TAXREP 37/11

REBALANCING THE NORTHERN IRELAND ECONOMY

Comments submitted on 1 July 2011 by ICAEW Tax Faculty in response to the consultation document *Rebalancing the Northern Ireland economy* published by HM Treasury on 23 March 2011.

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INTRODUCTION

1. This document sets out the comments of the Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) on the consultation document published on 23 March 2011.

2. We also appreciated the opportunity to attend and contribute to a roundtable meeting on this subject on 8 June 2011 which was chaired by the Exchequer Secretary. Our comments below seek to reflect what was said at that meeting.

3. Information about the Tax Faculty and the ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's ten tenets for a better tax system, by which we benchmark proposals to change the tax system.

WHO WE ARE

4. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

5. 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 Institute ensures these skills are constantly developed, recognised and valued.

6. The Tax Faculty is the focus for tax within ICAEW. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* who pay an additional subscription, and a free weekly newswire.

SPECIFIC COMMENTS

Will a 12.5% rate attract inward investment into NI?

7. The proposals in this document will directly affect Northern Ireland (NI) and are seeking to address economic conditions and difficulties that are particular to that part of the UK. As the Institute of Chartered Accountants in England and Wales, our detailed knowledge of these conditions is somewhat limited and we are happy to leave the detailed questions on these policy aspects to those who are better qualified to speak on them. It will of course be essential that any proposals generate new inward investment into NI and do not merely move investment from other parts of the UK.

8. It was clear at the policy meeting on 8 June 2011 that there is a wide consensus both within the UK Government and the NI Executive that something needs to be done to 'rebalance' the NI economy by reducing its current dependence on the public sector and sector and increasing exports.

9. The proposal to reduce the NI corporation tax rate appears to have widespread and cross party support at the political level in both Westminster and Stormont.

10. We have seen a draft of the submission that will be made by the Institute of Chartered Accountants in Ireland. In its submission, it agrees that something needs to be done and is also in favour of a reduction in the rate of corporation tax in NI.

11. We recognise that even if the NI tax rate is reduced to 12.5%, there remain considerable differences between the Irish and the UK corporation tax systems. There are then wider commercial considerations and differences, for example Ireland is in the euro zone. Clearly all these factors will have an impact on investment decisions. Nevertheless headline tax rates will be an important first step in considering where to locate investments.

12. Ultimately the question of whether NI should adopt its own rate of corporation tax is a policy question that must be addressed in two stages. First, the UK Government needs to decide if it is willing to give NI the necessary powers to set its own corporation tax rate. Second, assuming that the UK Government is willing to delegate these powers, the NI Executive must decide whether it wishes to exercise its powers and reduce the rate of corporation tax as proposed in the consultation paper.

13. Given the particular circumstances and the broad consensus that appears to exist, we will leave it for others to comment on the underlying policy proposals. We will instead focus on the wider policy ramifications and the likely practical consequences and considerations and in particular how they may impact on the rest of the UK.

UK corporation tax policy

14. As recognised in the consultation paper (see paragraph 1.12), these proposals need to be seen in the light of the Calman and Holtham proposals for potential devolution of the corporation tax rates to Scotland and Wales respectively. In respect of the former, the Scotland Bill currently before Parliament grants the Scottish Executive powers to set a rate of income tax for Scottish taxpayers; devolution of stamp duty land tax and landfill tax and the provision for other taxes to be added to this list by way of Statutory Instrument. We agree that the issues identified by the Calman and Holtham Commissions are relevant to considering the case for a separate, lower corporation tax rate in NI. However, the paper states that 'the implications of a lower Northern Ireland corporation tax rate need to be examined on their own merits'.

15. While we appreciate this view, nevertheless we believe it is important that before any decisions are made by the UK Government to delegate CT powers to NI, the UK Government needs to consider this as part of the overall UK tax policy and also that any proposals are consistent with the Government's statements and intentions that have already been set out in the corporation tax roadmap and the ambitious growth agenda.

16. Under current proposals, from April 2014 the main rate of UK corporation tax will be 23% and the small companies rate 20%. Assuming that the NI rate is cut to 12.5%, the main UK rate will therefore be 10.5% higher than the NI rate. It is one thing to have this difference between the UK and Ireland; quite another to have it between one part of the UK and the rest of the UK. In effect all the existing pressures caused by the differences between the UK and Irish rates will be imported into the UK with the creation of an internal quasi-tax haven.

17. If the NI Executive adopted a 12.5% rate, it seems inevitable that there will then be considerable pressure to devolve corporation tax to Scotland and for it too to adopt a 12.5% rate. Similar pressures are then likely to arise in respect of Wales. At that stage, it is inevitable that there will be pressure for the rate in England, or the less prosperous English regions (as perhaps identified for the purposes of the NIC Holiday policy) to also be reduced.

18. The point is that the NI rate cannot easily be considered in isolation because it is likely to have a knock-on effect on the rest of the UK and which ultimately could result in the removal of any competitive advantage from reducing the rate. If that happened, the reduction in the tax rate would not make Northern Ireland more attractive but it would lead to a fall in corporation tax

receipts at a time when one of the Government's three objectives is to reduce the deficit (the other two being enterprise and fairness – see paragraph 3.2).

19. We are concerned that any proposals in this area do not have unintended consequences such as putting at risk corporation tax receipts throughout the UK. The UK Government needs to consider very carefully where devolution of NI rates may lead and be prepared for the rest of the UK to ask for similar treatment.

Tax simplification

20. We are concerned that the NI policy proposals are in conflict with the Government's tax simplification proposals. The UK now has one of the longest and most complicated tax systems in the world. The Government has committed itself to a tax simplification agenda through the Office for Tax Simplification (OTS) and we are very supportive of its work. However, the work of the OTS to date has shown just how difficult it is to achieve real simplification of the tax system and the fact remains that when it is enacted the current Finance Bill will add yet more length and complexity to the UK tax code. We have great concerns that the creation of an internal tax haven would inevitably lead to the need for even more anti-avoidance legislation, and a new HMRC unit to police it.

21. The NI tax policy proposals add a further, significant, layer of complexity for any business that has operations that are not wholly in NI. This will add considerable extra admin burdens and costs and we are concerned that if the NI rules lead to excessive complications, then only the largest companies may be able to justify the investment needed in order to benefit from the lower CT rate.

EU and state aid compliance

22. The paper recognises (at para 4.29) the need to satisfy EU law and state aid requirements in accordance with the principles set out in the *Azores* case (C-88-03). Compliance with these principles is clearly fundamental to the setting of a separate NI rate and, in order to avoid problems at a later date, we think that early confirmation should be obtained from the EU of the precise criteria that will be applied so that any arrangements are not subject to legal challenge at a later date. It will be far better to identify any potential problem areas with the proposals and build in solutions now rather have to try and reengineer the proposals at a later date. The decision in the *Azores* case made it clear that the lower rate could not be applied to firms in the financial sector and 'activities of the intra-group services type. So these limitations need to be fully factored into any proposals. This clarification also needs to extend to the processes adopted, the block grant reduction and the way that the rate is administered and how the costs of development and implementation are allocated.

23. We believe that more generally the state aid position of these proposals and other possible alternative approaches should be clarified, not least because problems with state aid rules were given as a justification for scaling back the tax reliefs available on EIS and VCT schemes in 2006/7, only for many of these restrictions to be reversed in the March 2011 Budget. We believe there needs to be much greater transparency about state aid discussions, what is permissible under the rules and how other EU countries apply them in practice.

Two corporation tax systems in the UK

24. The paper recognises that the adoption of a lower rate in one part of the UK will have consequences for the rest of the UK corporation tax system. At the roundtable, it was clear that business representatives believed that attribution of profits to, for example, a branch could be managed relatively easily. The problems are likely to arise when it becomes necessary to consider what overheads and other costs such as interest should also be set against any profits arising in Northern Ireland. In addition, decisions will need to be made about what rules will be needed to satisfy the Azores criteria (see para 22 above), counter profit shifting, tax motivated incorporation (see paras 33 et seq below) and the availability of capital allowances etc. Many of these rules will have to be applied at the UK level rather than the NI level and the precise relationship between them made clear.

25. The net result of all these amendments and adjustments is that for many practical purposes the UK would have two corporate tax systems, one for NI and one for the rest of the UK. This will therefore increase burdens and costs although for businesses these are likely to be more than counterbalanced by the reduction in the rate of corporation tax. However, the overall costs of operating what is in effect a separate system will mean that HMRC's costs will be increased – would these need to be reflected in any reduction in the block grant so as to avoid state aid rules?

Who should administer the lower rate?

26. We presume that HMRC would administer any reduced rate of tax in NI although we question whether this would necessarily satisfy the EU state aid rules. It is not easy to decide from reading the *Azores* judgment whether NI would have the necessary institutional and procedural autonomies as set out in the *Azores* case unless it either has its own fiscal authority (HMRC NI) or it is contracted to HMRC on arms' length terms.

27. Assuming that any potential problems identified in the paragraph above are resolved, at the roundtable the general view of business was that questions about the operation of the lower rate should be dealt with directly by their allocated customer relationship manager. Given that many of the measures introduced are more likely to be applied at the UK level rather than NI level (for example checking what profit allocation measure had been used), this would appear sensible and logical. Nevertheless, the relative size of NI as compared to the rest of the UK may make such an approach very expensive. It might be best to concentrate HMRC's expertise only on those businesses with considerable investment in NI.

The need for a detailed cost benefit analysis

28. The above comments show that adoption of a lower tax rate is likely to result in the need for careful planning and development. The adoption of a lower tax rate is likely to require considerable investment and development in new computer systems by HMRC. In addition, it will be necessary to decide how the NI rate is administered – see further comments below.

29. Detailed consideration will be needed at an early stage of the practical and operational problems that are likely to arise for HMRC and businesses generally. Development and implementation costs are likely to be considerable and a detailed estimate of the likely costs needs to be prepared.

30. In other words, there needs to be a detailed and thorough 'R & D' programme to investigate the proposals. Policy advisers and HM Treasury/HMRC need to work with external stakeholders to build up a comprehensive and credible Tax Information and Impact Note that sets out in detail a cost/benefit analysis of the proposals.

31. We suggest that the effect of these measures should be modelled by reference to a number of detailed case studies which examine how these rules might apply in practice for different types of business. For example, the effect of the proposals on, say, a UK High Street retailer with branches in NI could be modelled both under the existing arrangements and what would be needed in any new arrangements.

32. This modelling would need to take account of all costs, ie, not just those directly related to the lower rate but also any consequential changes that arise in respect of the rest of the UK. It would also be relevant to consider a wide range of potentially applicable tax rules, such as how a business would be allowed to allocate losses to the NI part of the business, or employee costs where the employees work both in NI and on the mainland, or insurance costs (especially in view of the different risks in NI).

Dealing with tax motivated incorporation

33. Page 28 of the paper recognises that reducing the tax rate is likely to result in an increase in the number of businesses that incorporate in order to reduce the overall level of tax and NIC

paid. This is only to be expected, but this particular problem has been a feature of the UK tax system for a number of years now and we would have expected that many smaller businesses would already have incorporated. We would have thought that a reduction in the rate of this magnitude would inevitably lead to almost all businesses operating in Northern Ireland through a company rather than remaining unincorporated. The overall net revenue cost could therefore be substantial.

34. We understand that in Ireland, unlike the UK, smaller businesses are usually unincorporated and are not run through companies. We understand that this is because Ireland has close company provisions that discourage the retention of monies within a company. In particular, we understand that close 'service' companies are liable to a surcharge of 15% on one-half of their undistributed trading income and that there is a surcharge of 20% on the total undistributed investment and rental income of a close company.

35. In the past the UK had similar rules to prevent income being rolled up in a close company and benefiting from a lower rate of tax. However, although the UK has retained close company rules, for example in connection with loans to directors, the rules to prevent income being rolled up in a close company were repealed many years ago.

36. Accordingly, we would have thought it inevitable that close company rules would have to be introduced to prevent, or at least limit, profits being rolled up in this way. The question would then be whether any such rules would also apply only in NI or whether more generally to the UK. Given that the OTS is undertaking further work on small business tax, it would be far better if the UK could first identify a small business tax structure that can be applied consistently across the UK.

37. It is also possible that many mainland companies would incorporate in NI to take advantage of the new rate, albeit without creating significant economic activity there. If a NI company was trading 'with' the mainland rather than trading 'on' the mainland through a permanent establishment, it could potentially reduce its group tax charge without moving much activity. This potential problem is recognised in the *Azores* judgment in that in order for the proposal not be considered as illegal state aid, intra-group services need to be excluded. This is a potentially wide-ranging restriction and its implementation needs to be considered in detail. Many multinationals buy services (such as licensing intellectual property, advertising, marketing, insurance, etc) from group companies located in low tax jurisdictions. Detailed rules will be needed to address this point and presumably consideration given to extending transfer pricing rules to cover the pricing of services bought by mainland entities from NI associates but which do not form part of a group under the *Azores* criteria.

The effect of the proposals on HMRC's resources

38. We are concerned that the proposals would place further burdens on HMRC at a time when it is undergoing further rationalisation and reorganisation as a result of the latest spending review. Staff numbers at HMRC have already been reduced by about 30% since 2005 and under the proposals in the spending review they will be reduced from 70,000 to 60,000 over the current spending review period. HMRC's poor service standards are, and have been for some time now, a major cause for concern among our members.

39. HMRC is already in the process of a number of IT related developments such as real time information for PAYE and the move to compulsory electronic filing for many types of tax return. In addition, the proposals set out in the agent strategy consultation would appear to require further major changes to HMRC's systems.

40. The proposed adoption of a separate tax rate for NI is likely to require HMRC to devote a considerable amount of its increasingly scarce resources to this project – extra strain imposed by the need for vigorous anti-avoidance activity, such as intra-UK transfer pricing policing, would need to be a factor in any review and we question whether HMRC has the capability to

deliver successfully on all of these projects. If the Government decides to proceed with a lower tax rate for NI, HMRC is likely to require more funding to develop solutions.

Alternative mechanisms for reducing the rate of corporation tax in Northern Ireland

41. Para 4.67 et seq sets out a number of possible alternative ways of reducing the corporation tax rate, in particular deferral, phasing and exclusion of non-trading profits.

Phasing in of any tax rate reduction

42. The key requirement of all businesses is certainty as this enables them to plan for the future with confidence. Given the concerns about EU requirements and the need to reduce the UK's budget deficit, we can see merit in adopting a phased reduction in NI corporation tax rates rather than a immediate reduction to a lower rate of, say, 12.5%. 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.

43. It is also important that any announced plans are then implemented and not subject to further amendments. In particular, we do not think that the rate should be reduced by a small amount but with a commitment to review it at some stage in the future. The admin costs of such an approach are likely to be considerable and, with the benefits much reduced, we doubt that it would secure the support of business nor encourage inward investment into NI. Similar comments apply in respect of a deferral of the reduction in rates to a future date.

Exclusion of non-trading profits

44. As noted in paragraph 4.78 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. Adopting a similar approach for NI would make the two systems broadly comparable and is likely to reduce the scope for avoidance and arbitrage although it may introduce considerable administrative complications into the corporation tax system. On the other hand, if trading income was ring fenced this may reduce the need to have extensive anti avoidance provisions at the UK level.

Are there any other policy options that might work?

45. The purpose of the tax system is to raise revenue for government spending and using the tax system to pursue other policy objectives often results in conflicts. The paper mentions four other possible options to rebalance the NI economy, as set out below.

R & D tax credits

46. There remain concerns about the availability of R & D tax credits and particularly in relation to smaller businesses. In practice they are only likely to apply to a small group of companies and we doubt that multinational companies with extensive R & D would be overly influenced by a slightly higher rate of R & D credit, especially since R & D innovation is typically centred around high profile higher education institutions, most of which would not be easily accessible from an NI base. In any event the amount of the credits would have to be even greater than the current levels which were increased further in the March 2011 Budget.

Enhanced AIAs

47. Enhanced AIAs would benefit all businesses and proportionately favour smaller businesses over larger businesses. One of the difficulties is that the level of AIA has varied since it was introduced and, coupled with extensive changes to the general system of capital allowances and rates, means 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 would have to be set and guaranteed not be to changed for, say, the life of this Parliament. We also doubt the impact of an enhanced AIA on the target market because it is more relevant to smaller entrepreneurial businesses. The NI CT rate reduction policy is clearly aimed at attracting large overseas investors to set up a base in NI, and small businesses would seem less likely to relocate when they would reduce their CT bill by only 7½%.

Training credits

48. We have no particular experience of the efficacy of these but we doubt that by themselves they would be sufficiently attractive without some other measures.

National insurance holidays

49. 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 and they would probably be much easier to operate in NI than on the rest of the UK. However, 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. A NIC holiday might be more helpful in a labour-intensive business, but this is likely to apply to only a small segment of business.

Other possible policy options

50. We have recommended previously that as part of its growth agenda the Government should undertake a thorough review of tax related investment schemes and reliefs such as EIS, VCTs and entrepreneurs’ relief. It would be worth considering whether these schemes might have a role to play in encouraging investment into NI and what would be the costs and benefits of so doing.

51. In the Budget 2011 the Government proposed the establishment of 21 enterprise zones in England. It would be worth considering whether NI would benefit from being made an enterprise zone.

52. Consideration could be given to extending the existing stamp duty land tax relief for disadvantaged areas to cover commercial property. However, the relief is only available to designated wards in NI so may need to be extended to cover all of NI. It also needs to be remembered that enhanced reliefs reduce the tax take and in the current fiscal climate there would need to be a clear and compelling case that the cost of any such relief could be recouped by tax receipts from increased growth.

53. Consideration should be given to whether the intended policy objectives could be achieved in some other way that does not involve the tax system, for example using government grants. However, the consultation document states that one of the drivers behind these proposals is that the ability to make grants will be further limited from 2013 due to expected changes to the EU state aid rules. We refer to our comments in paragraphs 22 and 23 above about state aid discussions and the need for transparency about what is possible under state aid rules.

RESPONSES TO QUESTIONS POSED IN THE CONSULTATION DOCUMENT

54. We have listed below the questions in the consultation document and answered them by referencing them to our comments set out above.

Para 2.24

Whether there is a need to rebalance the Northern Ireland economy by strengthening the private sector over the longer term and to increase economic growth and promote significant new investment

Where there is most scope for increasing productivity, reducing labour market inactivity and increasing growth.

See our comments in paragraphs 7 to 13 above.

Para 4.14

The Government would welcome views on the importance of the headline corporation tax rate in encouraging investment.

See our comments in paragraph 11 above.

Para 4.28
The Government would welcome views on the extent to which a reduction in the rate of corporation tax in Northern Ireland could support additional investment, higher growth rates and increased employment in the Northern Ireland economy.

See our comments in paragraphs 7 to 13 above.

Para 4.42
The Government would welcome views on the estimated costs arising from a lower corporation tax rate in Northern Ireland.

See our comments at para 24 and 28 to 32 above.

Para 4.45
The Government would welcome views on the dynamic impacts on tax receipts arising from a lower corporation tax rate in Northern Ireland.

See our comments on tax policy from para 14 onwards and also dealing with tax motivated incorporation from para 33 onwards.

Para 4.48
The Government would welcome views on the risks to the Northern Ireland Executive arising from a devolved corporation tax rate in Northern Ireland.

See our comments on tax policy from para 14 onwards.

Para 4.59
The Government would welcome views on potential compliance costs and administrative burdens for business arising from a devolved corporation tax rate in Northern Ireland

See our comments on the need for a detailed cost benefit analysis from para 28 onwards.

Para 4.65
The Government would welcome views on the approach that would be taken to adjust the block grant arising from a devolved corporation tax rate in Northern Ireland.

See our comments on the need for EU and state aid clearance in para 22 onwards.

Para 4.66
The Government would welcome views on the balance of potential costs and benefits of a reduced corporation tax rate in Northern Ireland

See our comments above on two separate corporation tax systems (paras 24 and 25), the need for EU and state aid clearance (para 22 onwards) and the need for a detailed cost benefit analysis (para 28 onwards).

Para 4.71
The Government would welcome views on the merits of a deferred implementation of a rate reduction in Northern Ireland and its potential impact on investment decisions.

See our comments in paragraphs 42 and 43 above.

Para 4.77
The Government would welcome views on the extent to which a phased reduction in the rate of corporation tax in Northern Ireland could support a rebalancing of the economy while allowing the costs of the reduction to be more effectively managed.

See our comments in paragraphs 42 and 43 above.

Para 4.80
The Government would welcome views on the impact that restricting any reduction in corporation tax receipts to trading income only would have on the aim of rebalancing the Northern Ireland economy and the value for money of a corporation tax reduction.

See our comments in paragraph 44 above.

Para 4.82
The Government would welcome views on whether there are other options to offset the cost to the NIE of a reduction in the rate of corporation tax that would be consistent with the overall aim of rebalancing the Northern Ireland economy.

See our comments at para 50 to 53 above.

Para 4.99
The Government would welcome views on extent to which changes to R&D tax credits, annual investment allowance, training credits or a national insurance holiday could provide feasible, effective, affordable and value for money support for the rebalancing of the Northern Ireland economy

See our comments from paras 45 to 49 above.

FURTHER CONTACT

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APPENDIX 1

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see http://www.icaew.com/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide-4-99-towards-a-better-tax-system.ashx).