

ACCA POSITION PAPER

Tax After the Financial Crisis

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Introduction

Tax is a key issue at any time, but during a financial crisis, when public finances suffer due to shrinking tax receipts caused by higher unemployment and lower company profits, it becomes even more important. The current financial crisis has seen tax issues climb higher and higher up the political agenda, from 'tax havens' to tax cuts and increases.

This paper discusses some of the key issues relating to tax and the financial crisis, including:

- did tax cause the crisis?
- tax competition and stability
- corporate tax rates
- other competitive tools
- effective rates
- tax and small business
- tax cuts and rises
- tax policy and legislation.

The paper goes on to set out 13 recommendations for policy makers.

1. Governments should address national tax rules which distort behaviour, and reward one financing route over another. Care should be taken, however, to avoid sudden rule changes, as this could require significant wholesale restructuring that could have unintended consequences.
2. The UK's tax system needs to become less complex and more stable in order to enable business planning. It should also be benchmarked against a larger number of economies than just the G7, which excludes competitors such as China, Russia and Switzerland.
3. The volume of tax legislation, and changes in it, should be kept to a minimum – each law must only exist in response to a direct need for it.
4. ACCA supports the principle that nations are free to determine their tax affairs within the context of a global competitive environment, but the next government must be wary of causing retaliatory action and trade wars by drastic corporate tax cuts to ensure that the UK remains competitive.
5. Governments should address substantive issues of tax law that cause distortions, rather than relying on headline corporate tax rates and 'holidays' to attract FDI.
6. The system should be kept as simple and homogeneous as possible in order to provide the certainty that business needs.
7. Tax changes should not be short-termist ie tax reductions/raises should not be reversed in quick succession There should be long-term stability so that businesses can adopt long-term strategies. The caveat here is that in the recent climate tax stability has probably needed to be less rigidly adhered to but this we hope will only be a short-term necessity.
8. Governments should employ the 'think small first' principle when considering tax legislation.
9. There should be a level of transparency and stability in the tax system which reassures and encourages small businesses.
10. There should be consistent consultation with business on taxation issues, and industry should be invited to provide input at all stages of the process in order to provide advice, but also to remain fully apprised of any possible changes. Also, HMRC should ensure that the recommendations of the Varney Review are fully implemented, particularly in terms of taking the business perspective into account in everything it does - giving earlier clarity and reducing complexity and administrative burdens for business.
11. Corporate tax legislation should be largely removed from the Finance Bill to provide more possibilities for thorough examination of important clauses.
12. ACCA endorses the idea of sunset clauses whereby tax legislation is periodically overhauled and consolidated to bring it up to date and make it easier to follow. Outdated laws should be removed.
13. Governments and tax authorities should devise clear metrics to gauge whether the tax system is being appropriately and sufficiently reviewed.

Did tax cause the crisis?

The International Monetary Fund (IMF) has argued that the global financial crisis was exacerbated (though not caused) by tax policies which fuelled the credit boom that preceded the economic downturn. The IMF proposes¹ that governments should consider changing the rules that have encouraged companies to seek finance using debt rather than equity, and allowed individuals to take out larger mortgages. Many tax regimes allow companies to deduct interest payments against tax but not against returns on equity; this has resulted in an increase both in leveraged buy-outs by private equity organisations and in the holding of debt rather than equity by other financial institutions. The IMF argues that ‘corporate level tax biases favouring debt finance including in the financial sector are pervasive, often large and hard to justify given the potential impact on financial stability.’

So what is to be done? Given the political delicacy involved in eliminating the tax deductibility of interest payments, the IMF suggests creating deductibility for the notional cost of equity financing – effectively giving banks tax deductions on Tier 1 capital, thus encouraging them to hold more capital reserves. Countries such as Croatia and Belgium have adopted so-called ‘Allowance for Corporate Equity’ rules. There is much to be said for this although it can, and has, reduced the amount of tax revenue available to national governments at a time when they are already under financial strain.

But the bigger issue here is that tax distortions are artificially incentivising certain kinds of economic behaviours over others. It illustrates why tax neutrality should be such a fundamental aspect of any good tax system. The IMF points out that ‘securitisation and other devices can amplify the economic costs of those tax distortions (for example by reducing the costs of subprime financing) and their use to secure favourable tax treatment contributes to opaque financial instruments’. This cannot be in society’s interest.

Solutions, the IMF says, are not easily found given the scale and profundity of both debt bias and the general divergences in national tax rates, bases and practices.

ACCA argues that governments must seek to remove the distortions in their own national tax systems and work together to try to iron out the differences in tax bases which give rise to tax arbitrage. For example, in the EU there are still many barriers which frustrate the workings of the Single Market. The sharing of best practice and knowledge between countries, of the sort envisaged by the G20 in the new era of financial regulation, could certainly be useful in the international tax world. It is important, however, that this does not stretch into cartel-like behaviour which would damage the global economy.

RECOMMENDATION

Governments should address national tax rules which distort behaviour, and reward one financing route over another. Care should be taken, however, to avoid sudden changes, as this could require significant wholesale restructuring that could have unintended consequences.

1. *Debt Bias and Other Distortions: Crisis-related Issues in Tax Policy*, IMF Staff Paper, June 2009.

Tax competition and stability

It is clear that tax yields in many countries will have fallen as a result of the economic downturn. But another important reason for the decline is that companies choose to use their mobility and relocate their headquarters if the tax regime is insufficiently attractive in the country where they are based. For example, a growing number of British companies have moved their tax domicile from the UK, quoting the lower tax rates, greater stability and friendlier systems in their new domiciles². There have also been a number of US multinationals, such as McDonald's, which have switched their European headquarters from the UK to Switzerland, to take advantage of preferential intellectual property (IP) tax laws rather than have to pay tax on foreign profits relating to IP twice over, as would be the case under new UK tax rules applying from July 2009³.

Tax, is of course only one factor in such corporate decision making: the high quality of life and excellent transport in Switzerland have also been cited as key influencing factors. The UK government, keen to emphasise that point, has argued that 'evidence suggests a range of factors at play when investment location decisions are taken, and tax is not the most important'⁴. This is almost a self-evident statement, given that any business must be able to survive and grow in the location where it sets up; tax, although it is an important issue, is perceived just as another cost of production.

ACCA believes that tax legislation and operations should be as simple and straightforward as possible to understand and comply with. Research shows that, globally, companies spend almost two months per year complying with tax regulations – 15 days for corporate income taxes, 21 days for labour taxes and contributions and 21 days for consumption taxes⁵.

It is also essential that the volume of legislation is kept to a minimum. Much of the increase in tax law and administration in recent years is due to the number of new anti-avoidance measures introduced by tax authorities. Small businesses in particular have no time to engage in esoteric tax planning and are simply trying to cope with the volume of laws. Changes in tax law – particularly those that reverse previous tax breaks or incentives that have formed the basis of business planning – should be kept to an absolute minimum.

2. The *Sunday Telegraph*, 15 March 2009, referred to Brit Insurance, United Business Media, WPP Group and Regus having moved their tax domiciles from the UK, and quoted a spokesman for Royal Sun Alliance who said that the insurer had established an Irish subsidiary to write insurance in the UK but also to take advantage of Ireland's lower tax rate.

3. The *Financial Times*, 13 July 2009, reported that McDonald's was joining Kraft, Procter & Gamble, Google, Yahoo and Electronic Arts in moving their European HQ to Switzerland.

4. Treasury presentation, 1 June 2009. http://www.hm-treasury.gov.uk/d/govtaxforum_innovative_activity_010609.ppt

5. *Paying Taxes*, World Bank, 2008. Time recorded is in hours per year.

RECOMMENDATIONS

The UK's tax system needs to become less complex and more stable in order to enable business planning.

It should also be benchmarked against a larger number of economies than just the G7, which excludes competitors such as China, Russia and Switzerland.

The volume of tax legislation and changes in it should be kept to a minimum – each law must only exist in response to a direct need for it.

Corporate tax rates

Business is becoming increasingly global and companies now do more and more business across national boundaries. In response to these developments, governments around the world have lowered corporate tax rates in order to entice businesses to locate in their countries.

The intellectual property issue illustrates the fact that the overall corporate tax rate – so often referred to by the UK government, which cut it to 30% shortly after coming to power in 1997 – is only a part of the overall cost of production which the tax charge comprises. Governments around the world seem to have realised it is a symbolically important aspect of the initial impression an investing entity has of a location, rather as a supermarket always displays its big offers near the entrance. This has been borne out by the way corporate tax rates have changed over the past three decades; in the 1980s they were in the 50% range, by the 1990s rates in the range of 30% were the norm, but since the turn of the millennium such rates are now considered high, which is why the UK has steadily slipped down the corporate tax league table, even with a current rate of 28%.

The symbolic power of the corporate tax rate means that governments are still reluctant to raise it. The Irish government's 'austerity budget' of April 2009 – in which personal taxation was raised in an effort to combat the deficits caused by the property crash and bank failures – left corporate rates alone. In 2008, Japan also preferred to raise VAT through individuals. Further, Canada, Germany, Russia and Singapore have all cut their corporate rates. People are regarded as less mobile than corporations, and are therefore a more tempting tax target.

A recent IMF paper stated, however, that 'we find evidence that lower corporate income tax rates and longer "tax holidays" are effective in attracting Foreign Direct Investment (FDI), but not in boosting gross private fixed capital formation or growth'⁶. In other words, such tax cuts generate initial interest and investment but not long-term commitment.

RECOMMENDATION

ACCA supports the principle that nations are free to determine their tax affairs within the context of a global competitive environment, but the next government must be wary of causing retaliatory action and trade wars by drastic corporate tax cuts to ensure that the UK remains competitive.

6. Alexander Klemm and Stefan Van Parys, *Empirical Evidence on the Effects of Tax Incentives*, IMF, 1 July 2009. <http://www.imf.org/external/pubs/cat/longres.cfm?sk=23053.0>

Other competitive tools

One point worth highlighting from the IMF statement quoted earlier is that tax holidays are now rarely used by developed economies. In the EU, for example, tax holidays are considered inconsistent with a single market and are treated as amounting to 'unfair tax competition'. And China, in its corporate income tax reforms of 2008, reduced many of its tax holiday incentives. It may be that regional choices can cause the introduction and subsequent disappearances of certain tax incentives, as neighbours feel they need to directly compete with each other using similar competitive tools. However, the use of tax holidays is still considered a useful or necessary tool to attract FDI in Sub-Saharan Africa.

It begs the question of how significant these 'competitive tools' used to attract FDI or increase business activity actually are. The main results of the tax breaks are likely to be reduced costs on the business and hence lower prices for the consumer; but as shown above, they also lead to a shift away from corporate income tax to personal taxes so that governments can maintain revenue levels.

EFFECTIVE RATES

While the corporate tax rate may be, for example, 28%, the effective rate might be very different. If a government is willing to offer investment incentives, for research and development, for example, or significant or enhanced allowances for capital asset investments, the effective rate may turn out to be nil, negligible or even negative. Some jurisdictions, such as the UK, even offer relief for investment in intangible assets, which further recognises the way in which modern economies operate.

Where a tax system incorporates a large number of additional credits or allowances for different types of behaviour, extra complexity is inevitably generated. This in turn encourages greater tax-avoidance activity. A corporate tax environment that is as simple and homogeneous as possible can help create greater certainty for the tax base upon which a government has to rely, and engender less discussion between the business lobby and government over special treatment of certain groups of taxpayers.

Tax uncertainty is unacceptable for companies trying to plan their business activities, for which tax certainty is essential. It should always be possible for different taxpayers who look at legislation to come to the same interpretation of the law. Likewise, it should not be possible for authorities to overturn long-established practices, which businesses are accustomed to, and then seek to challenge them on an obscure point of law, as happened in the UK in the landmark Arctic Systems 'husband and wife'

case⁷. Taxpayers must have certainty over tax authorities' interpretations. Authorities should establish a proper and efficient clearing mechanism for complex anti-avoidance provisions.

It is the quality of the underlying tax system – rather than a simple focus on comparative tax rates – which is of interest to companies. An ACCA study⁸ of accountants' views of their national tax systems in six countries in 2008 revealed that the UK fared worse than other nations on tax fairness, complexity, transparency and above all, its sheer volume of tax laws. Retrospective changes to tax laws and stealth taxes were also criticised, while respondents felt problems were exacerbated both by a lack of communication and an aggressive attitude on the part of the tax authorities towards taxpayers. If such perceptions become deep-rooted enough, with no effective action to ameliorate them, a country's tax system could seriously damage prospects for inward investment and competitiveness.

This is not just an ACCA perception. The World Economic Forum's figures also show that the UK has moved further and further down the table of tax competitiveness in recent years⁹. Its overall tax burden is well above the OECD average, compliance costs have increased and the tax system has become more complex. The UK is now rated 84th out of 133 countries on the "extent and effect of taxation", compared to 2004-05, when it was at 18th position. One of the main reasons cited for this deterioration is the increasing burden of taxation and business regulation.

RECOMMENDATIONS

Governments should address substantive issues of tax law that cause distortions, rather than relying on headline corporate tax rates and 'holidays' to attract FDI.

The system should be kept as simple and homogeneous as possible in order to provide the certainty that business needs.

7. The Arctic systems case involved IT consultant Geoff Jones and his wife Diana who won a long-running legal battle with the UK tax authorities in 2007. http://www.thisismoney.co.uk/small-business/article.html?in_article_id=422721&in_page_id=10

8. Francis Chittenden and Hilary Foster, *Perspectives on Fair Tax*, ACCA, 2008.

9. World Economic Forum, *Global Competitiveness Report*, 2004-05, 2005-06 and 2009-10.

Tax and small business

Research has shown that the smallest companies incur five times the administrative burden per employee than larger firms¹⁰ and so every effort must be made to increase efficiency of the system.

The Open University's latest Quarterly Survey of Small Business¹¹ in December 2009 highlighted that 26% of small businesses identify the tax burden as one of the top three issues facing their business at the moment, while amongst the most entrepreneurial firms, 31% cite the tax burden as a top-three problem.

Questions that might be asked of governments could include:

- Can related companies be treated as single entities for VAT and other tax purposes and so be able to make only a single tax filing?
- Do multiple enquiries of the same taxpayer by different parts of the tax authority take place?
- Are the size of tax returns and the numbers of new or revised forms that need to be completed reasonable?
- Can the taxpayer have flexibility between completing a paper return or an electronic return?

There are a number of tax increases recently implemented or on the horizon for business, which may make operating even more difficult at an already challenging time. For example, the changes to Capital Gains Tax has essentially penalised small business owners and entrepreneurs.

ACCA recommends that there should be a greater level of transparency and stability in the tax system where small businesses feel that the tax system will support their competitiveness. Above all, governments should employ the 'think small first' principle in all of the legislation they bring in, rather than creating legislation appropriate for larger companies and adapting it for small businesses.

RECOMMENDATION

Governments should employ the 'think small first' principle when considering tax legislation.

There should be a level of transparency and stability in the tax system which reassures and encourages small businesses.

10. OECD (2001), Businesses' Views on Red Tape.

11. Open University, December 2009

Tax cuts and rises

In the US, tax cuts are often seen as the 'solution' to economic ills. Presidents Reagan, Bush and many others have used tax cuts to both increase labour productivity and boost demand. In the current financial crisis, roughly one-third of the \$800-billion two-year US stimulus package comprises tax cuts (to stimulate consumer spending). The US is not alone, as countries such as the UK, Vietnam, Russia and South Korea have all cut taxes during the economic downturn, with Gordon Brown calling for a coordinated programme of tax cuts by the world's leading economies to limit the impact of the global downturn.

Stimulus packages such as these are controversial, because they increase budget deficits, and result in the need to cut spending or raise taxes at some point in the near future. These are the terms of the current debate.

On the one hand, organisations such as the Centre for Policy Studies (CPS) in their December 2009 report¹² claim that cutting taxes for businesses and high earners further will stimulate growth and end the financial crisis. The CPS favours tax cuts and 'public spending restraint', on the basis that higher taxes would reduce economic growth, and would thus be counterproductive.

However, pressure for tax increases alongside public spending cuts are increasing as the deficit increases and tax receipts collapse. Chancellor, Alistair Darling has already announced a surprise increase in National Insurance in December's pre-Budget report from 11% to 12% – 0.5% more than previously announced – for employees. Further increases in VAT, National Insurance, Capital Gains Tax, fuel duty and high-earners' income tax are all possible ways to bring the public finances closer to balance.

RECOMMENDATION

Tax changes should not be short-termist ie taxes be reduced then go up again in quick succession. There should be long-term stability so that businesses can adopt long-term strategies. The caveat here is that in the recent climate tax stability has probably needed to be less rigidly adhered to but this we hope will only be a short-term necessity.

12. http://www.cps.org.uk/cps_catalog/go%20for%20growth%20-%20cut%20taxes%20now%20to%20cut%20debt.pdf

Tax policy and legislation

ACCA believes that most countries' tax systems suffer from political positioning in the creation of tax policy rather than taking account of what would be best for the economy. This inevitably leads to poorly thought-out legislation, instability and needless complication. And, owing to the complex and specialist nature of taxation, we tend not to see sufficient scrutiny of the draft legislation during the democratic processes in many regimes.

This is one of the main reasons why the creation of flat-tax regimes has been suggested as a potential antidote. So should the way in which tax law is created itself be changed?

In a research paper issued by ACCA in March 2009, the idea of an independent tax policy-setting vehicle for the UK was examined. The proposal involved setting up a body of experts, separate from government – working along the lines of the Bank of England's interest rate setting Monetary Policy Committee – that would be empowered to formulate and propose new tax policy and simplify existing tax legislation.

Using this model, the UK government would set the overall economic framework of the tax environment. It would need to define the public policy objectives (eg environmental, social welfare) in terms of public finance demands and fiscal targets that taxation measures were designed to achieve. A tax policy committee (TPC) would work on adjusting the tax system as appropriate with a view to making it more effective, simple and transparent over the medium and long term.

However, it is clear that politically, this idea is unlikely to bear fruit, especially in the short-term. Politicians do not believe that tax could or should be taken out of the political debate. As immediate priorities, we advocate instead the following.

- Tax policies should be transparent and non-discriminatory unless part of a declared discriminatory policy, such as one intended to encourage new enterprise. There is a wider political question about the extent to which it is appropriate to use taxation as an instrument of social policy (eg penalising smoking by heavy duties, or environmental taxes to mitigate climate change). ACCA's view is that this use of tax by elected governments is legitimate but such taxes should then meet other principles such as being transparent, simple and effective. Governments should be wary of increasing the complexity of the tax system by too much tinkering to 'reward' certain groups of taxpayers.
- Too often, consultation processes on tax policy are flawed exercises where government policy has already been decided, and are carried out largely for appearances' sake. On major issues of tax policy, there should be clear consultation where the different options

are specified at the start, and properly considered with an audit trail including unambiguous minutes and written responses.

- There should also be openness on the application of tax policy. So-called 'stealth taxes', such as the quiet reduction of tax exemptions, and the phenomenon of 'fiscal drag', whereby personal tax thresholds are not increased in line with rising prices and incomes, thus bringing more individuals into higher-rate tax bands, cannot be justified. Tax rises should be made openly and subject to debate.
- Finally, all tax systems should abide by a review principle whereby tax legislation is periodically overhauled and consolidated to bring it up to date and make it easier to follow. Outdated laws should be removed.
- There needs to be a positive prompt for justifying the existence of legislation. All anti-avoidance legislation should have sunset clauses attached to it. This will ensure that it is regularly reviewed and the need for it to remain in place is actively considered. Governments and tax authorities should devise clear metrics to gauge whether the tax system is being appropriately and sufficiently reviewed.

RECOMMENDATIONS

There should be consistent consultation with business on taxation issues, and industry should be invited to input at all stages of the process in order to provide advice, but also to remain fully apprised of any possible changes. Also, HMRC should ensure that the recommendations of the Varney Review are fully implemented, particularly in terms of taking the business perspective into account in everything it does - giving earlier clarity and reducing complexity and administrative burdens for business.

Corporate tax legislation can be largely removed from the Finance Bill to provide more possibilities for thorough examination of important clauses.

ACCA endorses the ideas of sunset clauses whereby tax legislation is periodically overhauled and consolidated to bring it up to date and make it easier to follow. Outdated laws should be removed.

Governments and tax authorities should devise clear metrics to gauge whether the tax system is being appropriately and sufficiently reviewed.

Conclusion

ACCA believes that taxation is a dynamic economic and social tool and must inevitably change in nature as national economies and business sectors develop.

It is vital, though, that it does so without damaging business. This therefore means that issues such as thorough consultation with business, reducing complexity, increasing stability in order to enable business planning and ensuring that all existing tax legislation is up to date and necessary, become key. Especially important but often forgotten, governments should also ensure that they employ the 'think small first' principle when considering tax legislation.

Moving forward from the financial crisis, the system should be kept as simple and homogeneous as possible in order to provide the certainty that business needs. It should also be benchmarked against a larger number of economies than just the G7, which excludes competitors such as China, Russia and Switzerland. This would provide a clearer and more realistic view of competitiveness.

Politically, ACCA believes that there is much that could be done to improve the design of tax legislation, from removing the bulk of corporate tax legislation from the Finance Bill to removing outdated laws and ensuring that there are clear metrics to gauge whether the tax system is being appropriately and sufficiently reviewed.

ACCA is keen to engage with policy makers and to offer its expertise on these issues wherever it can add value.

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