Tiley's Revenue Law

9th Edition

Glen Loutzenhiser DPHIL
Associate Professor of Tax Law, University of Oxford
and Tutorial Fellow in Law, St Hugh's College, Oxford

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59.1 Structure of UK Corporation Tax

Companies resident in the United Kingdom (UK) are subject to corporation tax on their profits; the term 'profits' includes both income and capital gains.[1] The general rate of corporation tax has been steadily declining for years; it is now normally 19% but is set to decrease to 17% in 2020.[2] Corporation tax is charged by reference to 'financial years' which begin on 1 April each year and end on 31 March the following year. Tax is charged on the company whether it distributes or retains its profits. Corporation tax was introduced in 1965. Before that time corporations were subject to income tax but not surtax on their income, with further taxes (profits taxes) also charged on their income to make up for the absence of surtax.

59.1.1 The Legislation and the Rewrite

Since 2009 nearly all of the corporation tax legislation has been rewritten. The rules formerly in the Taxes Act (TA) 1988 are now spread across, primarily but not entirely, the Corporation Tax Act (CTA) 2009, the Corporation Tax Act 2010 and the Taxation

[1] CTA 2009, ss 2 and 5, ex TA 1988, s 6; on non-residents, see below at §60.9; on gains, see TCGA 1992, s 2 *et seq*.
[2] FA 2012, s 5. The rate is to drop to 19% for the financial years 2017–19, and to 18% for 2020; see FA (No 2) 2015, s 7. A further reduction in the rate to 17% for 2020 was announced at Budget 2016.

(International and Other Provisions) Act (TIOPA) 2010. CTA 2009, Part 2 contains the basic charge to corporation tax in respect of both income and chargeable gains. It then follows the ITTOIA 2005 model dealing with Trading Income (Part 3) and Property Income (Part 4), before going on to Loan Relationships (Parts 5 and 6), Derivative Contracts (Part 7), Intangible Fixed Assets (Part 8), Intellectual Property (Part 9), Company Distributions (Part 9A) and Miscellaneous Income (Part 10). Parts 11–21 deal with other matters. The capital gains rules are still primarily found in the Taxation of Chargeable Gains Act (TCGA) 1992.

59.1.2 Shareholder Tax on UK Dividends

A company subject to UK corporation tax generally is not subject to corporation tax on dividends received from another company.[3] Individual shareholders are liable to income tax on dividends (and other distributions) received from the company and pay tax under ITTOIA 2005, Part 4, Chapter 3.[4] Prior to 6 April 2016, a dividend came with a tax credit attached to it of one-ninth of the dividend, so a dividend of £90 came with a credit of £10. Assuming that the shareholder was entitled to use the credit, the income of the shareholder was the sum of the dividend (£90) and the credit (£10), or £100. Basic-rate and savings-rate shareholders paid tax at the dividend ordinary rate of 10% so that there was no further income tax to pay; this had been the case for many years. Higher-rate taxpayers paid at the special dividend upper rate of 32.5%, which means that after the £10 credit the taxpayer had to pay another £22.50. The additional dividend rate of 37.5% plus credit applied to taxpayers in the 45% income tax bracket. It was a fundamental feature of this system that the shareholder could not, subject only to very limited exceptions, claim any repayment of the tax credit from the Revenue—and never from the company.

In 2016, a radical change was made to the taxation of dividends received by individuals. From 6 April 2016, the tax credit was abolished and instead all individuals were given a tax-free amount of dividends (the 'Dividend Allowance'), initially £5,000 but reduced to £2,000 from 6 April 2018. The Dividend Allowance applies to dividends received from UK resident and non-UK resident companies. Dividends within this allowance technically are taxed at the 'dividend nil rate' and still count in determining the taxpayer's tax band, however. In addition, the following dividend tax rates apply: 7.5% on dividend income within the basic rate band, 32.5% on dividend income within the higher rate band and 38.1% on dividend income within the additional rate band. An individual's personal allowance can shield dividend income. As a result, in 2019–20 a taxpayer with no other income will be able to receive dividends of £14,500 without a tax charge.

Example

In the 2019–20 tax year, T has non-dividend income of £45,500 and receives dividends of £10,000 outside of an ISA. Of the £45,500 non-dividend income, £12,500 is covered by T's personal allowance, leaving £33,000 to be taxed at the basic rate. This means an additional

[3] CTA 2009, Pt 9A, ex TA 1988, s 208.
[4] Ex TA 1988, s 20.

£4,500 of income can be earned within the basic rate limit before the higher rate threshold is crossed. T's Dividend Allowance covers £2,000 first, leaving £2,500 more to be taxed in the basic rate band. All of the first £2,000 of T's dividend income is covered by T's Dividend Allowance and is not subject to tax. Of the remaining £8,000 of dividends, £2,500 is taxed at 7.5% and the remaining £5,500 falls in the higher rate band and is taxed at 32.5%.

59.2 A Brief History of UK Company Taxation

59.2.1 Before 1965

The UK corporate tax system has suffered major shifts of policy in its (relatively) recent past. In the 19th century the system charged companies, like other persons, to income tax;[5] this lasted until 1965. Until that year dividends were not subject to *income* tax but were grossed up to give a figure for *surtax*,[6] whether or not the company paid income tax on its profits. This system was subject to two major modifications. First, the fact that a company was subject to income tax, but not to surtax, meant that it was advantageous for a high-rate taxpayer to leave income behind the veil of a company where it would be taxed at lower rates and so multiply more rapidly. Legislation was therefore introduced in 1922 to deal with 'one-man' companies, which took the form of a surtax direction treating the income of the companies as if it were the income of its owners and so liable to surtax.[7] The legislation continued in substance, but in a new form, as part of the modern close company legislation from 1965–89.

The second modification was the introduction in 1937 of the National Defence Contribution, which in due course became profits tax.[8] This was an extra tax on the profits of the company, which, not being income tax, could not be recovered by the shareholder. This device could be used to levy tax at differential rates on distributed and retained profits, and was so used between 1947 and 1958.[9] The two-tax system was subject to a number of disadvantages separate from the issue of whether it should encourage the retention of profits. First, since the basic tax on the company was income tax, not only was it subject to all the complexities of matters such as the commencement and cessation provisions, but the rate would also alter whenever the Government thought it right to alter the rate in the personal sector. Secondly, profits under the two taxes were computed differently. Not only was profits tax levied on a current as opposed to a preceding year basis, but some items were deductible in computing profits for profits tax which were not deductible for income tax, thus necessitating two sets of calculations; consequently, until 1952 profits tax was itself deductible for income tax. Further, companies whose profits were less than £2,000 were exempt from profits tax.

[5] For an explanation, see Royal Commission on the Taxation of Profits and Income, *Final Report*, Cmnd 9474 (1955), ch 2.

[6] However, where dividends fitted in with the Schedular system was obscure but Sch D, Case VI was the prime candidate; see Heyworth Talbot [1962] BTR 394.

[7] See Royal Commission on the Income Tax, *Final Report*, Cmnd 615 (1920), para 1021(2).

[8] See Royal Commission (1955), *op cit*, ch 20. This tax was precedented not only in the excess profits duty of the First World War, but also in the general corporation profits tax introduced in 1920 and repealed in 1924.

[9] For figures, see Singh and Whittington, *Growth, Profitability and Valuation* (CUP, 1968), 4.

59.2.2 1965–73

This untidy system was ended in 1965 when corporation tax replaced the previous income and profits taxes; this was a classical system. Dividends were taxed under Schedule F, which was entirely separate from corporation tax on the profits. This system was based on a view that corporations should be encouraged to retain their profits rather than distribute them to their shareholders (see further §59.4).

59.2.3 1973–97

For these years the tax system emphasised the close relationship between the shareholder and the corporation by allowing the shareholders to use a part of the corporation tax paid by the company to offset their own liability to Schedule F income tax. This was known as the imputation system because of the way in which the corporation tax paid by the company was imputed to the shareholder. Technically it was a 'partial imputation' system, since only part of the corporation tax paid by the company was imputed to the shareholder. In order to ensure that the tax used as a credit by the shareholder represented tax actually paid by the company, the company, when paying the dividend (or any other qualifying distribution), had to pay advance corporation tax (ACT) to the Inland Revenue. Liability to pay ACT arose whether or not the company was itself liable to pay corporation tax, eg through lack of taxable profits. ACT could, within limits, be set against the company's liability to corporation tax.

In 1973 the choice lay between the imputation system and a two-rate system (also called a split-rate system), whereby corporation tax would be charged at one rate on retained profits and another on distributed profits, the difference between the two rates being that of the basic rate of income tax. In a closed economy there would be little practical difference between the two; it would not matter to resident shareholders whether the distributed profit of the company was taxed at 50%, but shareholders were allowed to take three-fifths of that tax as a credit against their own liability (the credit or imputation system), or the tax on the company was 20% and there was no credit.

The imputation system was preferred for international reasons.[10] Under a two-rate system the lower rate of tax on distributed profits could not distinguish between resident and non-resident shareholders without risking complaints of discrimination from tax treaty partners.[11] However, the imputation system could restrict the income tax credit to residents. Non-residents requesting the tax credit were turned away; when they requested double tax relief for the ACT paid by the company on the dividend, they were denied this on the basis that ACT was a tax on the company in respect of its profits and not a tax on their dividends. It followed that no UK tax was payable on the dividend, and so there was no such tax to be used as a foreign tax credit against the non-residents shareholders' liability to income tax in their own country. The UK could protect its own revenue without great risk

[10] See Green Paper, *Reform of Corporation Tax*, Cmnd 4630 (1970); *Report of the Select Committee on Corporation Tax*, HC 1970–1971, No 622; and Prest [1972] BTR 15. In 1973 the basic rates of income tax and corporation tax were 30% and 50%, respectively.

[11] TA 1988, s 231, ex FA 1972, s 86.

of discouraging foreign private investment. This was designed to lead to the renegotiation of double tax treaties and the second reason for the imputation system. The two-rate system would, for the reasons given above, give rise to a lower tax take by the UK Government. This could be adjusted by a double tax treaty with the other country. However, the United States was firmly wedded to the classical system and so saw no reason to grant a different rate of withholding tax to the other country just because that other had moved to a two-rate system; it was therefore unwilling to negotiate agreements other than those giving identical rates of withholding tax for both countries. Thus the attraction of the imputation system was that by being so nasty to US shareholders, the UK could encourage that government to come to the negotiating table.[12]

The imputation system as implemented in the UK was found to have a serious flaw, in that surplus ACT could arise (see below at §61.6). As implemented in the UK and in most other countries, it was also found, eventually, to be incompatible with EU law; the very discrimination which lay at the heart of the system was contrary to EU discrimination law (see below at §§59.3 and 77.3.1).[13]

59.2.4 1997—New Labour

The reforms which began in 1997 and which were completed in 1999 retained the shell of the imputation system. Shareholders receiving dividends still received a tax credit on account of some of the corporation tax paid by the company. However, two major changes were made. The first was the restriction of the use of the tax credit. Until 1997 a tax credit might be used by the shareholder not only as an offset against an actual UK tax liability on the dividend but also where the circumstances allowed (eg where there was little other income to use the personal relief) to be repaid, the claim being made to the Revenue and not to the company. After 1997 there was virtually no right to a repayment, whether the shareholder was a UK pensioner with low income, a charity, a pension fund or most types of non-resident (see §61.3.1). On this last point, the 1997 change had one thing in common with 1973—a wish to attack the foreign shareholder and so the foreign fisc. One effect was to reduce to a minimum a non-resident's right to recover, under the relevant double tax treaty, part of the UK tax withheld on the dividend. The second major change was the abolition of ACT. To make up for the Government's loss of cash flow from ACT, a scheme of quarterly payments of corporation tax in advance was introduced. The overall effect was a system which for most individual shareholders was much the same as a two-rate system. Later the New Labour Government decided to offer a starting rate initially of 10% then of 0% if profits were below £10,000. Many thought this unwise as it over-encouraged incorporation. However, others thought it an important part of an overall scheme of tax for small businesses.[14]

The professed objective behind the 1997–99 changes was to encourage long-term investment. Companies had to be encouraged to make long-term investment decisions with confidence; hence, part of the money taken by ending the repayment of the credit

[12] For US retaliation, see Kaplan [1978] BTR 206.
[13] Case C-319/02 *Manninen v Finland* [2004] ECR I-07477.
[14] For a wide-ranging policy view, see Chittenden and Sloan [2007] BTR 58.

was returned as a cut in corporation tax rates. Companies were also expected to retain more earnings instead of paying them out by way of dividend, a point achieved by making dividends for investors, such as pension funds, more expensive. It was believed that many pension funds were in substantial surplus and that many companies were enjoying pension holidays, but that proved to be a very short-term view. What was true was that a pension fund had an incentive to ask for profits to be distributed, in that if the dividend came out of the company with a credit which could be reclaimed, there was more money to reinvest, perhaps in that very company, than if the money had been simply left in the company.

The attack on short termism was based on the hypothesis that fund managers, especially pension fund managers, take a short-term view of investments and that this is a bad thing for the economy as a whole.[15] It is thus a mixture of facts, and assessment of those facts. The facts asserted are that there is excess volatility in the investment behaviour of managers; this may, in turn, be due in part to the next fact which is the practice under which trustees regularly monitor their managers' handling of funds in their care against the performance of other managers and the various stock indices. Managers who feel threatened in this way will tend to favour opportunities for short-term gains. This leads to the undervaluation of firms with good earning prospects and a willingness by managers to sell shares in the event of a threatened takeover when there is no real business advantage to be gained from that takeover. In turn, this leads to a discouragement of long-term investment in research and development rather than paying dividends because the company wants the shortest pay-off period possible, and leads to fund managers wanting to sell out rather than help when a company hits bad times. It may also lead to pension funds being bad at investing in small and medium-sized enterprises. This last point may have other explanations; it may be because (a) the shares may not be marketable, (b) funds have difficulty in researching firms without track records and/or (c) there may be limits on the amount of equity which may be held. These objections may be met by the development of small share markets such as the Alternative Investment Market (AIM). It should also be said that some of the UK's entrepreneurs, such as Richard Branson and Alan Sugar, have not liked dealing with 'The City', regarding it as very expensive and unhelpful. The 'market discipline' exercised by the threat to sell out in the event of a hostile takeover must be balanced against the often negative effects of such takeovers.[16]

59.2.5 2010—Coalition Politics

The Conservative–Liberal Democrat Coalition, led by Prime Minister David Cameron, that formed the Government following the general election in May 2010 looked to business as the driver of future economic growth and innovation in the UK. To that end, the Government released a Roadmap for Corporate Tax Reform, which included plans to reduce the headline rate of corporation tax and create the most competitive tax system for business

[15] For critical discussion of the short-term hypothesis, see Walker (1985) 25 *Bank of England Quarterly Bulletin* 570–75; and Marsh, *Short Termism on Trial* (Ifma, 1993). For an examination of pension funds investment practices—and much else—see Davis, *Pension Funds* (OUP, 1995); and LSE Financial Markets Group, *Special Paper No 107* (LSE, 1999).

[16] Eg Deakin and Slinger (1997) 24 *Journal of Law and Society* 124. See also Singh, 'Corporate Takeovers' in *The New Palgrave Dictionary of Money and Finance* (Palgrave Macmillan, 1992).

in the G20.[17] The main rate of corporation tax dropped from 28% to 20% in this period. Even with tax rate cuts, however, research by the Oxford University Centre for Business Taxation made it clear that the UK remained a considerable way off its G20 competitiveness goal if effective average tax rate rather than the headline statutory rate was the measure.[18] In 2011 the Government also introduced a levy on UK banks.[19] In 2015 the Oxford Tax Centre produced an interesting report describing and evaluating these measures and others taken by the Coalition government to reform the UK business tax regime.[20] Those other measures include reforms to the controlled foreign company regime, reductions in capital allowances, and the introduction of the patent box, diverted profits tax, a code of conduct for banks, and the GAAR.

Simplification was another key aim of the Coalition Government's tax reform agenda.[21] In 2010, the Government created the Office of Tax Simplification (OTS) to provide the Government with independent advice on simplifying the UK tax system. In its first report, the OTS recommended abolishing some 47 tax reliefs and simplifying others; many of those recommendations were implemented. The OTS has since released other influential reports on small business taxation, partnerships, employee share schemes, and alignment of income tax and national insurance.[22] The OTS became a permanent office of HM Treasury from April 2016.

59.2.6 2015—Present and Future

The Conservative government led by David Cameron that won a majority in the May 2015 election wasted little time before announcing further corporation tax rate cuts were on the way—down to 17% by 2020. Following the June 2016 advisory referendum on Brexit in which the UK public voted by a narrow margin to leave the EU, the then Chancellor George Osborne publicly floated the idea of reducing the corporate tax rate further, to below 15%, in order to encourage businesses to continue investing in the UK.[23] A few days later the new Prime Minister Theresa May installed Philip Hammond as Chancellor, and he refused to commit to further corporate tax cuts.

In a 2016 report, researchers at the Oxford University Centre for Business Tax concluded that the UK had improved its competitiveness internationally, with the lowest statutory tax rate amongst the G20 countries and 5th lowest effective average tax rate.[24] The government

[17] See http://www.hm-treasury.gov.uk/corporate_tax_reform.htm. See also *The Coalition: our programme for government*, at http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/documents/digitalasset/dg_187876.pdf.

[18] See http://www.sbs.ox.ac.uk/newsandevents/news/Pages/UKcorporatetax.aspx. The UK is at the bottom of the G20 for allowances on capital expenditure, so the fairly competitive corporation tax rate applies to a broad base of profits.

[19] FA 2011, Sch 19, and commentary by Cummings and Gall [2011] BTR 454.

[20] See Maffini (ed), *Business Taxation under the Coalition Government* (2015) available at https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Reports/cbt-coalition-report-final.pdf.

[21] For a recent academic work on simplification see Evans, Krever and Mellor (eds), *Tax Simplification* (Kluwer Law, 2015).

[22] See the OTS's website at https://www.gov.uk/government/organisations/office-of-tax-simplification. For more on the accomplishments and future of the OTS see Morton, *Tax Journal* (30 June 2017) and Sherwood, Evans and Tran-Nam [2017] BTR 249.

[23] BBC News, 'Brexit: George Osborne pledges to cut corporation tax' (4 July 2016).

[24] Devereux, Habu, Lepoev, and Maffini, *G20 Corporation Tax Ranking* (March 2016).

also introduced a fundamental reform to the taxation of dividends. From 6 April 2016, the tax credit system was abolished and instead all individuals have a tax-free amount of dividends (the 'Dividend Allowance' of £2,000 from 6 April 2018) and dividend tax rates of up to 38.1%. A new Business Tax Road Map also was published in 2016. Further measures to clamp down on tax planning, avoidance and evasion were introduced, including a tax-geared GAAR penalty along with anti-hybrid rules and restrictions on interest deductibility following on from the G20/OECD Base Erosion and Profit Shifting (BEPS) project (see below §69.11). Additional possible implications for UK corporate tax arising from Brexit are discussed in chapter seventy-seven.

59.2.7 Small is Beautiful

One other long term trend deserves mention. This is the granting of special reliefs for small and medium-sized enterprises. Although small companies no longer benefit from a lower rate of corporation tax—as had been the case until the main rate was reduced to the former small profits rate of 20% in 2015—other special reliefs for small companies are available in the form of:

(1) exemption from payments of corporation tax by quarterly instalments;
(2) a special tax credit for research and development; and
(3) exemption from the transfer pricing rules.

The status as qualifying companies is determined for (1) on the basis of taxable profits, and for (2) and (3) on a more complex formula taking account also of assets and turnover. Other rules designed to benefit small companies include the generous rules for share options under the enterprise management incentive (EMI) scheme.

Some see these incentives as necessary assistance for a sector of the economy which suffers disproportionately from compliance costs while also providing substantial new employment opportunities. Others point out that statistics can show that small companies provide lower productivity, lower wages and less secure employment than large companies, or wonder why a large company should be entitled to some of these benefits just because it makes low profits.[25] A system might be preferred which distinguishes on the basis of newness and growth, or sees all done away with in the name of tax neutrality and the efficient allocation of resources by the market. The Institute for Fiscal Studies (IFS)-led Mirrlees Review recommended against blanket support for all small businesses on the basis that it is unlikely to be an efficient policy response, and concluded:

> There may be some justification for targeted forms of tax support that would tend to favour some kinds of smaller businesses—for example, those undertaking significant expenditures on investment or research and development—more than a typical large company. However, it seems difficult to rationalize the nature and scale of generalized tax advantages for all small businesses that we see in the UK and in many other developed countries.[26]

[25] See Chennells, Dilnot and Emmerson (eds), *Green Budget 2000* (Institute for Fiscal Studies, 2000) §8.1.

[26] Mirrlees *et al* (eds), *Tax by Design: The Mirrlees Review* (OUP, 2011) 455. The Review, chaired by Nobel Laureate Professor Sir James Mirrlees and drawing on the work of leading international experts in economics and tax law, undertook the most comprehensive study of the UK tax system since the 1978 Meade Committee: see https://www.ifs.org.uk/publications/mirrleesreview/.

For many years a related concern has been the effective tax burden on small business across various legal forms.[27] Historically it has been tax-advantageous for small businesses to adopt a company structure over an incorporated form, due to lower levels of taxation on distributed and undistributed corporate profits as compared to income tax on the profits of an unincorporated business. In turn, both of these business forms have been more lightly taxed than employees carrying on similar economic activity, principally due to higher NICs on earnings from employment. Both the Mirrlees Review and the OTS have concluded that a difference in the combined tax and NIC treatment of employees, self-employed and corporations is undesirable.[28] First, it is potentially distortionary as it may lead to a choice of business form that is not the most appropriate and efficient in the particular circumstances. Second, it penalises some activities that are unable to adopt the most advantageous form of organisation. Third, it creates incentives for taxpayers to convert earned income into unearned income where possible, such as by choosing to take remuneration in the form of dividends rather than highly taxed salary. Lastly, the discrepancy in tax treatment may favour more economic activity being undertaken by small firms and less activity being undertaken by employees of larger firms.

The Mirrlees Review recommended aligning the personal and corporate tax rates to equalise the tax/NICs on income derived from employment, self-employment and running a small company.[29] The key ingredients of this rate alignment were (1) uniform application of NICs to income from employment and self-employment, and to distributed profits and capital gains, (2) lower personal tax rates for dividend income and capital gains on company shares to reflect corporate tax paid; and (3) abolition of the small profits corporation tax rate.[30] The OTS and Crawford & Freedman also have argued that such alignment could go some way towards reducing the present difficulties with the employee/self-employed classification and the application of IR35.[31] The 2016 introduction of higher taxes on dividends above the tax-free Dividend Allowance were aimed specifically at addressing the 'imbalance' in favour of incorporating small businesses and unquestionably have gone a considerable distance towards aligning tax/NICs across legal forms on distributed profits at least. Finally, in 2016, the OTS undertook a special study of small company taxation. It its report, the OTS suggested a number of simplification measures including optional cash-flow accounting (currently available to small unincorporated traders) and also advocated examining the merits of 'look through' taxation of nano-businesses as well as whether a new trading vehicle (a 'sole enterprise with protected assets' or SEPA) would be useful.[32] It should be said that there appears to be little appetite to pursue either look through taxation or SEPAs.

[27] See eg Mirrlees, *op cit*, ch 19 and Crawford & Freedman, *Dimensions of Tax Design: The Mirrlees Review* (OUP, 2010), ch 11. The discussion that follows is an excerpt from a larger article on this subject: see Loutzenhiser (2013) 72 *CLJ* 35.

[28] Mirrlees, *op cit*, ch 19; Crawford & Freedman, *op cit*, ch 11; OTS, *Small Business Tax Review*, (March 2011), para 6.3.

[29] Mirrlees, *op cit*, ch 19; Crawford & Freedman, *op cit*, ch 11.

[30] *Ibid*.

[31] Crawford & Freedman, *op cit*, ch 1044–46; OTS, *Small Business Tax Review*, (March 2011), para 5.10.

[32] OTS, *Small Company Taxation Review*, (March 2016).

59.3 The EU Dimension

The UK is, for now at least, a Member State of the European Union (EU). It is understandable that the EU should take an interest in tax matters with a view to harmonisation either with regard to the structure of the corporate tax system, or at least with regard to the tax base.[33] Tax systems and their differences represent significant obstacles to a free market across the EU. The various proposals on corporate tax structure show how difficult it is to reach agreement on any of the underlying economic or commercial principles.[34] The Neumark Report, in 1962, recommended the two-rate system; the Van den Tempel Report, in 1967, recommended the classical system; and the Simonet Report, in 1973, recommended the imputation system.[35] A White Paper was anticipated in 1987, but nothing materialised.[36] Subsequently, there were proposals for harmonisation on particular aspects, eg the draft directive of 1984 concerning the carry-over of losses and a report in 1980 on the possibility of convergence, but nothing much was achieved until 1990 and the arrival of Mme Scrivener. She abandoned the search for the holy grail of harmonisation in favour of a series of highly specific proposals to attack specific problems of discrimination. However, at the same time she set up the Ruding Committee to see how seriously tax problems led to distortions affecting the functioning of the internal market. The report accepted that distortions arose from the interaction of the different tax systems, but that other considerations argued not for heroic action on a broad front but for specific (ie piecemeal or targeted, depending on the point of view) removal of the major distortions. These reasons included the need to allow Member States much flexibility to collect revenue through direct taxes and the principle of subsidiarity.[37] In the new millennium efforts have switched to greater co-operation amongst Member States on tax administration, fighting tax avoidance by multinationals in particular, and trying to achieve agreement on a common consolidated corporate tax base (CCCTB).

As discussed below in chapter seventy-seven, the Court of Justice of the European Union (CJEU, formerly ECJ) has proved to be an unpredictable body, especially when invoking its non-discrimination jurisdiction. Until 2000 many of the corporation tax rules which follow were confined to entities resident in the UK, and it was uncertain when those would be found to be incompatible with EU law and when not. Thus, Lodin, writing in 1998,[38] suggested (and as it happened suggested very correctly) that because imputation systems imposed heavier burdens on foreign dividends than on domestic dividends, they must be

[33] Literature (with citations) includes Gammie [2001] BTR 233; Haufler (1999) 20 *Fiscal Studies* 133; and Devereux (1999) 20 *Fiscal Studies* 155. For lessons to be learnt by EU Member States from explicitly federal systems, see Daly and Weiner (1993) 46 *National Tax Jo* 441. See also chapter seventy-seven.

[34] See Easson (1992) 40 *Can Tax J* 600. There is a broader analysis in Radaelli, *The Politics of Corporate Taxation in the European Union* (Routledge, 1997), esp chs 5 and 6.

[35] See [1975] BTR 422; and [1976] BTR 39.

[36] See [1987] *Simon's Tax Intelligence* 423.

[37] Ruding (chair), *Report of the Committee of Independent Experts* (EC Commission, 1992); for discussion, see (1992) 13(2) *Fiscal Studies* 85. Dr Ruding's rather brief Tillinghast lecture for 1999 is printed in (2000) 54 *Tax L Rev* 101 and is followed by a longer comment by Stewart at 111. See also comments by members reported in (1993) 33(1) *European Taxation*; Daly (1992) 40 *Can Tax J* 1053 (Daly was Secretary to the Committee); and, more generally, (1991) 1 *EC Tax Review* 12 and (1991) 2 *EC Tax Review* 116.

[38] (1998) 7 *EC Tax Review* 229.

incompatible with EU law. In the 2005 case of *Manninen*, the Court said that Member State A might use an imputation system only if it gave its resident shareholder taxpayers a credit for the tax paid in another Member State.[39] Similar problems emerged from cases involving the UK itself (see below at §77.3.1). Although this was not something Member States wanted to do, some have granted partial dividend relief with respect to foreign dividends. So Germany grants the same half exemption for foreign dividends as domestic dividends. The UK has followed suit, to a point, by, for example, exempting dividends received by a company from corporation tax irrespective of whether the payer is a UK or a foreign company. It is the hope of some that this very unpredictability may persuade the Member States to try to harmonise their tax rules in this area. The choice was well put by Vanistendael in 1996:[40]

> 1) Further unplanned destruction of national tax systems by successive decisions of the ECJ which has to fulfil its mandate and cannot refuse to do so. 2) Approximation of the basic structure of income tax thereby legitimising and defining the place of national tax systems in the EC legal order and giving guidance to the ECJ about what types of income tax are compatible with the treaty. 3) Full restoration of national sovereignty of income tax which means the beginning of the end of the EU because full national tax sovereignty is incompatible with EMU and a single currency.

Developments from 2000 to 2005 provided more examples of this 'unplanned destruction' of national systems, but there are signs of a more sophisticated and deferential approach by the ECJ more recently (see §77.2.2 below).

59.4 Theory and Practice[41]

59.4.1 Significance of Corporation Tax

In most OECD economies companies pay several forms of tax. In addition to a national tax on their profits, they may also pay a regional or local tax, one or more local property taxes (in the UK the business rate is charged on all businesses whether in corporate or unincorporated form), a payroll tax, an annual wealth tax and some minor forms of tax—as well as paying social security contributions as employers.[42] For the countries concerned, of these

[39] AG Kokott in Case C-319/02 *Manninen v Finland* [2004] ECR I-07477.

[40] (1996) 5 *EC Tax Review* 122.

[41] The literature on this topic is prodigious. Among many books and articles, see Gammie [1992] BTR 148 and Gammie [1992] BTR 243; McLure, *Must Profits be Taxed Twice?* (Brookings Institute, 1979); Cnossen, *Corporate Taxes in the European Community* (IBFD, 1992); Cnossen in Sandford (ed), *Key Issues in Tax Reform* (Fiscal Publications, 1993); King, *Public Policy and the Corporation* (Chapman and Hall, 1977), reviewed [1978] BTR 321; Ballantine, *Equity, Efficiency and the US Corporate Income Tax* (Brookings Institute, 1980); and McLure (1975) 88 *HLR* 532. For older material, see Whittington, *IFS Lecture Series No 1* (Institute for Fiscal Studies, 1974), a review of the then economic literature; Royal Commission (1955), *op cit*, ch 2; Carter (chair), Canada Royal Commission on Taxation, *Report*, vol 4 (Queen's Printer, 1966), ch 19; Reamonn, *The Philosophy of Corporate Taxation* (Institute of Public Administration, 1970); Chown, *The Reform of Corporation Tax* (Institute for Fiscal Studies, 1971); Coyle [1964] BTR 408, 417; Wheatcroft [1964] BTR 416. For a fascinating, fresh view see Snape, *The Political Economy of Corporation Tax* (Oxford, Hart Publishing, 2011).

[42] See annual guides by OECD—'OECD in figures'.

forms of tax the national tax on company profits is often much less important as a source of revenue than social security contributions.[43] It may therefore be that the tax on corporate profits is significant rather than critical.

59.4.2 Should Companies be Taxed?[44]

The first question is whether companies should be taxed at all. On a benefit theory approach, the company should be taxed because it has legal personality and receives benefits, such as the protection of its property and the privilege of limited liability. This is generally considered a weak argument since there is no systemic relationship between the tax on profits and the benefits received.[45] Other reasons may be that taxing companies is politically more acceptable than taxing individuals, being less personal, and that companies occupy so important a place in the economy that governments cannot afford not to tax them.[46] One suggestion is that companies should be taxed because they lock in capital which should reach the shareholders.[47]

If a tax system had a truly comprehensive income tax (CIT) at shareholder level it would not be necessary to tax companies, although a tax may be charged on a basis other than profits along the lines of one of those just listed in §59.4.1. Under a CIT, shareholders would be taxed each year on any dividends received and, importantly, on the change in the value of their interest in the company. Since profits of the company would be taken into account in valuing those interests, they would be taxed in the hands of the shareholders. Under a universal expenditure tax (ET) the return on savings is taxed only when consumed and, since profits retained by the company are not consumed, there is no tax charge on such profits. Under a CIT, there is therefore a tax charge on the shareholder in respect of the change in value due to the retained profits, while under a ET there is no charge at all.[48]

However, neither a CIT nor an ET is feasible. The main general issues with an ET are the potentially high tax rate and the problematic distinction between a business expense incurred in producing income (and so deductible) and a (chargeable) consumption expense: for more see §1.6.3.4 above. The obvious problems with a CIT include the difficulty of identifying the shareholder to which the retained profits may be attributed,[49] especially in a world of volatile stock markets and nominee companies, and the liquidity issues for a shareholder who has to pay the tax but has no money to do it with. Exempting corporate entities from tax opens up opportunities for tax avoidance by accumulating profits in the company and then selling the shares—opportunities which are not wholly corrected by having a capital gains tax.[50] Therefore a tax on companies may be needed to protect the individual income tax.

[43] For 2009, in the OECD countries corporation tax yielded an average of 8% of the tax take and social security yielded 27% (OECD, Tax Stuctures in the OECD-area, Table C); the UK percentages were 7% and 19% (HM Treasury, *Budget 2010*, Table C11: Current receipts).

[44] A good starting point is the Mirrlees Review, 408–12. See also the Green Paper, *Reform of Corporation Tax*, Cmnd 8456 (1982), Pts I and II.

[45] Messere, *Tax Policy of OECD Countries* (IBFD, 1993) 325.

[46] Eg Blough (1943) 10 *Law and Contemporary Problems* 108, 110.

[47] Bank (2004) 30 *Journal of Corporation Law* 1.

[48] See Gammie [1992] BTR 148, 149.

[49] On significance of accruals basis versus receipts basis, see *ibid*, 154.

[50] Bagchi (1990) *IBFD Bulletin* 243.

59.4.2.1 Profits or Turnover?

A related question is whether the tax should be on the profits of the company or on its turnover.[51] The argument in favour of the latter is that it can be shown that a tax on some companies enters into the company's pricing process and so is shifted forward to the consumers of the company's products rather than falling on the shareholders—or backwards on the employees of the company through lower wages or other suppliers. If this view is correct or, more accurately, partially correct, a tax on companies is in effect an indirect tax, and a tax on the profits of profit-making companies is simply an erratic and therefore inequitable tax which penalises the profitable companies and subsidises the inefficient. This argument has rarely found favour. First, the shifting of the tax by companies is a matter of great speculation and it is less than clear that taxes are shifted on to consumers. Secondly, a turnover tax would presumably have to apply to individual businesses as well as companies in order to avoid too great a gap between the incorporated and unincorporated business, thus, in turn, making a further division between the self-employed and others. Recently, narrowly targeted turnover taxes have been mooted by the European Commission as a means of taxing the digital economy. At the time of writing the UK Government was consulting on a 2% digital services tax on revenues of large digital businesses, to be effective from April 2020.[52]

59.4.2.2 Profits and Shareholders

If the tax falls on the profits of the company rather than on its turnover, it is easy to begin to design an ideal tax system; however, it is less easy to complete the task. This is because there are major disagreements over how the corporation tax works, not only as to whether it is 'shifted', ie the burden falls not the company and its shareholders but on others, but also on the corporate finance implications and the role of equity finance in comparison with other sources. Moreover, the topic cannot be taken in isolation from decisions about taxation of savings in general. These problems multiply when other countries are considered, not as a source of ideas but as trading partners—if individual nations find it hard to settle on a coherent tax policy in a purely domestic setting, it is very unlikely that two or more nations will agree on their policy objectives. Under these conditions one nation's tax policy may be cancelled out by another's.[53]

59.4.3 Various Models of Tax Treatment of Dividends under Personal and Corporate Income Tax

If the tax falls on the profits of the company rather than on its turnover, the next question is whether that tax is to be regarded as separate from the taxation of the shareholder.[54] Taxing profits first at the corporate level and again at the shareholder level when distributed

[51] See Richardson (chair), Committee on Turnover Taxation, *Final Report*, Cmnd 2300 (1964), which rejected the idea of a VAT on companies.

[52] See https://www.gov.uk/government/consultations/digital-services-tax-consultation.

[53] See, generally, Gammie [1992] BTR 148, Gammie [1992] BTR 243 and *Taxing Profits in a Global Economy* (OECD, 1991), ch 2, part D.

[54] See, generally, Gammie [1992] BTR 148 and [1992] BTR 243; Cnossen in Sandford (ed), *op cit*, 40; and Cnossen (1996) 17(4) *Fiscal Studies* 67.

gives rise to economic double taxation. The polar starting points are that the corporate and shareholder tax should be treated as entirely distinct or as one integrated whole. A major report from the OECD in 1991 identified at least seven models of taxing companies and their shareholders that may be discerned.[55] All of these methods have been used at one time or the other in OECD countries. The further we move down this list of models, the more the two tax systems are viewed as an integrated whole, with a corresponding greater attention paid to reducing or eliminating economic double taxation, either at the corporate or at the shareholder level:

Model 1 – Classical system—tax paid by company on profits; tax paid by shareholders on dividends received

Model 2 – Split rate—tax paid by company on undistributed profits at one rate and on distributed profits at a lower rate; tax paid by shareholders on dividends received

Model 3 – Partial dividend deduction—tax paid by company on profits but with a partial deduction for dividends paid; tax paid by shareholder on dividends received

Model 4 – Partial imputation system—tax paid by company on profit; tax paid by shareholder on dividends received, but with a partial credit for corporate tax paid

Model 5 – Partial shareholder relief schemes—tax paid by company on profit, tax paid by shareholder on dividends received, but with a partial credit for domestic shareholders only

Model 6 – Zero rate system. Tax paid by company on profits; a zero rate of tax paid at shareholder level on distributed profits

Model 7 – Full imputation system or full shareholder relief system. Tax paid by company on profits; shareholders receive a full tax credit for corporate tax paid in computing their personal income tax liability.

Under *model 1*, usually called the 'classical system',[56] the corporate level and shareholder level taxes are viewed as separate and distinct. Profits distributed to shareholders are fully or almost fully liable to both corporation tax and personal income tax. Under this model there is little or no reduction in economic double taxation of distributed corporate profits. The total tax taken from distributed profits is greater than that from undistributed (or retained) profits. The classical system also discriminates between equity finance and debt finance, the latter being cheaper.[57] This model was part of the UK system from 1965–73, and has been in force in the US and other countries for much longer.[58]

The remaining models (*models 2–7*) provide some degree of relief from economic double taxation.[59] The opposite pole from model 1 (*models 6 and 7*) treats company and

[55] *Taxing Profits in a Global Economy*, Table 3.1.

[56] See Royal Commission (1955), *op cit*, 382 (Memorandum of Dissent). As Cnossen in Sandford (ed), *op cit*, points out, the classical system is actually more recent than some of the imputation systems.

[57] However, see Andrews (1984) 30 *Wayne LR* 1057–71, pointing out that shareholders gain by not having their income taxed until the profits are distributed by way of dividend.

[58] For a 2003 survey, see IFA Cahiers LXXXVIIIa (International Fiscal Association, 2003).

[59] Cnossen (1996) 17(4) *Fiscal Studies* 67, 81.

shareholder as effectively identical.[60] Double taxation is eliminated either by levying a zero rate of tax on dividends at the shareholder level (*model 6*), or by giving a full tax credit to the shareholder for the tax paid at the corporate level (*model 7*). The difference between the two is that it will be possible to apply progressive taxation to shareholders under model 7, but not under a pure model 6. Model 7 is likely to break down at international level.[61] The UK's regime after 6 April 2016 is a hybrid system, combining a model 1 classical system with elements of model 6 as the first £2,000 of dividends are subject to a nil-rate of tax.

Models 2–5 are intermediate positions seeking to reduce rather than eliminate economic double taxation. The difference between some of these models may seem insignificant but becomes critical when considering the position of foreign shareholders, and especially their rights under double tax treaties. The reduction in economic double taxation may be effected at the corporate level—by having a split-rate system in which the tax on corporate profits is charged at one rate on retained earnings and another (lower) rate on distributed earnings (*model 2*), or by allowing the company to claim a partial deduction for dividends paid (*model 3*). There are two ways to reduce economic double taxation at the shareholder level. One (*model 4*) gives the shareholder a partial credit for the corporate tax paid, eg the UK system prior to 6 April 2016; the other (*model 5*) gives a partial credit for domestic shareholders only.

59.4.3.1 Hybrids

Variations of these models start with the classical system but then apply a special (flat rate) tax on dividends separate from normal progressive rates. The 'dual income tax' has become fashionable in EU countries and examples of it may be found in Sweden, Denmark and Finland.[62]

59.4.3.2 The Role of Capital Gains Tax

One other point of comparison should be made—the burden of capital gains tax (CGT) on shares. In the UK we are used to having this charge, although it may, in practice, be softened by the annual exemption, or by the use of intermediaries such as individual savings accounts (ISAs). In the UK there is now a corporation tax exemption for substantial shareholdings held by companies (§62.3.3). A CGT is found in many other European countries as well as in the US, Canada and Australia; however, it is not found at the individual level in Greece, New Zealand and Switzerland.[63] The lesson to be drawn is that comparison is hazardous unless complete and detailed; the more so since local taxes, a wealth tax or other taxes on businesses, such as social security or payroll taxes, have not been considered. It is therefore appropriate to turn to the arguments used in the debates on the choice of model.

[60] Full integration was recommended by the Canadian Royal Commission in 1966, the US Treasury in 1979 and the Campbell Committee in Australia in 1981, but was rejected as impracticable by the US Treasury in 1992; on the United States see, generally, McLure, *Must Corporate Income be taxed Twice?* (Brookings Institute, 1979); and US Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (1992); for US colloquium on 1992 proposals, see (1992) 47 *Tax L Rev.*

[61] *Ibid*, 248.

[62] OECD, *Taxation of SMEs in OECD and G20 Countries*, (2015), 35–36. See also Cnossen (1996) 17(4) *Fiscal Studies* 67, 87–89; and Gammie [1992] BTR 243, 252.

[63] Harding, 'Taxation of Dividend, Interest, and Capital Gain Income', *OECD Taxation Working Papers, No 19*, (2013), 32–33.

59.4.4 The Arguments

59.4.4.1 Classical Versus Imputation Systems

The debate over the two poles of the classical and imputation systems is long and unresolved, and has been governed by a mixture of rhetoric and business. Critics of the classical system regard the interests of shareholders and those of companies as being one and the same; its defenders point to the role of the equity market and claim that most investors take little interest in management, provided their dividends continue to be paid. In the 1970s fundamental problems arose over the virtues of the free market system; these problems are thought to be less important now, but memories are short.

The classical system is favoured by those who believe that the company is not the alter ego of the shareholders but is run instead by managers for their own interests[64] and by those who believe that the burden of the tax is not borne by the shareholders, ie that it is shifted to employees or customers. The classical system also has attracted support from those who believe in the 'new' view of dividends, ie that the form of corporate tax is completely irrelevant to a company's dividend decisions.[65]

Behind the rhetoric are debates over various 'distortions' or examples of discrimination. As with all these situations there are two reactions: one is to find a countervailing device to correct the distortion; the other is to try to remove the bias which underlies the distortion. The classical system means a higher burden of tax on incorporated business than on unincorporated business; in turn, this means that, assuming distribution, the rate of return required by a company to make a profit is higher than that for an unincorporated business.[66] The classical system discriminates in favour of retained, as opposed to distributed, profits. This is not necessarily efficient since it makes it more expensive for a company to maintain its net flow of dividends to its shareholders. This, in turn, makes it more expensive for the company to raise the money for its needs, and especially its growth, from the equity market; instead it must look to borrowing or its own income. On this view a shift away from a classical system and to integration will provide more funds for the corporate sector.[67]

Critics of the classical system assert that an investment financed from outside may be looked after more closely than one funded purely from within. They also suggest that a tax which discriminates against distributions means that companies are encouraged to retain money which could be used better by other companies and so encourages businesses which already have adequate reserves at the expense of those which wish to expand faster than their present profitability will allow. If a company is not expanding, managers should not be encouraged to keep liquid reserves for their own sake; reducing retentions would limit the financial discretion of—and so potential misuse by—management.

[64] See, generally, Bratton (1989) 1 *Stanford LR* 1471, reprinted in Wheeler, *A Reader on the Law of the Business Enterprise* (OUP, 1995), 117. For an historical account see Bank, *Anglo-American Corporate Taxation* (CUP, 2011).

[65] Bagchi (1990) *IBFD Bulletin* 244, considering the views of Bradford. For an explanation of Bradford's views by himself, see *Untangling the Income Tax* (Harvard University Press, 1986), ch 6.

[66] *Report of the Select Committee on Corporation Tax*, *op cit*, §259; see also Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts* (Warren, Gorman & Lamont, 1989) §§95–96.

[67] Eg the Department of the US Treasury (1992), *op cit*, 138.

Supporters of the classical system approve of the use of borrowed money to expand a business;[68] the right to deduct interest but not dividends in computing profits encourages the practice of high gearing. This practice is beneficial because lenders have an incentive to monitor the activities of the managers.[69] Whether the double tax (on profits and dividends) makes investment more expensive for the corporate sector than for the unincorporated sector depends on whether the 'optimistic' view of corporate tax is accepted. This view argues that because companies rely on debt-finance at the margin, the tax is neutral or even mildly beneficial. This is highly controversial.[70] However, it remains true that since most countries not only allow a full deduction for interest payments but also allow inflation to erode the value of corporate debt, they give an artificial stimulus to debt.

These arguments were much debated in the UK in the 1970s at and around the time of the switch from the classical system to the imputation system.[71] The perceived view of dividends at that time (the 'old' or 'traditional' view) was that tax had a major influence on company pay out rates. A classical system, combined with preferential tax on capital gains,[72] made dividends more expensive than retentions. This led people to ask why companies continued to pay dividends when other devices were cheaper in tax terms, and why they preferred to try to raise new equity to finance new investment in order to prevent dividends being lowered even though the effect of this might be that the investment would not be made at all. The explanation seemed to be that a company paying a dividend saw itself as sending a signal that it was in a healthy state and its future earnings prospects were good; critics thought this an expensive way of making such an announcement.

The modern view of dividend taxation suggests that shareholders should, as rational people, prefer lightly taxed capital gains to heavily taxed dividends, and that corporations should therefore retain as much as possible. On this view retained earnings are a much more important source of investment than a new share issue. The new view also asserts that dividend taxes do not affect the profitability of investments funded from retained earnings and so do not distort investment choices; this is because a tax on the shareholder may reduce the value of the shareholding and so the value of the firm, but this will not affect the company's decision whether or not to invest. Since dividend taxes must eventually be paid, they are capitalised into the share values, reducing share prices to compensate for those taxes. In effect, a dividend tax is a lump-sum tax on equity existing when the tax is imposed or new equity is issued.[73] However, this view contains two assumptions and one caveat. First, it assumes that capital gains will be lightly taxed in the hands of the shareholders. Secondly, the non-distortion argument assumes that the tax on dividends remains unchanged. Thirdly, the new view applies only to mature businesses; new businesses will

[68] On the importance of non-tax aspects for preferring equity to debt, eg the costs of financial distress and bankruptcies, see Department of the US Treasury (1992), *op cit*, ch 1, 115.

[69] See Department of the US Treasury (1992), *op cit*, 115 *et seq*, where it is pointed out that this might be an ineffective way of improving performance, especially as it did not work where the variation in the firm's cash flow was the same as that of other firms.

[70] See Stiglitz (1973) 2 *Journal of Public Economics* 1.

[71] These paragraphs draw unashamedly from *Taxing Profits in a Global Economy*, ch 2, and Messere, *Tax Policy of OECD Countries* (IBFD, 1993), ch 12, section D, 365–66.

[72] UK CGT was charged at a maximum of 30% until 1988.

[73] Department of the US Treasury (1992), *op cit*, 116.

not have enough retained earnings and so will need external finance in the form either of loans or shares.

In 1991 the OECD Report reached the dull conclusion that there was some truth in both views, but highlighted the more interesting point that the differences in policy implications should not be exaggerated.[74] By contrast, Cnossen states that most empirical studies support the old or traditional view,[75] and the US Treasury 1992 Report states that the tax policy implications are different.[76] The US Report argues that, on the new view, reducing the tax on dividends would increase the value of the shares and so benefit existing shareholders, and that companies would not pay more dividends. The old view asserts that shares values would not go up just because of a change in the law, making dividends less disfavoured, and that making the tax system more neutral between retentions and distributions would increase distributions and so economic efficiency. These (Treasury) views thus deal with the effect of the transition, itself as well as the long term.

Three concluding points may be noted on the dividend debate. First, the attractiveness of shares is affected by many matters other than tax. Secondly, although the imputation system discriminates less strongly than the classical system in favour of retained profits, it may discriminate to some extent against them. Thirdly, it may be a mistake to tax all companies, other than close companies, in the same way, regardless of size and function. In fact, the present UK structure, by withholding capital allowances from buildings, does discriminate substantially against property companies, and by giving special reliefs to small companies, tries, however unsuccessfully, to distinguish large companies from small.

59.4.4.2 International Matters

The policy issues have so far been considered primarily in the domestic context. However, companies operate increasingly in the international economy, and the cosy fireside view is no longer appropriate. Cross-border investment brings its own problems; thus why is it that tax systems almost invariably make international investment more expensive than purely domestic investment[77]—and what can be done about it? What is to be done about those differences between tax systems which cause distortions and, in extreme cases, naked tax competition between countries,[78] or about those domestic souls who can make use of foreign entities, legally or illegally? We also have new problems of equity and neutrality—as between resident and non-resident shareholder and between resident and non-resident company. The G20/OECD Base Erosion and Profit Shifting (BEPS) project unquestionably has had an impact on the international tax sphere, even if critics argue it was a missed opportunity for more fundamental reform (see below §69.11).

[74] *Taxing Profits in a Global Economy*, 29.
[75] Cnossen (1996) 17(4) *Fiscal Studies* 67, 93, citing, eg, Zodrow (1991) 44 *National Tax Jo* 497.
[76] Department of the US Treasury (1992), *op cit*, 116.
[77] *Taxing Profits in a Global Economy*, ch 2, part D, and ch 5. See also the slightly more recent Chennells and Griffith, *Taxing Profit in a Changing World* (Institute for Fiscal Studies, 1997), 102.
[78] A good starting place is the Mirrlees Review, *op cit*, ch 18 and below at §75.1. For a view of the problem in the corporate as opposed to the tax field, see Charney (1991) 32 *Harvard Journal of International Law* 423; reprinted in Wheeler, *A Reader on the Law of the Business Enterprise* (OUP, 1994), 365.

59.4.5 Cash Flow Tax

In 1978 the Meade Committee developed ideas for taxing companies on cash flow rather than profits.[79] This might simply total receipts and deduct payments other than those made to banks and others for finance, including shareholders, and pay tax on the resulting figure. It would also universalise capital allowances, and abolish the difference between capital and income. It would have the advantage of taxing property companies, but would initially cause difficulties for highly geared companies. Special provision would have to be made for banks, which could be taxed under the then existing system. There are several variant forms.

59.4.6 Tackling the Bias Against Equity[80]—Widening the Deductions

59.4.6.1 The IFS and Mirrlees Review ACE Proposals[81]

In so far as the debate concerns the different treatments of debt and equity finance (ie the deductibility of debt and the non-deductibility of dividends), one solution is to allow the deduction of dividends at corporate level either completely (*model 6*) or in part (*model 3*). An alternative approach is to have an allowance for corporate equity (ACE). The essential idea is simple—a company would be entitled to deduct an allowance based on the value of the shareholder's equity employed in the business for the period. A set percentage representing the normal rate of return, as determined by the Government, is applied to the value of the shareholders' funds. Those funds would consist of the sums of: (a) funds from the previous period; plus (b) any new equity contributed; plus (c) the ACE allowance for the previous period; plus (d) taxable profits. From this total would be deducted: (a) the tax paid on those profits and dividends; and (b) distributions to shareholders and capital repaid. In order to avoid a double allowance, adjustments would have to be made when one company invested in another. The allowance would leave most of the UK system of corporation tax exactly as it was. The result is that tax is levied only on 'excess' returns above the normal rate of return.

Three advantages in taxing the company are seen to flow from the idea:

(1) neutrality as between debt and equity finance—since a full allowance would be given for the costs of finance, whether debt or equity, and without regard to the level of dividends actually paid, the treatment of equity finance would be assimilated to that of debt finance;
(2) neutrality as between realised and unrealised profit—realisation of profit will lead to more funds and so a higher rate of allowance; deferral of profit means deferral of tax but a lower rate of allowance; and

[79] See Meade, *The Structure and Reform of Direct Taxation* (Allen & Unwin, 1978), ch 12. The idea is supported on administrative and economic grounds by McLure and Zodrow (1996) 3 *International Tax and Public Finance* 97.

[80] For a good review of methods of tackling the debt-equity distinction, see Wood (1999) 47 *Can Tax Jo* 49.

[81] See the Mirrlees Review, *op cit*, ch 17. Earlier work includes the influential Gammie (chair), Report of the IFS Capital Taxes Group, *Equity for Companies; A Corporation Tax for the 1990s* (Institute for Fiscal Studies, 1991). For a summary of the 1991 IFS report, see Gammie (1991) 31 *European Taxation* 238–42; there is another summary in Devereux and Freeman (1991) 12(3) *Fiscal Studies* 1.

(3) inflation—as shareholders' funds rise in response to inflation, so the value of the allowance would also rise.

In addition, the ACE proposal would be economically neutral in terms of its effect on decisions on scale of investment, since only excess returns are taxed.[82]

The system would have to face the familiar problems of interaction between corporate and shareholder levels.[83] The favoured solution is to adopt a classical system for the taxation of dividends, since the effect of the ACE system is that the company's finance costs are fully deductible and so there is no need for imputation. The system can, however, work perfectly well in conjunction with an imputation system. More problems arise over the taxation of capital gains, but these are seen as arising from the nature of the personal tax system—if the corporate tax system is neutral but the personal tax system is not, an overall neutral system cannot be created simply by dealing with the corporate side. The Mirrlees Review recommended taxing capital gains on shares (and dividends) at a lower rate than earned income to reflect in part tax paid at the corporate level.[84]

Although the ACE proposal has been generally admired rather than widely implemented, it was the inspiration behind a reform in Croatia lasting from 1994 to 2001, and more recent relief for equity finance offered in Belgium and Italy.[85] Like other reforms which increase the amount that may be deducted, the change would mean that the same amount of tax would have to be raised from a smaller amount of net profits—assuming that the change is to be revenue neutral.[86] On this basis, ACE would mean both an increase in the rate of corporation tax if the change were to be revenue neutral (Isaac suggested an increase of 10% under an imputation system, say, from 35% to 45%[87] for the years 1973–91, with a 25% rate under a classical system) and a major increase in the burden of tax between different companies, with successful companies paying more tax and less successful companies enjoying a tax reduction.

It is likely that the rate of ACE would be set at a level which would protect a certain amount of real profit. There would be problems on the taxation of capital gains in the hands of companies, in that these ought to be taxed at the same rate without indexation relief; such a high rate would be vulnerable to weakening as a result of either political pressure or avoidance, or both. Furthermore, the ACE does not solve, and may exacerbate as a consequence of its potentially high tax rate, economic distortions related to location of discrete investment projects (especially for more profitable projects) and location of taxable

[82] See Auerbach, Devereux and Simpson, 'Taxing Corporate Income' in Mirrlees *et al* (eds), *Dimensions of Tax Design: The Mirrlees Review* (OUP, 2010); the Mirrlees Review, *op cit*, chs 17–19; de Mooij and Devereux, 'An applied analysis of ACE and CBIT reforms in the EU' (2011) *International Tax and Public Finance* 118, 93–120.

[83] See Report of the IFS Capital Taxes Group (1991), *op cit*, paras 2.4.12–2.4.16; and Cnossen (1996) 17(4) *Fiscal Studies* 67, 85.

[84] The Mirrlees Review, *op cit*, 489. The RRA is discussed in detail *ibid* chs 13–14.

[85] Keen and King (2002) 23 *Fiscal Studies* 401–18 (on Croatia), and the Mirrlees Review, *op cit*, 449 (on Belgium).

[86] The Mirrlees Review did not support revenue neutrality, opting instead for lower corporation tax revenues, principally on international competitiveness grounds: 'If a source-based tax on the normal return component of corporate profits is undesirable, and the current UK corporate tax rate is considered more or less appropriate, the implication is that less revenue should be raised from the corporate tax' (Mirrlees *Review*, *op cit*, 450).

[87] Isaac (1997) 18 *Fiscal Studies* 303, 305. Contrast Bond, Devereux and Gammie (1996) 12 *Oxford Review of Economic Policy* 109–19.

profit (ie profit shifting to lower-tax jurisdictions).[88] There would be the further question whether the principle—that the opportunity cost of capital should not be taxed—should be extended to income tax. In fact, the Mirrlees Review recommended a rate of return allowance (RRA) for income tax as a 'natural counterpart' to the ACE for corporation tax.[89] As with all fundamental changes, there may also be international tax problems in implementing such a change unilaterally. Cnossen agrees that there are attractive neutrality aspects, but suggests that these are best achieved if capital markets are perfect.[90]

59.4.6.2 The American Law Institute Proposal[91]

The American Law Institute (ALI) had other ideas for reforming the US system so as to reduce the bias against distributed earnings in a classical system. One would be to allow a company to deduct dividends paid on new capital up to a certain percentage geared to the long-term interest rate plus 2%. It differs from the ACE, *inter alia*, in that it applies only to new equity.

59.4.7 Tackling the Bias Against Equity—Narrowing the Deductions[92]

A second way to reduce the bias against equity is to look at the company rather than the shareholder, and at the company's inability to deduct dividend payments. Why not reduce or remove the company's right to deduct interest? In fact, following on from the G20/OECD's Base Erosion and Profit Shifting recommendations the UK (and other countries) has introduced restrictions on corporate interest deductibility: see below §63.2.9. In 1992 the US Treasury issued a report on integration which suggested a comprehensive business income tax (CBIT).[93] Under this scheme, all company earnings would be taxed at the company level, and there would be no deductions for either dividends or interest paid to shareholders and debt holders; these items would not be taxed as the recipient's income. This would make the debt/equity distinction irrelevant and reduce the retained/distributed distinction; whether the distinction is abolished would depend on what happened to capital gains rates. The attack on the debt/equity distinction means that many familiar problems would disappear, eg thin capitalisation. The idea has the further attraction of benefiting growing firms at the expense of existing ones—one person's benefit is another person's distortion. Another advantage of the CBIT is that it has a wider base than the ACE and thus lends itself to a lower tax rate than the ACE, all else being equal. This would in turn mean

[88] See Auerbach, Devereux and Simpson, *op cit*; Mirrlees Review, *op cit*, chs 17–19; de Mooij and Devereux, *op cit*, 93–120.

[89] Mirrlees Review, *op cit*, 496.

[90] Cnossen (1996) 17(4) *Fiscal Studies* 67, 85.

[91] Andrews, *Reporter's Study Draft for the ALI Federal Income Tax Project, Subchapter C* (American Law Institute, 1989). See also Department of the US Treasury (1992), *op cit*, 108–09; and American Law Institute, *Federal Income Tax Project, Tentative Draft No 2, Subchapter C—Corporate Distributions* (American Law Institute, 1979). The 1979 proposals were criticised as unworkable by Warren (1981) 94 *HLR* 719 and Warren, *ALI Federal Income* Tax *Project: Integration of the individual and corporate income taxes, reporter's study of corporate tax integration* (American Law Institute, 1993).

[92] See Gammie [1992] BTR 244, esp 246. This paragraph is based on the summary by Cnossen (1996) 17(4) *Fiscal Studies* 67, 86–87.

[93] For comment, see Gammie [1992] BTR 244, esp 257–61; and, for a comparison with ACE, see *ibid*, 273–75. See also Goode (1992) *Tax Notes* 1667; and, for an economic viewpoint, Sunley (1992) 47 *Tax L Rev* 621.

a reduced level of economic distortions related to location of discrete investment projects and location of taxable profit compared to an ACE, but the CBIT would not be neutral in terms of decisions on scale of investment (unlike the ACE).[94] Research by Devereux and de Mooij also suggest potential economic benefits could be had from adopting a half-way house approach to reducing the debt/equity distortion with a combination of partial interest restictions and a partial ACE.[95] Finally, it should be emphasised that as corporate tax rates continue to fall generally in the UK and elsewhere, the benefits from a tax deduction for interest and the bias in favour of debt financing over equity fall as well.

[94] de Mooij and Devereux, *op cit*, 93–120.
[95] *Ibid*, 110–113.