there would also be considerable economic drag caused by the increased compliance costs for all affected businesses, as described below. If UK growth was reduced by external perceptions of complexity inherent in a multiple rate CT regime, this unquantifiable cost would necessarily be borne by the UK as a whole, including Scotland.

Given these uncertainties, a strategy to promote economic growth in Scotland should also consider the merits of other fiscal instruments that could provide an attractive effective marginal rate for all taxes paid in Scotland, including possible reductions in other business taxes and charges such as the business rate which is devolved and generates almost £2bn annually for the Scottish Government and could be reduced very quickly. It is not the headline rate of CT that matters to businesses when they invest, but the overall post-tax returns on investment.
The CBI’s main concerns about the consequences of a differential CT rate in Scotland fall under three headings:

A. Tax distortion
B. Effectiveness
C. Precedent creation

A. Tax distortion

Incentive for profit shifting

The potential size of the differential in CT rates would create an incentive to change corporate structures and operations to take advantage of this differential, leading to many business decisions being made to reduce tax rather than for commercial reasons, e.g. rerouting of business in RUK through Scotland. This type of arbitrage would almost certainly not result in higher employment and growth in Scotland. The CT base is very mobile, and companies could be expected to take advantage of the lower rate without creating significant new economic activity, thus reducing total UK tax receipts and possibly reduced consequential funding for Scotland through a reduced block grant resulting from lower overall UK public spending. Account needs to be given, therefore, to profit shifting, including by SMEs. Sales and distributor functions in particular could be relocated to Scotland from RUK to exploit a reduced rate or higher allowances, without generating any new business activity or employment in the UK as a whole. The effect would simply be to shift a proportion of the affected UK groups’ taxable profits to a potentially lower rate regime in Scotland, so reducing the UK tax yield significantly on the profit shifted.

There would also be an incentive for businesses to assert that their Scotland activities created more value there, so diverting profit, or to set up new companies with little commercial substance to which profit could be allocated, leading to greater HMRC scrutiny of all businesses with Scottish operations. This could open up all sorts of administrative and compliance burdens associated with:

- intra-UK transfer pricing,
- allocation of interest, and
- controlled foreign companies (CFCs)

to deal with the rerouting of business and profit shifting through Scotland. This would be costly and burdensome. It is disappointing that the discussion paper contains little analysis on these issues of concern to business.

Transfer pricing

The transfer pricing rules exist to counter diversion of profits by multinational enterprises from a high tax jurisdiction to a low tax one through the use of non-arms length prices for transactions between related parties, including financing arrangements (thin capitalisation). The term ‘non-arms length’ refers to prices which would not be agreed between unconnected parties. The rules are not currently
applied to small enterprises, and apply to medium-sized ones only where HMRC formally requires this for a specified period. These rules would have to be used by HMRC to counter diversion of profit to Scotland, assuming Scotland had a lower rate of CT, potentially involving any business with activities in both Scotland and RUK in the burdensome record keeping, evidence collection, analysis work and discussions required to demonstrate to tax officials that the criteria for arms-length pricing had been met. Such complexities would be further exacerbated by any creation of a separate Scottish revenue service that would need to work closely with HMRC.

Transfer pricing rules were extended to UK/UK transactions in 2004 on the basis that EU law required this to prevent any potential discrimination against EU enterprises’ transactions with their UK associates. However, it is worth observing that in the ECJ Thin Cap Group Litigation case the Advocate General questioned the necessity for the UK’s 2004 legislation applying the transfer pricing rules to intra-UK transactions, noting that “Such an extension of legislation to situations falling wholly outwith its rationale, for purely formalistic ends and causing considerable extra administrative burden for domestic companies and tax authorities, is quite pointless and indeed counterproductive for economic efficiency.” The introduction of a different Scotland CT rate would remove any prospect of getting the 2004 measures removed, and would almost certainly result in much greater scrutiny of such transactions across the board.

**Interest allocation**

New rules would be needed to limit or prevent companies from getting tax relief at the higher RUK CT rate on interest paid in funding equity in a Scottish company, whose taxable profits would only be taxed at the reduced rate. This might be achieved by extension of the unallowable purposes rules, which deny relief where the purpose of the borrowing is not part of a company’s business or commercial purposes, or where tax avoidance is a main purpose of the borrowing. Any such tracing, would, however, add considerable complexity.

**CFC rules**

The UK Government might also seek to apply some form of internal UK CFC regime to Scottish companies controlled from RUK to prevent income not attributable to genuine and substantive commercial activity from benefitting from a reduced tax rate. CFC rules, currently the subject of a major consultation by HM Treasury and HMRC, are very complex, and these could be applied to Scottish companies which paid less than 75% of the tax which would be paid if the same activities were conducted in RUK, unless the conditions for certain tightly defined exclusions were met. Where a company is caught by the CFC rules, some of its profit may be attributed to its shareholders, who each pay, in effect, the difference between the main UK rate and the reduced rate on their share of the profit.

**EU State Aid rules**

The application of a Scottish CT could be made optional for companies to allow them to balance the benefit of a lower rate against the burden of complying with
associated anti-abuse measures. However, the EU State Aid rules mean that it is unclear whether it would be possible to make a lower Scotland CT rate and/or allowances, etc. optional for companies trading in Scotland, so that they could decide for themselves whether the additional administrative burden of producing Scottish taxable profit computations and complying with anti-abuse measures was a price worth paying for lower tax. A recent Dutch proposal for an optional reduced rate regime for interest (interest box) was blocked by the EU Commission under the State Aid rules. These rules also mean that entitlement to a lower CT rate could not be restricted to Scottish companies; branches of RUK or foreign companies would have to qualify, and be subject to the greater compliance burden, as well.

**US tax credit relief**

In the event that an optional reduced rate was possible, this could have adverse implications for those potentially entitled to US tax credit relief who did not opt for the reduced rate, as the full US foreign tax credit is not given for “voluntary tax payments”.

**B. Effectiveness**

While recognising that the headline rate of CT and more attractive tax structures can stimulate domestic economic activity and attract the attention of potential inward investors leading to inclusion on the short list of investment locations, the decision on whether to invest will also be driven by other aspects of the tax system and the broader economic environment. Other important tax considerations include the effective rather than the headline rate of tax, the ease of tax compliance and the network of tax treaties which apply. More broadly, economic factors such as access to markets, education of the population, business infrastructure, land-use planning, reliable and affordable energy and the quality and price of skilled labour are important drivers of location decisions.

For example, the success of the Irish Republic in attracting FDI was down to a number of factors:

- membership of the euro, eliminating intra-European exchange rate risk;
- an affordable, skilled workforce;
- a very well funded and joined-up inward investment agency;
- the range of non-tax related grants and incentives available;
- specific incentives applicable to intangibles;
- the headline rate of CT;
- an extensive tax treaty network (and generous interpretation);
- the absence of a CFC regime; and
- the tax treatment of foreign profits and intellectual property.

The discussion paper acknowledges that any reduction in devolved CT would reduce the yield from the tax in Scotland depending on the extent to which the tax base and/or yield were adjusted. However, this was not well developed in the paper. Nor
were the options fully explored and discussed for addressing the short-term, and it may not be short-term, reduction in yield from the tax. Indeed there is understatement on page 42 that “decisions regarding budgetary priorities would be needed”. They would indeed be needed and the concerns of business also relate to the extent to which the options for dealing with the shortfall might adversely impact on other areas of Scottish Government expenditure that promote and secure economic growth in Scotland, e.g. cuts to skills development, infrastructure spending or business support.

C. Precedent creation

Devolution of CT to Scotland could well set a precedent for other devolved administrations and over time to other regions of the UK, which, if followed, would lead to even further complexity in the UK’s system of CT in the future. It would be difficult to make the case that only Scotland should have CT devolved. The Scotland Bill Committee of the 2007-11 Scottish Parliament said: "The Committee's view is that if a scheme to vary corporation tax were to be available in some of the devolved countries of the UK as a tool of the UK Government's regional economic policy, it should be available as an option for a Scottish Government to use also." This statement almost certainly holds good for other countries and regions of the UK were CT to be devolved to Scotland.

The Commission on Scottish Devolution’s recommendations (that CT was not a good tax for assignment given its volatility and the mobility of its base) were predicated upon an assumption that there was a unitary CT regime in the rest of the UK. The Commission also commented that “...the potential for differing rates of corporation tax across the UK would create economic inefficiencies as firms react to tax considerations rather than commercial factors. We also think the potential administrative impacts of such a move are significant.”

These findings are mirrored by the views of CBI Scotland and our position on devolving Corporation Tax remains that such change cannot be supported because we remain to be convinced that the certain costs, complexities and costs associated with devolving CT are outweighed by the benefits claimed.

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