

Feedback on the Scottish Government's *Discussion Paper on Corporation Tax: Options for Reform* (August 2011) and the subsequent paper, *Devolving Corporation Tax in the Scotland Bill* (September 2011)

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ABOUT ICAEW SCOTLAND AND OUR WORK ON CORPORATION TAX

1. ICAEW Scotland serves over 1400 ICAEW members across the private and public sectors in Scotland and represents the views of ICAEW members who work in Scotland for local, national and international organisations. Across the World, ICAEW members' expertise and experience is fed into the corporate strategy of the Institute to help form and influence policy.
2. ICAEW is an international body based in the UK and operates under a Royal Charter, working in the public interest. The regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council.
3. As a world-leading professional accountancy body, the ICAEW provides leadership and practical support to over 136,000 members in more than 160 countries. Strengthened by the expertise of our whole membership, particularly those in the UK/EU who are interacting with government and institutions on similar economic issues, ICAEW is working with governments, regulators and industry in order to ensure the highest standards are maintained.
4. We believe in acting responsibly, in the best interests of our members and the general public. We act with integrity, creating effective partnerships with organisations and communities worldwide to ensure the highest technical, professional and ethical standards.
5. The ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
6. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.
7. The ICAEW Members in Scotland (ICAEW Scotland) welcome the opportunity to respond to the Scottish Government's Corporation Tax Discussion Paper, published on 16 August 2011, as well as the further information published in September by the Scottish Government in *Devolving Corporation Tax in the Scotland Bill*.
8. We recently submitted a response to the Scottish Parliament's Scotland Bill Committee's request for written evidence on the Scotland Bill 2010, including a section discussing the implications and practicalities of alterations to Scotland's Corporation Tax regime.
9. In addition, on 1 July 2011, the ICAEW's Tax Faculty submitted a detailed representation in response to the HM Treasury consultation document *Rebalancing the Northern Ireland economy*. This ICAEW Tax Representation is attached as an appendix to this document.
10. The Scotland Bill has implications for Scottish, UK and global economies and the interaction and sustainability of these future economies. The comments we make reflect our members' views and the impacts concerning both Scotland and the global economy.

The desire for enhanced financial accountability

11. We understand the desire for wider tax-varying powers for the Scottish Parliament to recognise the different social, political, geographical and economic circumstances faced by Scotland and by businesses operating in Scotland. There is an argument that fiscal policies should be tailored to meet the needs of particular locations, geographies and business economies. Ultimately, the granting of such powers are major policy questions for Parliament to decide.
12. In our recent response to the consultation on the Scotland Bill 2010, we suggested that a situation where Scotland can only introduce new taxes without reducing existing taxes such as corporation tax and national insurance could lead to higher taxation in Scotland than the rest of the UK – a situation which should be avoided.
13. Corporation tax powers as part of the wider control of the taxation system could provide flexibility for Scottish Ministers to respond to changing economic circumstances. The current debate appears to be focused mainly on rates (mainly rate reduction) on the one hand and potential corporation tax migration from/to other parts of the UK.

The consequences of tax system changes

14. A broad based taxation system would provide the benefits of increased flexibility and responsiveness to economic developments.
15. However, whatever the potential benefits of enhanced financial accountability in terms of the Scottish economy, it needs to be recognised that potentially serious, expensive, complicated and unintended consequences may arise as a result of changes to the Scottish tax system. Such proposals may result in more complexity within the UK infrastructure and this raises concerns about the capacity of HMRC – an organisation that is already under severe budgetary pressure and which is in the throes of yet further restructuring. Changes to taxation would add further complexities and practical collection issues which may result in overall costs being disproportionate to the potential benefits.
16. Nonetheless, any decision to make, or to not make, any particular change (including devolving corporation tax) must be taken in the context of other changes which are already taking place. There may equally be serious and unintended consequences arising as a result of not making a particular change.
17. Furthermore, it is also worth bearing in mind that much of the expense created by introducing any form of devolved taxation is a 'fixed cost' – in other words, the cost already arises as a consequence of any change being introduced and is not further exacerbated by increasing the degree or extent of the change. So, in order for the benefits of any changes to outweigh the costs, those changes must be significant enough to be worthwhile. This, in turn, provides a strong argument for saying that, in order for devolved taxation to be efficient, as many taxes as possible should be devolved.
18. ICAEW's Tax Faculty has developed Ten Tenets for a Better Tax System - full details are attached as an appendix. Our core principles are that tax should be certain, simple, and easy to collect and calculate. We advocate simplicity in tax systems as a basic core element to aid understanding, compliance and avoid unnecessary costs.

Concerns over stability of a devolved Corporation Tax

19. Given the lack of evidence concerning existing sources of corporation tax take in Scotland – we note estimates are based on Scottish activity – it is difficult to comment on whether the current tax base (by firm, firm size and type of industry) has sufficient scale and diversity to maintain stability over the cycle.
20. The UK, which as a whole is an open market economy more than 10 times the size of Scotland, has struggled to cope with the loss of corporation tax revenues from the banking and financial services sectors. A devolved Scottish corporation tax take would have suffered even more, proportionally.
21. Corporation tax is more volatile than other taxes such as VAT or income tax, especially during the downside of the economic cycle. It would be very important to ensure that the tax base is sufficiently diverse to cope, otherwise the overall total Government budget would be at risk of unexpected deficit.

Devolved Corporation Tax in the wider context of the Scotland Bill proposals

22. Nevertheless, whilst a devolved corporation tax alone might perhaps be excessively volatile, it is important to place it in the wider context of a broad-based devolution of tax-raising powers and responsibilities. As part of a 'suite' of devolved taxes, any volatility in the corporation tax rate could be absorbed within the devolved government's wider fiscal policy.
23. It is also important to consider some of the potential consequences of **not** devolving corporation tax.
24. Under the current Scotland Bill proposals, part of the income tax arising on employment and self-employment income within Scotland will be devolved to the Scottish government.
25. There is, of course, a strong desire within Scotland to use this devolved power to encourage business growth within Scotland through a reduction in Scottish income tax rates. However, as we have commented previously in our responses to consultations on the Scotland Bill, the current proposals may have the adverse effect of providing greater benefit to the UK tax take flowing to Westminster whilst providing little or no benefit to the Scottish tax take flowing to Holyrood.
26. By not devolving corporation tax to the Scottish Government, there may be another unintended and perverse effect. If devolved income tax rates are used to generate growth in the Scottish economy, new and existing businesses will grow and prosper. As businesses grow, there generally comes a point when it becomes sensible to transfer the business into a company (known as 'incorporation'). Hence, the business will move from generating income tax to generating corporation tax.
27. If corporation tax is not devolved to Scotland, the unintended and perverse consequence of these business incorporations will be that the Scottish tax yield falls and the UK tax yield rises. This will further exacerbate the difficulties discussed above – once again, the Scottish government's efforts to stimulate economic growth in Scotland will result in additional tax revenues flowing to Westminster rather than the benefit of Scotland.

The 'Irish Miracle' and Scotland

28. The 'Irish Miracle' is often cited to promote a low corporation tax regime as a generator of economic growth. Proponents are often unaware of Ireland's unique economic history which allowed their policies to be successful. At the end of the

1980s, prior to the economic boom which saw Ireland move from an agriculturally dependent economy to a modern service based economy, Government spending was low per capita (emigration helped to reduce the burden of unemployment and the cost of other services).

29. Over the next 25 years, Ireland was able to grow its economy through inward investment and at the same time grow its government spending in line with its economic development. This allowed status quo spending to be financed by existing government revenues, with real growth in net revenues coming from the growing corporate worth in Ireland (until the Government took on its Banks Debts).
30. In contrast Scotland has been an industrialised country for over a century. Government spending in areas such as education, infrastructure and health is all committed so unlike Ireland, there is an existing dependency on corporation tax at current levels. The impact of this is that a reduction in corporation tax rates in Scotland will reduce the annual yield whilst waiting for new businesses to register as 'Scottish' and this shortfall will have to be met (both in the short and long-term) by some other source of funding.
31. If this alternative funding is sought through increases in other taxes such as income tax, VAT or excise duties, this provides a significant risk to domestic consumption and economic growth (note for example the current impact of UK Government tax increases) that can undermine any theoretical benefits from corporation tax rate reductions.

Corporation Tax Rates

32. The debate on corporation tax rates tends to focus on the success of Ireland's 12.5% and the possibility of tax tourism (highlighted by WPP's move to Dublin in 2008 to avoid increased UK taxes). It is unlikely that a 12.5% rate is achievable in Scotland, or for that matter by Northern Ireland, without significant subsidy from the UK Government due to existing expenditure patterns. In addition, the already announced reduction in UK corporation tax rates from 28% to 23% over the next 4 years means that Scotland, to generate economic activity, would need to take a substantial gamble on a corporation tax reduction generating an increased yield in the medium to longer term, to compensate for a reduced corporation tax take in the short term.
33. A more fundamental problem is that a policy of pursuing corporation tax reduction can become a race to the bottom that in the end is unsustainable and does not deliver long-term business investment. It is interesting in this context to note that WPP are planning to return their corporate HQ to the UK in 2012 after less than 5 years in Dublin.
34. We would raise concerns that there could be no real benefit to Scotland if other taxes have to be raised on residents to cover the shortfall of such transfers. It may therefore be sensible to examine additional tax incentives that can be focused on activities that will specifically support genuine investment and growth in Scotland rather than encourage the type of 'artificial' head office relocations seen in Ireland.
35. For many reasons, including those outlined above, Scotland is in a very different position to both the Republic of Ireland and to Northern Ireland. Hence, there is no 'one size fits all' solution to devolved corporation tax rates within the UK.
36. Northern Ireland has the specific problem of competing with its immediate neighbour to the South, especially in the critical area of attracting inward investment.
37. Scotland's position is very different. As a well-established industrialised economy, Scotland can be seen as more of a 'mainstream' (although small) European nation.

Scotland has a well-established economic infrastructure of its own and can therefore look more to internal investment and growth rather than relying excessively on inward investment.

38. This different picture in Scotland leads to a very different view on the sort of differential required in the corporation tax rates. Whereas Northern Ireland needs to look predominantly at inward investment and therefore requires a very substantially reduced rate of corporation tax, Scotland can look more at encouraging the growth of an existing economy – thus requiring only a more reasonable (but still significant) reduction in corporation tax rates.
39. With a smaller differential between the corporation tax rate in Scotland and elsewhere in the mainland UK, there would also be less risk of ‘tax tourism’, or arbitrage, undermining the UK economy.

The effect of additional complexity

40. Clarity will be required for companies with dual residence status and guidelines as to the allocation of profits between branches of companies operating across the UK.
41. Transfer pricing is already a complex area for companies trading outwith the UK, a situation of varied corporation tax rates within the UK will increase the complexities of an already complex area. It is therefore important to ensure that the benefits of a reduced rate outweigh the increased complexity and costs that arise.
42. In our tax representation ‘Rebalancing the Northern Ireland Economy’ (see Appendix 2), we pointed out that business representatives generally believe that the attribution of profits to branches and other permanent establishments can be managed relatively easily but that problems are likely to arise when it becomes necessary to consider what overheads and other costs such as interest should also be set against profits arising in the devolved territory.
43. While multinational companies operating outside the UK will already have mechanisms in place for the allocation of profit to extend this to the UK may involve a substantial amount of work.
44. Companies whose current operations are confined to the UK may have to incur substantial costs in installing new systems to provide the necessary accounting information.
45. The ICAEW Tax Faculty recently responded to the HM Treasury consultation document *Rebalancing the Northern Ireland Economy*. In this response, we set out some further key issues, including the need for simplicity, the implications of having more than one corporation tax system in the UK, the need for a detailed cost benefit analysis, and the implications for HMRC, as well as looking at alternative mechanisms and policy options that might work. Many of these issues are also relevant to the question of devolving corporation tax to Scotland. This document is therefore attached as an appendix.
46. We note that this paper suggested that the costs to business of introducing a separate rate of corporation tax in Northern Ireland might be as much as £50m and the cost in Scotland would be expected to exceed that in Northern Ireland.
47. There is a danger that the additional costs of tax compliance may act as a disincentive to companies setting up business in Scotland, regardless of the rate of tax. We point out that companies will have to incur these costs even if they do not have taxable profits and so do not benefit from any reduction in tax. Also there may be companies that make losses in Scotland and profits in England or vice versa who may be unable to offset these losses and so will pay more tax than at present. It

would be much better if tax incentives could be offered in a different form (such as enhanced capital allowances) so that only those companies that were able to benefit would suffer additional costs.

48. On consultation, some of our members take issue with the comment that "There are numerous examples where corporation tax has been successfully devolved in other countries and they all continue to perform effectively and competitively". In particular the system in the USA with different states having the power to levy their own taxes, which differ from state to state, in addition to federal taxes imposes significant costs and acts as a disincentive to doing business in the USA.

Alternative mechanisms and policy options for increasing economic activity in Scotland

Phasing in of any tax rate reduction

49. One of the key requirements of all businesses is certainty, as this enables them to plan for the future with confidence. Given concerns about EU requirements and the need to reduce the UK's budget deficit, we can see merit in adopting a phased reduction in Scottish corporation tax rates rather than an immediate reduction to a substantially lower rate. If the former approach is adopted then, in order to provide businesses with certainty, we believe that a clear rate reduction plan and timetable should be set and published in advance. It is also important that any announced plans are then implemented and not subject to further amendments.

Exclusion of non-trading profits

50. The 12.5 per cent rate in the Republic of Ireland is applied to trading profits only and non-trading profits are taxed at 25 per cent. A similar approach could be adopted in Scotland by applying the reduced, devolved, rate to trading profits only whilst retaining the main 'UK rate' for non-trading profits. This is likely to reduce the scope for avoidance and arbitrage, although it may introduce some additional administrative complications into the corporation tax system. On the other hand, if trading income was ring-fenced in this way, this could reduce the need to have extensive anti-avoidance provisions at the UK level.

Other policy options:

R&D tax credits

51. There remain concerns about the availability of R&D tax credits and particularly in relation to smaller businesses. Enhancing either the rates or availability of R&D credits for businesses operating in Scotland could be an appropriate way to promote economic growth, especially considering the number of high profile higher education institutions located within the country.

Enhanced annual investment allowances ('AIAs')

52. Enhanced AIAs would benefit all businesses and proportionately favour smaller businesses over larger businesses. However, one of the difficulties in UK taxation is that the level of AIA has varied since it was introduced in 2008 and, coupled with extensive changes to the general system of capital allowances and rates, this has meant that businesses have little certainty about what rates will apply at the time investments are made as the business planning cycle operates over a longer timescale. In order to make a difference, the rate should be set and guaranteed for a reasonably lengthy period, say for five years.

53. An enhanced AIA would be particularly beneficial in promoting internal growth within the Scottish economy, as it is more relevant to smaller entrepreneurial businesses.

National Insurance Contribution ('NIC') holidays

54. NIC holidays cause administrative problems and we are not convinced that they would be the right way to proceed. However, other European countries use 'NIC' type holidays to incentivise employer behaviour.
55. In respect of existing businesses, we question whether cutting the cost of employment will increase the number of jobs. For new businesses, employers will factor in any NIC holiday but it will just be one of many commercial considerations that they will need to consider, and, by itself, is unlikely to be decisive.
56. An NIC holiday will be most helpful in labour-intensive businesses, such as hospitality and catering. Hence, given the importance of Scotland's tourism industry, and notwithstanding our more general comments above, there may be sufficient benefit to outweigh some of the administrative burdens involved.

Tax-related investment schemes

57. We have recommended previously that, as part of its growth agenda, the UK Government should undertake a thorough review of tax-related investment schemes and reliefs such as the Enterprise Investment Scheme, Venture Capital Trusts and entrepreneurs' relief. It would be worth considering whether these schemes might have a role to play in encouraging investment in Scotland and what the costs and benefits of doing this would be.

Enterprise Zones

58. In Budget 2011, the UK Government proposed the establishment of 21 enterprise zones in England. It would be worth considering whether Scotland would benefit by establishing its own enterprise zones in key areas for economic development.

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