Taxation of the Financial Services Sector in the UK
Predictability and Competitiveness

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The UK, and London in particular, has historically been seen as an attractive place in which to locate and do international business. This report continues our long series of commissioned research looking in depth at what policymakers can do to maintain the UK’s position as a leading global financial centre.

The UK has thrived through being open to global trade. There is now, however, a growing perception that its competitive attraction as a location for global business is being questioned, which is a significant concern at this time when the domestic economy is recovering from the recent severe recession, and when the UK fiscal policy is concentrating on eliminating the present budget deficit.

The broader City international financial cluster has been and remains a robust component of the UK economy through the financial crisis and recession and continues to contribute substantially to the UK’s foreign trade balance, to GDP and to the public exchequer. A successful future for this cluster offers a substantial part of a ‘growth solution’ for dealing with the fiscal adjustment planned by the UK coalition government over the next four years.

This will of course be a difficult balancing act. Evidence has long been pointing to an increasing sensitivity of the highly mobile international sectors of the economy to any perceived deterioration in the taxation environment. Hence the need for government to pay careful attention to the tone, application and long-term impact of the regime.

We therefore welcome the commitment of the coalition government to improving the UK’s position as a business location for international firms. This will require appropriate and well thought through taxation and regulation, and a sensitive treatment of movements of those skilled international workers that bring such enormous benefits to the UK.

Original independent research commissioned from Charles River Associates (CRA) in 2008\(^1\) by the City of London had concluded that the UK corporate and personal tax regimes, and the manner of their implementation, were impacting progressively and detrimentally on the perception of competitiveness of the UK financial services sector and hence business location decisions.

This latest commissioned research by CRA is at the behest of a tax working group of the International Regulatory Strategy Group, made up of a wide range of City practitioners and trade associations. CRA has explored the predictability and certainty of the UK tax regime compared with other jurisdictions in this new report. It draws on

in-depth interviews with senior decision-makers in a broad range of financial services firms operating across the City.

The research highlights some widespread concerns in terms of the predictability; overall tax burden; compliance cost and complexity (i.e. exemptions and deductions) and attitude of tax authorities relative to other regimes. The financial services industry would like to work with government to address these in a positive spirit and reflective of the stated coalition objectives for building a competitive economy.

The research also captured positive reports of the approach of Her Majesty’s Treasury and especially of Her Majesty’s Revenue and Customs’ (HMRC) developing commitment to early, effective and consistent consultation on tax matters. The Customer Relationship Management system adopted by HMRC in recent years is seen as a model of developing good practice in this area with many firms encouraged by the commitment reflected in their day-to-day involvement with tax officials.

There is considerable scope for policy development that creates a high degree of certainty and through a joined-up approach. The debate, which focuses on "political taxes", has often been simplistic and misleading. A framework for engagement needs to be developed by government with the industry. I am sure that tax policy is an area which can be developed in a way that smartly achieves the shared objectives we all have for delivering fiscal balance and sustainable growth.

Stuart Fraser
London
October 2010
EXECUTIVE SUMMARY

Introduction

“Taxation of the Financial Services Sector in the UK: Predictability and Competitiveness” is a report commissioned by the City of London Corporation (CoL) and written by Charles River Associates (CRA).

The UK, and London in particular, has traditionally been viewed as an attractive place in which to locate and from which to conduct international financial services business. This attractiveness has been based on excellent access to international markets as well as the relative ease of operating a global business from the UK. London has been able to attract a highly skilled, mobile, international work force, and manage and deploy capital with extremely high efficiency. London has also been seen as offering an attractive regulatory and tax framework compared to other locations.

The financial services sector has therefore become an extremely important contributor to the UK economy. The sector provided £66 billion in tax revenues in 2009, employed 1 million people, accounted for 10% of GDP and contributed a £40 billion pound surplus to the country’s balance of payments. It was also a sector showing strong growth up until the financial crisis of 2008/09.

London’s competitiveness appears to have been declining in recent years, however. Recent research\(^2\) has shown that one factor that has increasingly concerned mobile global businesses based in, or considering the UK as a location, has been the sustained deterioration in the UK tax regime relative to other international locations. This deterioration concerns not just the headline rates of corporate and personal tax but also the unpredictability of the UK tax regime and of the tax (policy) development process in the UK.

Headline rates of tax, both corporate and personal, have clearly become less competitive versus other countries in a sustained trend over at least the last five years. For much of the 1980s and 1990s and early part of the 2000s, the UK had highly competitive rates of corporate and personal tax versus major trading partners, especially in Europe. This situation has largely been reversed in recent years, with the UK having been undercut by many countries on corporation tax while personal tax rates have gone up, especially for high earners, to levels roughly equivalent with traditionally high tax regimes such as France and Germany.

In order to inquire further into these issues, CRA conducted an interview programme with senior executives of a broad range of financial services firms to gather their perspectives on UK tax competitiveness.

Summary of Findings

The UK's system of taxation, while moving in the right direction on some issues, has seen a notable deterioration in the perception of its taxation compared with other competitor jurisdictions.

The new government has issued documents and made statements indicating its understanding of the competitive weaknesses in the UK tax regime and demonstrating an intention to rectify them. Interviews we conducted with senior officials suggested a belief that the current government will be much less “interventionist” than the last, and that tinkering and “surprises” would be much reduced or eliminated. There was a perceived desire on the part of officials to engage constructively with the City.

The new government states explicitly that it will have regard to the competitiveness of the UK tax system, and has proposed reductions in corporation tax as evidence of this intent. The participants in our interview programme welcomed the marked change in tone, but note that it is still too early to judge whether these intentions will be translated into action and they remain particularly concerned over the continuing focus on tax avoidance, which they see as disproportionate, and the significant deterioration in the personal tax regime from the City's perspective.

The interview programme tested firms’ perceptions of the UK on six factors: predictability; overall tax burden; attitude of tax authorities; network of tax treaties; complexity; and cost of compliance. The UK was scored “below average” in comparison with international partners in five of the six categories tested. These were: predictability; overall tax burden; compliance cost; exemptions and deductions; and attitude of tax authorities. Scores for the UK were positive for networks of tax treaties.

Every respondent gave the UK a poor rating on predictability. This was the most important factor in judging competitiveness, but also the one on which the UK got its worst score and fared the worst in comparison to other countries. The level of predictability was considered to be poor a few years ago; the situation has more recently become “out of control”. As regards the overall tax burden, it is clear that the UK is now seen as a high tax jurisdiction not dissimilar to continental countries.

A review of the last three years shows a large number of highly significant and unexpected “tax events” such as the bank payroll tax, the bank levy, the increase in the top rate of income tax to 50%, and a variety of other changes, some of which are still under consideration, thus increasing uncertainty. The surprise nature of these events have fundamentally altered the perception of the UK fiscal environment by the UK financial services industry and the way in which the UK is viewed by foreign investors. The impact of these measures varies by sector, with the greatest weight of change felt by the banking and investment banking sector.

Recommendations

On the basis of interviews across a broad range of financial services, the following issues are recommended as needing to be addressed if the UK is to maintain and
improve its comparative attractiveness to international financial services as a place with a predictable, competitive and constructively applied taxation regime. Many of these are likely to be shared concerns with other international business sectors:

1. **Predictability.** Predictability and consistency are critically important features of a stable and attractive tax regime. The interview evidence is very supportive of the Government’s commitment to consultation and dialogue in the development of new taxation measures. Openness and dialogue foster industry buy-in to Government objectives, and are effective in mitigating against uncertainty. Respondents considered, furthermore, that:

   - All areas of taxation policy development should be consulted upon, particularly anti-avoidance policy. This is a part of the regime that has greatly exacerbated unpredictability in the development and application of tax policy in recent years;

   - Government should aim to develop tax policy within existing established frameworks and administrative structures so as to increase significantly the certainty of the entire tax regime.

2. **Attitude of tax authorities.** The interview evidence suggests that HMRC specialist technical groups can be sometimes unnecessarily adversarial and a number of respondents also noted the depletion of tax expertise and experience within HMRC, and strongly urged that both trends are reversed. However, the evidence also highlighted a clear success in the HMRC Large Business Service’s Customer Relationship Manager (CRM) programme. The CRMs are seen to be pragmatic, helpful and quick in resolving problems within their remit. It was considered that:

   - HMRC should nurture and harness the success of these programmes, and reinforce this success by spreading the positive lessons throughout HMRC.

3. **Overall tax burden.** On this critical measure of competitiveness, the UK has fallen behind in recent years. Interviewees welcomed the commitment by the Government to restore, over time, the UK’s competitiveness in tax versus key competing locations. Respondents noted that:

   - In future, impact assessments of new tax policy should include competitiveness as an explicit criterion;

   - while the movement on the corporation tax rate was welcome, it is also important to recognise that personal taxation is a critical aspect of international competitiveness, and of the ability of the UK to attract the best international talent.

   - Competitor jurisdictions are introducing special (favourable) tax measures in order to attract senior internationally mobile staff, and that this has eroded the UK’s competitiveness. This needs to be taken into account as the UK develops its tax policy in the short and medium term.

4. **Policy co-ordination.** Respondents pointed to the need for greater efforts to be made to construct a coherent and consistent taxation regime, and also to create
consistency between the tax and regulatory regime where appropriate. Respondents considered that:

- The remuneration proposals being developed by the FSA, and that flow from CRD3, do not fit easily in the international environment in which the industry works;

- The development of the Bank Payroll Tax appears to have little reference to the G20 and FSA’s remuneration treatment and approach on, for example, Long Term Incentive Plans;

- Firms are more sensitive to some taxes (particularly where an unfavourable international comparison is readily apparent) than others, and a taxation regime that recognised this would be welcomed;

- The recent and potential tax measures directed at the sector, especially banks, when taken together with the extensive regulatory changes in prospect, gives an appearance of insufficient fiscal and regulatory coordination. This is beginning to raise concerns about overloading the industry.

5. **Contribution of the financial services sector to the UK economy.** The debate which focuses on the financial services sector being “big” or “small” or “too big”, is simplistic and short-sighted. Financial services are completely interdependent with other parts of the economy, and the health of one is very much a function of the health of the other. This is one of the main lessons of the crisis, and the perspective from which respondents believe these sectoral issues should be viewed.
1. INTRODUCTION

In support of its programme of engagement with policy makers, practitioners and trade bodies, the City of London Corporation (CoL) has commissioned Charles River Associates (CRA) to undertake research on the UK tax regime. The CoL has asked CRA to work in conjunction with the International Regulatory Strategy Group (IRSG) to systematically review evidence on recent developments in the regime and gather perspectives of international financial services companies as to how international business confidence in the UK tax regime is currently placed and can be improved.

1.1. Background

The UK, and London in particular, has traditionally been viewed as an attractive place in which to locate and from which to conduct international financial services business. This attractiveness has been based on excellent access to international markets as well as the relative ease of operating a global business from the UK. London has been able to attract a highly skilled, mobile, international workforce, and manage and deploy capital with extremely high efficiency. London has also been seen as providing an attractive regulatory and tax framework compared to other locations. This combination of attributes has underpinned its growth as a leading global centre for international financial services firms, as a favoured domicile for their headquarters functions, and as a driver of associated growth in professional services firms (lawyers, accountants, consultants). It has also traditionally led to strong inward investment from across the globe in international financial services activities. This combination of factors has delivered substantial private sector jobs growth for the UK and London over the last decade, and a large tax contribution for the UK, that in the case of the international financial services cluster has been robust in the face of the international crisis and downturn3.

London’s competitiveness appears to have been declining in recent years. Recent research4 has shown that one factor that has increasingly concerned mobile global businesses based in, or considering the UK as a location, has been the sustained deterioration in the UK tax regime relative to other international locations. This deterioration concerns not just the headline rates of corporate and personal tax but also the unpredictability of the UK tax regime and of the tax (policy) development process in the UK.

This report examines in detail current data on the UK tax regime relative to other jurisdictions, and reports on the views of leading international financial services firms on recent developments in UK taxation.

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3 PwC, The Total Tax Contribution of UK Financial Services - Second Edition, December 2009 estimates the industry contributed an estimated £61.4bn to UK government taxes in the 2008/09 financial year, which accounts for 12.1% of the total UK tax take.

1.2. The Research Brief

The brief for the work requires that evidence be gathered on the UK tax framework and its impact on City firms. In particular it was felt that the research should examine perceptions of financial services industry leaders on the predictability of the tax regime, the process of tax policy development, and the manner of HMRC’s application of the regime. This evidence should be gathered through structured interviews with key firms in the City as well as quantitative analysis of the UK tax regime in an international comparative context.

The research would have two main objectives:

- Establishing an evidence based drawing from a range of financial services firms and government agencies to understand relocation pressures arising from tax uncertainty in the UK; and

- Framing a positive contribution to Her Majesty’s Government ahead of the Autumn Statement highlighting best practice in tax certainty elsewhere and ways to improve the predictability of the current regime with a view to restoring trust.

The research considers both corporate and personal taxation regimes.

In addition to reviewing levels of tax, the work will explore how certainty of interpretation, predictability, and the attitude of the tax authorities are affecting senior executives’ perceptions of the business friendliness of the UK and the potential impact on the location of their activities.

The content of the work, as noted above, is derived from a structured interview programme with 26 leading international financial services firms based in London. We have also set out the major “tax events” of the past three years that were identified as of greatest importance by the interviewees. We also make a high level comparison of certain aspects of the UK regime to other tax regimes, and show comparative data. Finally, we have reviewed relevant academic and other literature on the UK tax framework that has emerged in the past few years.

1.3. Structure of this report

Chapter 2 discusses the contribution of the financial services sector to the UK economy, provides an overview of the competitiveness of UK tax rates, and some academic views on the competitiveness of the regime. Chapter 3 provides an overview of the findings of the interview programme we conducted. Chapter 4 summarises key tax events in the past 3 years and the views of our respondents on them. Chapter 5 summarises the views of financial services sectors (banks, insurance companies, asset managers, etc.). Chapter 6 covers recent government statements on the competitiveness of the UK tax regime, and summarises interviews we completed with officials from Her Majesty’s Treasury (HMT) and Her Majesty’s Revenue and Customs (HMRC).
2. UK FINANCIAL SERVICES AND TAXATION OVERVIEW

This chapter provides an overview of the contribution of the financial services industry to the UK economy. It also places the tax regime of the UK in an international context by comparing rates across countries, reviews recent literature on UK tax competitiveness, and lists some firms that have left the country, or moved significant activities and/or personnel from the UK for tax reasons.

2.1. Contribution of the UK financial services sector to the UK economy

According to TheCityUK, the financial services sector in the UK accounts for 10% of GDP, which is a much higher contribution to GDP than the financial sector in the United States, Japan, France, or Germany. Associated professional services activity (accountants, lawyers, consultants, etc.) generated another 3.9% of GDP. By way of contrast, the manufacturing sector in all types of goods accounts for 12% of GDP.

The financial services sector has also been growing more rapidly in the UK than in most other European countries, at least up until the financial crisis began in 2008. Significant decline in 2008 and 2009 shows the impact of the financial crisis, with an upturn in 2010 showing the beginning of recovery for the sector. Ireland has shown greater growth in financial services up to 2007, and a greater decline since then, with the start of a recovery in 2010 as well. However, it is still much smaller as a sector than in the UK. Figure 1 illustrates these trends.

5 TheCityUK. www.thecityuk.com
In 2008/9, the financial services sector paid £61bn in taxes to the UK government on a total tax take basis. The contribution of the financial services sector to UK corporation tax receipts is shown in Figure 2. The financial services industry was one of the largest contributors of any UK industry up until 2008/09 (noting that “Home, Industrial & Commercial” combines several industries).

Source: Datastream

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6 TheCityUK. www.thecityuk.com
Figure 2: Distribution of Corporation Tax Revenue

Source: National Audit Office

The UK financial services industry employs over 1 million of the 31 million people employed in the UK, including 319,000 in London. Significant numbers are employed in the Northwest, the Southeast, East Anglia, and the Midlands.

The financial services sector generated a trade surplus of £40bn in 2009. The deficit in goods, by way of contrast, was £82bn. Figure 3 shows the trade balance figures for the financial services industry expressed in dollars for a number of countries. The chart demonstrates that the UK industry has by far the largest trade surplus in financial services of comparable countries, and that the financial sector has shown by far the greatest growth in its surplus of any of the countries shown.
2.2. UK fiscal position

The UK, along with many other countries, has suffered a sharp deterioration in its finances as a result of the financial crisis of 2008/2009 and the resulting recession. This deterioration in the country’s financial position sets the context for the taxation regime over the past several years and into the short and medium term future. The following chart sets out the recent history and the Government’s forecast of the evolution of the deficit over the next few years.
Figure 4: UK Budget Deficit (2000 to 2016)

Source: OECD and UK Government forecast (F)

The following chart shows the evolution of the budget deficit in a number of countries in addition to the UK.

Figure 5: Comparison of Budget Deficits (1990 - 2011)

Source: OECD
2.3. Competitiveness of UK rates of tax

There has been a growing perception that the UK tax regime is losing competitiveness and becoming progressively more burdensome for companies and individuals. The following charts illustrate the evolution of UK rates over time. The first of these shows statutory corporate tax rates in a number of countries from 1980 through to 2010. From 1985 until 2005 the UK had a highly competitive corporate tax rate. From 2005 onwards a number of countries have significantly undercut the UK on corporate tax rates, especially Switzerland, Ireland, the Netherlands, and the EU accession countries. The UK is no longer judged to have a competitive corporate tax rate.

Figure 6: Comparison of Corporate tax rates (1980 - 2009)

Source: IFS and KPMG

With regard to personal taxes, rates have generally trended upwards since 2000, with some slight improvement towards the end of the period based on banding changes in the tax structure. Figure 7 reports average combined personal income tax and social security contribution rates for a single person without dependents, at various multiples (67%, 100%, 133%, and 167%) of average earnings.
The increase of the marginal rate of tax to 50% occurred in 2009 for individuals earning over £150,000. The effect of this change is shown in the chart below on the average rate of tax for highly paid individuals. This tax change is of high importance to many executives in the financial services sector.

Figure 8: Total deductions to Gross Income in the UK (income tax and NIC)

Source: listentotaxman.com

Figure 9 shows the evolution of tax for a highly paid individual in selected countries. The chart demonstrates that a considerable gap has opened up between the UK and
countries such as Switzerland in the taxation of high earning individuals. Rates of tax are now comparable to countries such as Germany which has traditionally been seen as a high tax location.

Figure 9: Total deductions\(^7\) to gross income of £250,000 (or equivalent)

![Graph showing total income deductions over time for various countries.](image)

Source: OECD, CRA Analysis

2.4. Studies on the competitiveness of the UK tax regime

This section of the report reviews recent academic and other literature on the tax competitiveness of the UK, which is seen to have deteriorated significantly. A number of recent studies have discussed and documented this trend.

In a report of nearly three years ago for the CoL,\(^8\) CRA noted that tax incentives are fairly closely tied to capital movements. In essence, a series of studies were found to demonstrate that low tax jurisdictions are able to attract capital over time, and that companies may also move if they are internationally mobile. That is, if staff are mobile and customers can be served from multiple locations, then companies may move if tax becomes a major problem for them.

We quote from that paper of nearly three years ago below.

> “Until fairly recently the UK had what was felt to be a very attractive tax regime as regards both corporate and personal tax rates, but this has

\(^7\) Being income tax plus National Insurance contributions, or equivalent.

changed .. The UK tax regime did not fare well in comparison with that of other financial centres, in the view of executives we interviewed … London, while it has become less competitive in tax, retains great strengths which inhibit a sharp outflow of firms.9

The rest of this section of the report reviews a set of more recent papers by influential commentators on the competitiveness of the UK tax regime.

“Corporate Taxation and Its Impact on Foreign Direct Investment”

In an article10 by Graeme Leach, Chief Economist of the Institute of Directors, he argues that foreign direct investment is becoming more and more sensitive to rates of taxation in a country, and that increases in tax have a strong negative impact on inward investment. He notes the OECD’s observation that tax competition amongst countries is increasing. We choose illustrative passages and quote them below.

“Recent OECD research has suggested that the impact of taxation on Foreign Direct Investment (FDI) is increasing—FDI is becoming more sensitive. One reason is that the nontax barriers to capital movement have been reduced over recent decades, and consequently tax has shifted up the agenda of considerations—illustrated by the decision of WPP to move its tax base to Ireland.

The OECD has recently stated that: “there is a broad recognition that international tax competition is increasing and that what may have been regarded as a competitive tax burden on business in a given host country at one point in time may no longer be so after rounds of tax rate reductions in other countries.

Of course, there is variation across different sectors and countries but a rule of thumb is that FDI decreases by up to 5% following a one percentage point rise in the tax rate on FDI.

In response to these pressures, many countries have lowered their rate of corporate income tax. This is a headline grabbing and obvious means to signal a lower tax burden to potential inward investors. Such reductions have tended to involve measures to broaden the tax base. Indeed, in the UK, Conservative proposals to reduce corporate income tax are funded by the withdrawal of various reliefs and allowances.

To summarize, there is likely to be an increase in the sensitivity of FDI to tax systems over the coming years. As the world economy weakens, companies will face even greater pressure to maintain, after tax, returns in the face of much weaker pre-tax returns. There will also be increased emphasis on clearly defining the nature of the tax burden (marginal rates, average rates, effective rates etc.) and what it means for individual enterprises.

9 Ibid. pp. 3-5.
10 Leach, Graeme: “Corporate Taxation and Its Impact on Foreign Direct Investment,” Q Finance Issue 1, 1 November 2009
“The most successful economies will marry the lowest tax burdens with strong performance in other key drivers of FDI such as market size, growth, labour supply and transport infrastructure.”

“Corporation tax: beating the competition”

In their report from February of this year, Richard Baron and Corin Taylor address the competitiveness of the UK tax regime. They quote a wide variety of statistics to demonstrate that the UK is falling down the international league tables in terms of tax competitiveness we quote from the report below.

Over the past decade, the UK has lost much of the competitiveness that its tax system once enjoyed. The increasing complexity and instability of the UK’s business tax system are further reasons for the growing trend of companies relocating overseas.

The financial crisis and its associated effects on the tax burdens of countries around the world will clearly distort the data in the short term, but the longer-term trends pre-date the 2008 crash and will no doubt re-appear once the global recovery is underway. Over the past 12 years, the UK’s tax burden has moved in the opposite direction to that of other developed economies:

The overall burden of tax in the UK, as a share of GDP, has moved from the eighth lowest in the OECD in 1996 to well above the average today (There are 33 countries in the OECD).

In 1996, the UK’s tax burden was 38 per cent of GDP, compared with 38.5 per cent in the OECD as a whole. In 2008, before the financial crisis really hit tax revenues, the UK’s tax burden was 42.6 per cent of GDP, compared with an OECD average of 38.2 per cent.

Compared with the eurozone, the UK’s tax burden was 8.4 percentage points below the eurozone average in 1996, but in 2008 the differential had fallen to just 2.3 percentage points.

It is not just with respect to the overall burden of tax that the UK has lost competitiveness. Rates of corporation tax are also far less competitive than they were a decade or so ago:

In 1996, the UK’s corporation tax rate was joint fifth lowest in the OECD. In 2009, it was the joint 17th lowest.

In 1996, the UK’s corporation tax rate of 33 per cent compared favourably with the OECD average rate of 37.7 per cent. In 2009, the UK’s rate of 28 per cent was above the OECD average of 26.3 per cent.

Compared with the EU15, the UK had the third lowest rate of corporation tax in 1996, and its rate was well below the EU15 average of 37.9 per cent. In 2009, the UK’s rate was only the ninth lowest, and above the average EU15 rate of 27 per cent.

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Among the 27 EU countries as a whole, in 2009 the UK’s corporation tax rate was the eighth highest, and well above the average rate of 23.2 per cent.

The complexity and uncompetitive state of the UK’s tax system have already been key factors in the decision of a number of large groups to move their holding companies overseas, while an increasing number of businesses are considering making the same move. KPMG’s most recent annual survey on the UK’s tax competitiveness found that the proportion of groups surveyed that were actively considering leaving the UK had more than doubled, from 6 per cent the previous year to 14 per cent, and that those groups included four in the FTSE 100. And initial results from a survey of 57 very large groups that KPMG conducted in its November 2009 annual survey of the UK’s tax competitiveness showed that over half had either looked at the implications of moving out of the UK or were actively considering it. Of the 20 FTSE 100 companies surveyed, four were actively considering moving.

The departure of companies from the UK is one, high-profile way in which the negative impact of higher taxation on economic growth manifests itself.

PwC Total Tax Rate Reports

PwC publish annual data on total tax rates in a long list of countries (TTR). Total tax rate is a measure of all taxes borne by a company including labour taxes borne by the employer as well as corporate income tax.

Table 1: Comparison of TTR rankings 2008 - 2010

<table>
<thead>
<tr>
<th>Country</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>157</td>
<td>160</td>
<td>165</td>
</tr>
<tr>
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<tr>
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<tr>
<td>Luxembourg</td>
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<td>Singapore</td>
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<td>Switzerland</td>
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<tr>
<td>United Kingdom</td>
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<td>67</td>
</tr>
<tr>
<td>United States</td>
<td>102</td>
<td>92</td>
<td>118</td>
</tr>
</tbody>
</table>

Source: Paying Taxes 2008, 2009 and 2010 PwC

PwC place the UK 67th in the world based on its most recent TTR ranking in 2009 (the “2010” report). Rankings of selected other countries are: Hong Kong (22); Switzerland (37); Singapore (29); Ireland (26); Luxembourg (17); USA (118); Germany (112); and France (165).

These figures demonstrate that the UK has a total tax rate considerably less than, say, Germany and France, but much higher than Ireland, Singapore, Hong Kong or Luxembourg.

The Wigley Report 13

This comprehensive review of the competitiveness of London as a financial centre makes the following comment on tax.

“A further issue is the decline in the UK’s reputation for predictable, favourable and constructively applied taxation. As an objective indicator of this deterioration, the UK dropped from first to fourth place between 2003 and 2008 in a KPMG-EVCA ranking of the tax and legal environment in EU countries. The World Economic Forum cites deterioration in the tax environment as an important factor in the UK’s fall in its ‘global competitiveness index’, from second in 2006 to ninth in 2007 and to twelfth in 2008. These indicators are underlined by announcements from major companies, including Shire, Regus, Henderson and WPP, that they are relocating or considering relocating their headquarters outside the UK to save on corporate tax.”


This survey of senior executives, published earlier this year, states the following:

“Almost exactly half of the respondents said that they had either looked at the implications of migrating from the UK or that they were actively considering it. This has crept up slowly since 2007. The proportion saying they were actively considering moving out of the UK fell slightly but it still included 4 FTSE 100 companies.

82 percent of the sample felt that the 50 percent rate had made the UK less attractive from a tax perspective and that it would make it more difficult to persuade senior people to come to the UK.

The 50 percent rate was a motivating factor for over a quarter of the respondents who had looked at moving their tax residence away from the UK. 11 percent of this group said it was the main factor causing them to actively consider moving their tax residence out of the UK and 15 percent said that, added to other factors, it was causing them to actively consider moving. For a further 11 percent, the new rate prompted them to study the implications of leaving the UK but they are not actively considering it.”


2.5. Financial services firms that have left the UK

Whilst concern over the decreasing competitiveness of the UK tax regime has been growing for several years, it has often been assumed that companies’ threats of leaving are not serious. Recently, however, a number of financial services firms have moved their global headquarters from the UK. Others have moved enough of the substance of their firms that it may be said the economic centre of gravity of the firm may no longer be in the UK. We provide below a list of the firms we are aware of that fall into these categories.

In the insurance sector, the following firms have moved their tax home from the UK:

- Brit Insurance;
- Kiln;
- Hiscox; and
- Beazley.

XL, formerly based in the Cayman Islands, has recently come back “onshore.” It chose Ireland as its tax domicile in preference to the UK, despite having a large subsidiary based in London.

In the fund management sector, Henderson has moved to the Netherlands.

Amongst hedge funds, the following firms have moved significant activities or personnel to Switzerland:

- Blue Crest (Europe’s third largest hedge fund): opened a Geneva office with some 70 analysts and traders;
- Brevan Howard (Europe’s largest hedge fund): Alan Howard, joint founder, has moved to Geneva;
- Moore Capital: senior personnel recently opened an office in Zurich.

With regard to these firms, it was explained to us that from a transfer pricing perspective, it would be easy to demonstrate that the economic centre of gravity of a firm has moved from the UK if its key leaders and wealth generators have left the country. This would have a negative impact on tax take from these firms for the UK government.
3. INTERVIEWS WITH FIRMS: OVERVIEW

This chapter sets out the overall findings from our interviews with firms and industry associations on tax predictability and competitiveness of the UK. The next chapter of the report provides comments on individual tax events and issues, such as the imposition of the bonus tax on UK banks. This chapter describes views of the tax regime in its entirety drawing on comments from all of our interviewees.

The feedback in this chapter is in two forms: a set of summary scores and ratings of the UK regime derived from responses to our questionnaire, and qualitative comments from interviewees.

3.1. The interview programme

We conducted 26 interviews with institutions and industry associations based in London, and two interviews with government bodies. Seventeen of the interviewees from industry provided responses to our structured questionnaire. Figure 10 shows the mix of interviews by financial services sector.

Figure 10: Interviewee by institution-type

Source: CRA Analysis

The category of “Other” consists of exchanges and private investment managers.

3.2. Interviewees: overall assessment of the UK tax regime

Our questionnaire asked respondents to rank the UK tax regime relative to other countries. To assess the tax regime we broke it down into 6 factors as listed below.

- Overall tax burden;
- Cost of compliance;
- Predictability;
- Exemptions/deductions;
- Attitude of tax authorities;
- Tax treaty network.

Countries included in the comparison were: the Netherlands; Belgium; Bermuda; Ireland; Germany; Frankfurt; Hong Kong; Luxembourg; the USA; Singapore; and Switzerland.

The UK was below average in 5 of the 6 areas, as can be seen in Figure 11.

**Figure 11: How does London compare to other locations on the basis of tax?**

Source: CRA Analysis

It is also important to understand which of these 6 factors interviewees considered most important. Of the 6, predictability, overall tax burden, and attitude of tax authorities were said to be most important by interviewees, with predictability slightly more important than the other two. The following chart shows the ranking provided by interviewees.
We also asked interviewees whether they thought the UK tax regime had improved, deteriorated, or remained the same in terms of competitiveness during the past three years. The great majority felt it had deteriorated during this time period relative to other jurisdictions.

Source: CRA Analysis
3.3. Interviewees: competitiveness of UK regime versus other countries

Figure 14 shows a summary of the questionnaire responses ranking a number of financial centres on the 6 factors listed. London is shown ranked against 14 other financial centres on predictability, overall tax burden, etc.

Figure 14: Which are the best performing financial centres on the basis of …?

Source: CRA Analysis

The next sections of the report focus specifically on four of the most important factors illustrated in the charts above. These are: predictability; overall tax burden; attitude of tax authorities; and tax treaty network.

3.4. Interviewees views on predictability and stability of UK tax regime

This factor relates to the stability of the tax regime and to the incidence of tax “surprises”. As noted above, predictability is considered the most important of the 6 factors in judging the competitiveness of a country’s tax regime. On this measure London fared worst of any financial centre in the comparative set, as shown in the figure below.
Every single interviewee gave London a poor “grade” on predictability, and it was judged to be the worst aspect of the UK’s relatively uncompetitive regime. It was also seen to have become considerably worse over the past few years.

Interviewees identified two forms of instability that caused them concern. The first is the sudden and unexpected imposition of highly significant tax measures with little or no consultation, often in response to short-lived political pressures. Examples in recent times would include the bank payroll tax, changes to the non dom regime, the increase in the top rate of income tax to 50% and the recent increase in capital gains tax. These individual changes to the regime are discussed in detail in the next chapter of the report.

The second is what interviewees described as the “constant tinkering” with complicated rules resulting in Finance Bills of inordinate length and complexity. Due to the fact that this tinkering is associated with curtailing tax avoidance it is, by its nature, not consulted upon. Often the resulting rules are viewed as poorly written, flawed, difficult to interpret, and consequently destabilising.

Some representative quotes from interviewees give an indication of the feeling on the predictability issue:

“You can only describe it as a roller coaster ride, these past few years;”

“No matter where you look, there is complete uncertainty on every front.”

“Unpredictability is the issue. We have no idea where we are going. We don’t want a fossilised system, but management of all this has to be much, much better.”

“Predictability is the big problem … there’s far too much change without consultation. I’m less concerned about rates of tax, more about my ability to plan ahead.”
3.5. **Interviewees views on overall tax burden**

The overall tax burden is another issue where London scored poorly relative to a number of other financial centres, as seen in the chart below. The picture is better than for predictability, but is still negative relative to most other centres with the exception of New York and Paris.

**Figure 16: Which are the most attractive financial centres on the basis of overall tax burden?**

![Graph showing attractiveness based on overall tax burden]

Source: CRA Analysis

The issue that was raised in terms of tax burden by nearly all of the interviewees was the 50% tax band introduced in 2009. It was noted that with NIC, this figure is effectively 51%, and will rise to 51.5% next year. While the old 40% rate was seen as competitive and fair, the new rate was seen as opening a very considerable gap relative to other countries where people might work, such as Switzerland, and as being no better than countries traditionally seen as being very highly taxed, such as France and Germany.

The reduction in corporate taxes from 28% to 24% was welcomed by all, but without notable enthusiasm.

The overall impression from the interviews and the questionnaire scores is that London is now perceived as a high tax location.

3.6. **Interviewees views on attitude of tax authorities**

On this factor, the attitudes towards HMRC as a whole were divided, netting off to a slightly negative score, as is shown in the following chart. However, this marked a significant improvement over the generally very negative view expressed in the report.
CRA prepared for the CoL nearly three years ago\textsuperscript{15}, mainly as a result of the changes implemented following the Varney Review.

The poor position of the USA is noteworthy. It is seen by all as having the most aggressively hostile tax authority of virtually any country.

**Figure 17: Which are the most attractive financial centres on the basis of attitude of tax authorities?**

Source: CRA Analysis

One of the key reasons for the improvement in the perception of HMRC in recent years was the interviewees’ experience with their firms’ Customer Relationship Managers (CRMs). They felt these individuals made significant efforts to understand the tax affairs of their assigned companies, to be responsive, and to clear up issues quickly to the extent that it was in their power to do so. The CRM programme put in place by HMRC clearly seems to have been successful. There is also a belief that the authorities are approachable in a way that is not possible elsewhere.

“You can talk to the tax people here. You simply can’t do that in a lot of other countries, at least not without lawyers in the room.”

“The tax authorities are very reasonable and pragmatic. They do a risk-based approach ... we are transparent to them so we have a good relationship.”

However, some significant negative sentiment towards HMRC still remains as there is a continuing, aggressive, anti-avoidance drive and an adversarial approach purveyed by some tax departments.

3.7. Interviewees views on network of tax treaties

For an internationally orientated financial centre such as London, this is a very important aspect of the tax system. This is because large financial firms in the UK often have extensive networks of overseas subsidiaries and branches. A very strong network of tax treaties is therefore a highly desirable and advantageous feature of the UK tax regime in terms of the attractiveness of operating from here. Though not the most important of the 6 factors it still ranked highly in the estimation of our interviewees. The table below shows the strong position of the UK on this factor. That such a network exists here is another indicator of London’s pre-eminence as an international financial centre (alongside other indicators such as the strongly positive balance of payments from the financial services sector noted earlier in the paper). When asked to list the positives of being located in London this factor was invariably mentioned by our respondents.

Figure 18: Which are the most attractive financial centres on the basis of tax treaties?

![Bar chart showing relative attractiveness of financial centres based on tax treaties.](chart.png)

Source: CRA Analysis

3.8. Relative importance of various types of tax

The chart below shows the relative importance assigned by our interviewees to various kinds of taxes. This chart shows that corporation tax is relatively less important than personal tax issues. These are discussed in more detail in the next chapter.
The other taxes that were indicated as important related to investment funds and investment management.

3.9. Companies’ location plans

Part of the discussion with our interviewees was around whether they had plans to move from the UK, in part or in total. Several companies stated they had no plans to leave and found the UK a good place to do business. One company had moved its tax jurisdiction to another country in recent times. Another company, not originally located in the UK, had recently moved its tax domicile and considered the UK as a place to locate, but explicitly rejected this option for tax reasons. Nearly all companies we interviewed stated that they would not grow their activities in the UK, or make further investments here as a result of the tax environment (and also the regulatory environment). A number of companies said they were progressively “hollowing out” their UK operations and setting up operational units in other more attractive locations. Although this had started years ago as a labour cost reduction initiative aimed at back office functions, tax has moved up the agenda and higher value added functions, it was said, will increasingly be moved to lower tax jurisdictions. The quote below captures some of this feeling:

“All the growth in headcount in our company will be outside the UK. The headcount here will not decrease, but it certainly will not grow.”

On the other hand, we had comments from one or two firms, including very large ones, along the following lines:

“As a matter of record, we are fairly comfortable with the UK tax regime.”

We also asked firms about the impact of personal taxation on key personnel and the likelihood that large numbers of people would leave the UK. The issues here were the 50% rate and the changes to the non dom regime. There was a general feeling that there would not be an exodus of personnel from the UK, but that the UK had become a much less desirable place to be for talented, internationally mobile staff.
This meant there would be a trickle of staff away from the UK, but a quite significant drop off in the number of people wanting to come to the UK. This is in addition to the effect of the highly restrictive visa quotas which in many instances are lower than the number of overseas staff currently employed. Over a period of years these combined factors could lead to a significant diminution of the top-flight talent base. We again provide some quotations below:

“A lot of our senior employees are non doms. They are doing deals around Europe. More of them will be based on the Continent in coming years.”

“We now have pretty good evidence that the increase in the top rate of income tax and changes affecting non doms are beginning to affect attitudes in our Group towards London. The number of people wanting to come has dropped very sharply … London was always a desirable place to be … so we have people going home and new ones not coming in.”

3.10. Summary of views

Overall, a wide range of views were expressed during the interviews, with some seeing a dramatic deterioration and indicating that their organisations are close to a ‘tipping point’, e.g. in relation to a preparedness to re-locate business functions out of the UK, whilst others recognised that there are significant issues, but seemed relatively content to stay in the UK.

This range of views seems to be due to a great extent to the varied circumstances of the interviewees’ companies, in particular the different sectors they are in; whether they are foreign ‘inbound’ groups or UK-headquartered ‘outbound’ groups; the mix of staff (e.g. proportions of non doms and high earners) and differences in the inherent mobility of their business models.

However, there was general consistency of concerns around:

- The unpredictability of the UK regime and the uncertainty this creates;
- The manner in which action to counter tax avoidance is implemented;
- The adverse direction of changes to the personal tax regime;
- ‘Political taxes’, like the Bank Levy and Bank Payroll Tax, on which the UK is perceived as taking the lead in the G20.

An overriding concern was that the full extent of the declining attractiveness of the UK may only be fully apparent when it is ‘too late’. Many noted the cumulative negative effect of regulatory and fiscal change, and the continuing political pressure on and media hostility against financial services companies.

Whilst many acknowledged that the Government must allow for the UK’s fiscal position in setting taxes going forward, it was clear that decision-makers within the financial services sector would need to put commercial interests first and this could be affected by moving mobile operations relatively easily. Several observed that organisational momentum, particularly in major, geographically dispersed groups, can build slowly. However, once sufficient negative sentiment has built in relation to a
given territory, it can be very hard to change course. Worryingly, it was noted that the cumulative impact was beginning to get the attention of senior management, with some boards actively discussing the UK tax system for the first time.

A key related commercial concern was that the drift of business away from UK was bad for all given the interconnectedness / clustering effect in the City of London. One interviewee noted that if “other people move they would be less keen to stay in the UK - if the relationships move then we will have to go where they are”.

A common point also made was that once a business has left, it would be unlikely to return. This did not appear to simply be an emotional response to current issues but a commercial reality, since for a move to be made, the upfront cost associated with re-location would generally be expected to be less than the long-term, recurring benefit.

3.10.1. Approach and attitude of UK authorities

In general, attitudes towards HMRC had improved significantly since we canvassed them for a report we prepared for the City of London Corporation nearly three years ago, with one interviewee noting that the UK tax regime is “tempered by having a much more reasonable tax authority than some other countries”.

In particular, the relatively new role of the CRM was singled out for general praise. Whilst the firms’ experiences with their CRMs depended on the individual in the role, in general they were noted to be very good: “Very contactable, very constructive”. Many would like the relationship to expand so that the CRM was better equipped and authorised to work on a commercial basis with the taxpayer. The Sheffield collective investment unit was also singled out for praise, with similar views being expressed.

However, some still perceived some staff and certain functions as adversarial, suffering from a “lack of trust”, having a “very defensive mentality” and harbouring the misconceptions that the private sector has limitless resources to undertake tax avoidance. It seems that there remain a significant number of staff and certain functions that continue to adopt a ‘pre-Varney’ approach. Some HMRC staff also seem to continue to believe that “more legislation is better” and are ready to engage in a high level of unnecessary “tinkering”.

There was also a perceived complacency in that the tax authorities, including HMT, simply consider the UK to be ‘a great place to do business’ and do not feel the need to fully allow for the relative merits of the tax regimes in other countries. Whilst the City of London clearly remains a pre-eminent financial centre, many of the interviewees considered that the UK was no longer tax competitive and that HMT could be mistakenly overstating the attractiveness of the City’s other attributes.

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3.10.2. Continuing Focus on Anti-Avoidance

There remains a strong and widely-held view that the UK authorities continue to be heavily focused on stopping tax avoidance and on creating anti-avoidance measures. Whilst it was generally recognised that the authorities have a legitimate concern and need to deal with avoidance, the manner in which highly complex legislation is introduced is very problematic. Many respondents pointed to the volume of new anti-avoidance legislation passed in recent years, with many changes being made piecemeal and without notice, undermining commitments to consultation. This produces uncertainty and adds considerably to compliance costs, especially where legislation supposedly targeted as a specific mischief has unintended consequences – a concern which was mentioned a number of times. It was noted that it is often “the innocent bystanders that the legislation affects more than the people who it is intended to catch”, given the rules introduced are often “ambushes” with unpredictable outcomes.

This attitude is felt to be increasingly out of date in view of the measures that have been adopted in the past, in particular the disclosure scheme. Several noted that a significant reputational risk is also attached to aggressive ‘tax planning’, which acts as a strong preventative. The UK tax authorities do not seem aware of this constraint on corporate behaviour.

Respondents also noted the fear of creating new ‘loop holes’ has led to unnecessary delays in much needed overhauls of existing legislation.

3.10.3. Predictability / Uncertainty

Due in large part to the continuing flow of new, and often unexpected anti-avoidance legislation, perceptions of uncertainty have worsened in recent years. This perception was also not limited to anti-avoidance legislation, with examples such as the sudden introduction of the Senior Accounting Office rules being provided as another example.

Critically, several major areas of tax also remain unsettled, such as the CFC regime, which further complicates long-term decision making.

The tax agenda, particularly in recent years, was considered by many to be noticeably and regrettably driven by the Media, e.g. the bank payroll tax, and so not necessarily principled in its basis and also reactive.

3.10.4. Tax simplification

The remarkable complexity of the UK tax regime is noted by all respondents, and evidenced below by the table showing the length of tax documents. Nor is there much faith in the ability of the authorities to make an impact on complexity, despite the creation of the Office of Tax Simplification.
Table 2: Comparison of volume of Tax Legislation, 1960 - 2009

<table>
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<th>Period</th>
<th>Total no. of pages</th>
<th>Average no. of pages</th>
</tr>
</thead>
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<td>1960 – 1964</td>
<td>210</td>
<td>42</td>
</tr>
<tr>
<td>1965 – 1969</td>
<td>504</td>
<td>101</td>
</tr>
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<td>2,525</td>
<td>505</td>
</tr>
<tr>
<td>2005 – 2009</td>
<td>2,097</td>
<td>419</td>
</tr>
</tbody>
</table>

Source: ICAEW
4. KEY DEVELOPMENTS IN THE UK TAX REGIME: VIEWS OF FINANCIAL SERVICES COMPANIES

The period 2007 to the present has seen a number of important developments in the UK tax regime that have strongly affected the financial sector. A complete review of all changes to the tax code since 2007 would be too exhaustive for this report because changes are numerous and frequent (indeed, this is of very great concern to our interviewees). This chapter therefore briefly summarises only those developments which are considered of major importance by senior executives in the finance sector, together with their views of these issues. The chapter is divided into sections on business taxation, personal taxation, and a section on other potential developments in UK taxation.

As a reminder from an earlier section of the paper, the most important taxes were employment taxes, followed by personal income tax, followed by corporation tax and taxation of foreign subsidiaries and branches.

4.1. Key corporation tax developments

4.1.1. Reduction in UK Headline Rate to 24%

Background

In its June 2010 Budget, the Government stated its intention to reduce the UK statutory rate of Corporation Tax from 28% to 24%, over a four year period from April 2011. The Chancellor of the Exchequer noted that this "will give us the lowest rate of any major Western economy and the lowest rate in the G20."17

This change in headline rates should place the UK in a strong position (in four years time, if other countries do not change their rate in the meantime) relative to many large countries as regards the headline rate of tax on companies. The following table shows headline rates in a variety of large and small countries in order to provide a comparison with the proposed UK programme.

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17 [http://uk.reuters.com/article/idUKTRE65L2AX20100622](http://uk.reuters.com/article/idUKTRE65L2AX20100622). It is also noted that within the G20 Russia, Turkey and Saudi Arabia have a lower tax rates of 20% (Deloitte "Corporate Tax Rates 2010" rate comparison).
Table 3: Selected Headline Rates of Corporation Tax

<table>
<thead>
<tr>
<th>Country</th>
<th>Headline Rate of Corporation Tax (2010)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>28% (to fall to 24% by 2016)</td>
</tr>
<tr>
<td><strong>Selected G20</strong></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>33.3%</td>
</tr>
<tr>
<td>Germany</td>
<td>15% + local rate, so approx. 30-33%</td>
</tr>
<tr>
<td>United States</td>
<td>30% + local rate, so approx. 35-47%</td>
</tr>
<tr>
<td><strong>Selected other</strong></td>
<td></td>
</tr>
<tr>
<td>Ireland</td>
<td>12.5%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>25.5%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>8.5% + local rate, so approx. 13-22% depending on canton</td>
</tr>
</tbody>
</table>

Source: Deloitte\(^\text{18}\)

Clearly a rate of 24% will probably be very competitive in four years time relative to countries such as Germany, France, and the USA. It will not be especially competitive with regards to Ireland, Switzerland, the Netherlands, or Hong Kong, however. The key question is whether the UK’s key competitors are the former or the latter set of countries. Evidence from the UK so far in terms of where firms have moved to is that the truly relevant competitive rates of corporation tax are those of the latter set of countries.

Commentary of interviewees on the Corporation Tax rate reduction

The headline rate reductions were generally welcome and seen by some as an encouraging sign for the future direction of the UK tax regime, but some interviewees considered that the UK rate would still not be highly competitive even at the planned 2016 rate.

Also, for a number of interviewees, the impact on their businesses of this rate reduction appeared to be relatively small. For example, for many of the foreign groups operating in the UK, the level of UK Corporation Tax is not a major issue when they are, say, US headquartered or French headquartered, and so ultimately taxed in the USA or France. Their UK taxable profits may also be relatively limited given the relatively limited nature of their activities in the UK. For banks that have made significant losses during the financial crisis, the impact will also be limited for some time because of deductibility of losses, whilst for those banks that will continue to pay Corporation Tax, the benefit is perceived as being offset by the introduction of the bank levy.

There was also a general expectation that the cost of the planned reduction would eventually be re-imposed on business through other means, noting that the Chancellor had previously indicated that a cut in the UK Corporation Tax rate could be funded through targeting tax avoidance and simplifying business tax reliefs19.

So, while our interviewees clearly welcomed the planned reduction in corporate rates, there was not a resounding enthusiasm for this proposal. To quote one executive:

“The reduction in the corporate tax rate is marginally useful to us. But you really have to get below 20% to catch people’s attention. Anything that begins with a 1 is when you really make a splash.”

4.1.2. Exemption of Foreign Dividends and the Worldwide Debt Cap

Background

Since 1 July 2009 foreign dividends received by a UK company from foreign subsidiaries have been exempt from UK Corporation Tax. Previously, dividends received from non-UK companies were subject to UK tax with a credit given for foreign tax paid, under the relevant double taxation agreement. The principal benefit for multinational groups of the new rule is a potentially significant reduction in their compliance burden rather than lower cash taxes, given the credit system previously in place.

The Worldwide Debt Cap rules accompanied the foreign dividend exemption and were introduced for accounting periods beginning on or after 1 January 2010. The Debt Cap was intended to further tighten the interest relief rules for UK companies that are part of large international groups, to prevent them from reducing their UK taxes by extracting profits in the form of excessive finance charges. Broadly, the rules restrict the aggregate UK Corporation Tax deductions for financing costs to the level of the group’s external, worldwide financing costs.

Financial services groups are excluded from the rules where substantially all of their activities fall within a narrowly defined set of qualifying activities.

Commentary of interviewees on the Foreign Dividend Exemption & WW Debt Cap

The exemption of foreign dividends was generally received positively, however disappointment was expressed that the Government had felt it necessary to accompany this change with the introduction of the Worldwide Debt Cap. Some considered this was unnecessary given the UK transfer pricing rules in place and the existing anti-avoidance measures, and felt that it significantly diluted the intended improvement in tax competitiveness. It was also felt that in common with much anti-avoidance legislation, the Worldwide Debt Cap legislation and its gestation were overly complex, with a number of amendments being necessary after its original enactment to address difficulties and uncertainties arising. Further changes are anticipated in the Finance Bill to be introduced this autumn.

Nevertheless, the exemption of foreign dividends was seen as one of the most positive changes to the UK tax regime in the past few years. Amongst our respondents in the interview programme were a number of very large international firms with subsidiaries spread across the world. For them, this was a very beneficial change.

### 4.1.3. Controlled Foreign Company (CFC) rules

#### Background

CFC rules allow governments to tax the profits of a company’s overseas subsidiary that is subject to a lower level of tax on a current basis, i.e. to tax the subsidiary’s profits without waiting until they are repatriated to the parent jurisdiction.

For many UK financial services companies that have foreign subsidiaries, the UK CFC rules are of critical importance. Due in part to challenges made to the validity of the UK CFC rules under EU law, the rules have effectively been under review since 2005.

The new Government has recently launched a new consultation on interim improvements to the rules, to be legislated in spring 2011. The final, overall position will however not be clear until spring 2012, which is the date that has been given for the introduction of substantive new legislation.

#### Commentary of interviewees on the UK CFC rules

The general view was expressed quite simply by one interviewee as, “The CFC rules are broken.” It seems that the final rules will be a prime determinant of the competitiveness of the UK tax regime for many financial services companies.

The length of time that the UK CFC regime has and will remain under review (7 years by 2012) was of particular concern. It was noted that during this long period, whilst the tax treatment of many foreign subsidiaries of UK companies remained unclear, tax regimes elsewhere had moved on and other EU countries were adapting more quickly. Critically, it was noted that the uncertainty in UK CFC position has been a principal reason for the re-domicile of some previously UK-headquartered companies in recent years.

Concern was also expressed over the quality of the consultation process, with the consultation document issued in June 2007 that proposed a new “Controlled Companies” income-based system being singled out for particular criticism.

The fact that the new Government has recognised that proper reform of the CFC rules is a key priority for UK multinationals was acknowledged by our respondents. However, they saw the very long gestation period for the new rules as simply another example of the uncertainty of the tax regime.
4.1.4. Proposed foreign branch exemption

**Background**

As part of a shift towards a more territorial tax regime (following the exemption of foreign dividends), the new Government is currently consulting on reforming the basis for taxing foreign branches of UK companies with effect from spring 2011, including exempting their profits from UK Corporation Tax.

Similarly to the old treatment of foreign dividends from subsidiaries, currently, credit is given against UK tax for foreign taxes paid on branch profits. Where the UK tax is higher the difference must be paid to bring the total up to the UK level. With a branch exemption the UK company would instead only pay the foreign tax rate, although the treatment remains unclear where the UK authorities might consider the foreign rate to be too low.

Subject to the detailed proposals, a branch exemption should therefore make the taxation of foreign branches and foreign subsidiaries broadly equivalent.

**Commentary of interviewees on the proposed foreign branch exemption**

In general, those interviewees who expressed a view considered that an exemption would help improve the UK’s tax competitiveness. In particular, many of the interviewees representing banks and insurance companies considered that the introduction of a branch exemption rule by the UK could significantly benefit their organisations.

For financial sector companies it was noted that a branch structure enables a more efficient use of capital than a subsidiary-based structure since the branches are part of a single legal entity, i.e. a UK company, rather than separate subsidiaries that may each require a separate pot of capital. In the current capital constrained environment, consolidation of capital in a branch structure is more efficient. Yet, the tax system favours a subsidiary structure. The branch exemption rules could thus align tax incentives with capital incentives, bringing considerable benefit. A UK hub company with EU branches was seen as particularly attractive for insurance companies that will soon be subject to the forthcoming EU Solvency II regulatory requirements, which will increase the pressure to manage capital as efficiently as possible.

Other EU countries already offer branch exemptions or their equivalent, e.g. the Netherlands and Ireland. This is just one of the many reasons why these two countries have highly attractive tax regimes.

4.1.5. The Payroll Tax

**Background**

In 2009 a payroll tax was imposed on the banking sector. This was a 50% tax on the bonus pool paid by any bank in the UK. This tax was in addition to tax paid by the individuals receiving bonuses from the bonus pool, and to taxes on profits of the banks concerned. HMT estimated the take from this tax would be approximately £500 million, but the actual figure has been much higher. Estimates suggest the total
raised was £3.5 billion, although a few of our interviewees suggested the total could be as high as £5 billion. This was because many of the bonuses due were paid despite the tax, which the Government did not expect. It was stated by Government that this should be a one-time tax, but it has very recently been suggested by senior members of the present Government that it could be imposed again.

It is important to note that the UK was the only country in the world to impose such a tax. France imposed a onetime tax on a particular group of employees in French banks which raised, according to interviewees (including French banks) a small fraction of the amount raised by the UK bank payroll tax.

*Commentary on payroll tax from interviews with banks*

Bank interviewees, and interviewees from other financial sectors, were uniformly dismayed by the bank payroll tax, and highly critical of it. It was felt to demonstrate all the problematic characteristics of the UK tax regime.

It was seen as an example of unpredictability and uncertainty. This was because the bank payroll tax was introduced suddenly and with no consultation. Further, it was seen to have had a chaotic gestation and implementation with an unworkable set of rules that Treasury and HMRC officials clearly did not know how to interpret in the weeks after its sudden announcement. It was also unclear to which institutions it would be applied: a variety of asset managers and insurance companies stated in our interviews that it took much hard work and lobbying of Government to demonstrate that they were not, in fact, banks.

The sums concerned were huge. One bank we interviewed paid in excess of £400 million, another in excess of £250 million. These amounts were large enough to materially change the financial situation of the concerned banks on a global basis. One foreign bank stated that the tax paid amounted to several years profit of its UK business. These tax outlays were, of course, impossible to plan for given the suddenness with which the tax appeared. In all cases, an event of this significance became a major concern for Chief Executives and Boards of Directors.

Foreign banks we interviewed particularly resented paying this tax, and clearly stated that perceptions of the UK held by senior management in their home countries had been seriously damaged by it. To the extent that these foreign banks received any aid, which most of those in our interviews had not, this came from their home country government and not the UK. But there was no bank payroll tax in their home country.

Our banking interviewees were concerned that the payroll tax would not be a one-off, as had been promised by the previous Government. This fear may well be justified as, at the time of writing this report, senior government ministers had just threatened to revive the bank payroll tax in the event of an “unacceptable” bonus round early next year.

Finally, this tax was repeatedly referred to by interviewees as a “political” tax imposed for short term political reasons, but with long term consequences. Such a tax was outside the experience of the tax professionals with whom we spoke.
We provide below several quotations from interviewees on the payroll tax and its political context:

“It has damaged the standing of the UK in the eyes of our senior management (foreign bank). If it were repeated that would result in really a very severe reaction, some really very serious problems.”

“Our senior management is taking a very dim view of the UK these days as a result of the payroll tax.”

“From New York it looked like a series of blows. The cumulative effect made them feel we were being got at. Changes that have long term effects were being made in response to short term political pressures.”

“We struggled through the payroll tax with people from HMRC and HMT who did not know what was intended by the tax or how to implement it. No one from government could say whether a commodity trader or an asset manager in our Group was in or out of the tax.”

“As a major investor in the UK, with an appropriate and conservative compensation policy, we felt very strongly that we should not have had to pay such a tax.”

“The payroll tax effectively cancelled out all our profits from the UK for the last three or four years.”

4.1.6. Bank levy

Background

The Government will introduce a levy based on banks’ balance sheets from 1 January 2011 following consultation. The intent, it has been said, is to incentivise banks to move to a less risky funding profile. The Government has further stated that the tax should raise £2.5 billion. Unlike the bank payroll tax, it appears that several governments will apply a bank levy, and not just the UK.

Commentary of interviewees on the bank levy

Discussion of the bank levy amongst our interviewees focused on several issues: the philosophy and rationale for the levy; the amounts that will be raised; the role of the UK government in bringing this idea forward; and the political dimension of the levy.

Although Government initially stated that a key objective of the levy was to incentivise banks to use a less risky funding profile, bank interviewees stated that it seems the true objective is simply to raise a given amount of new tax revenue. It was said by various interviewees that Government had decided a level of £2.5 billion was “affordable” and would not meet strong resistance from the banking community. Indeed, some interviewees stated openly that if the levy was the price necessary to stop political agitation against banks, then it would be worth paying their share.

One or two bank interviewees criticised the initial proposals as poorly conceived, unworkable, and likely to raise far more than £2.5 billion. As such, they saw it as another example of uncertainty, risk, and a certain degree of incompetence in the
development of the evolving tax regime. Other interviewees felt certain that £2.5 billion was the clear and simple objective of the levy, and that the industry's assistance would be sought in calibration to ensure that this was the revenue actually raised. In our contacts with Government for this project this latter view was also conveyed to us.

Several interviewees felt that the bank levy was a brainchild of the UK government, which had then lobbied for this idea to be accepted by the G20 and the EU. Indeed, the UK was seen to have taken the lead amongst the G20 in pushing generally for harsh new measures affecting banks. The UK’s decision to impose the levy was therefore seen as unilateral in the sense that it would be imposed even if other governments did not follow suit. This was one more factor adding to the generally negative perception of the UK government’s aggressive approach to bank taxation.

We provide once again several quotations:

“We have a huge balance sheet in the UK. The levy could hit us very hard.”

“Gross liabilities are trillions, net liabilities are millions. Which will it be? They don’t know. Which of those numbers do we multiply by 0.07%?”

“The definitions in the initial proposal are unworkable. How do you define a retail deposit, for example?”

“Based on the initial proposal, the levy could cost us hundreds of millions.”

4.2. Key developments in personal taxation

4.2.1. Increase in top UK income tax rate to 50%

**Background**

As a part of a package of radical measures announced in the 2009 Budget to increase the taxation of higher earners, with effect from 6 April 2010 the top rate of income tax was raised from 40% to 50% for individuals earning over £150,000. Many taxpayers in the financial services sector earn in excess of £150,000, so these changes have considerably reduced their take home pay. In its June 2010 Budget document, the new Government noted that that the 50% rate “will remain in place for the time being.”

The increase makes the top rate of income tax in the UK one of the highest in the larger western economies. Figure 20 shows the evolution of the tax rate for a highly paid individual in a selection of large and small countries, including the impact of the 50% rate in the UK. The change significantly increased the tax a high earning individual working in the UK would pay relative to one based in Switzerland, and now also compared to one working in Germany. Whilst the UK is now taxing the income of individuals at a similar level to the Netherlands and Ireland, the increase to 50% must be considered against the background of a tax regime that many interviewees already considered as being relatively uncompetitive.
Commentary of interviewees on the increase in the top UK income tax rate

There was general agreement that this significant increase in the top rate of income tax represented a step in the wrong direction in terms of the competitiveness of the UK tax regime, and compounded the impact of the other personal tax issues set out below in the global market for talented financial services professionals.

The change was already affecting both the willingness of some firms’ more mobile employees to continue working in the UK, and also impacting firms’ views on whether it is economic to set up new operations in the UK, or to expand their existing operations here. We provide a number of quotations below:

“The government has not made the link between personal tax and international competitiveness. 40% was competitive. 50% is not.”

“People will pay 50% … reluctantly. Some will move, but not many. But make no mistake, we are at the breaking point.”

“The most damaging changes have been in personal taxation … 50%, plus NIC hikes, plus damaging changes to pensions. The best talent won't want to work in the UK. Also, we tax equalise for inward secondments, and this has now become prohibitively expensive, and we will therefore have fewer secondments. That will be damaging.”

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20 Being income tax plus National Insurance contributions, or equivalent.
4.2.2. Pension tax relief

Another significant element of the package of changes announced in the 2009 Budget was that tax relief on pension contributions for those earning more than £150,000 p.a. (including the value of their pension contributions) would be restricted from 6th April 2011. From this date, a ‘tapering’ of the tax relief on pension contributions that eventually reduces the tax relief for higher earners to the basic rate figure of 20%, combined with the loss of other reliefs, will result in an effective marginal rate of tax for some of 60%²¹.

In addition, the 1% National Insurance contribution that is paid on earnings at this level will rise by a further 0.5% from 6th April 2011.

Transitional “anti-forestalling” provisions on pension relief were also introduced in order to prevent taxpayers from making artificially large pension contributions prior to 6 April 2011, which gave immediate economic effect to the changes.

The new Government announced in the June 2010 Budget that it will be revisiting the tax treatment of pension contributions made by higher earners.

Commentary of interviewees on the changes in pensions tax relief

Some interviewees considered that the reduction in the tax relief for pension contributions for high earnings significantly reduced the attractiveness of a UK pension to many executives. One interviewee noted that the anti-forestalling provisions were “hugely punitive” and said they were also particularly complex. It was noted that the new Government “needs to sort out ‘mess’ around pensions”.

“We have come close to deciding that it is not worth having a pension scheme for senior management because it is so tax inefficient. The whole point of pensions is to give people tax incentives to save for retirement.”

“People think the top rate is 50%, but with NIC and the way pensions are treated now, it is considerably higher, over 55% for some people.”

4.2.3. Non doms regime

Background

Important changes to the UK’s “resident but not domiciled” regime occurred in 2008. Previously, taxpayers who had come to the UK from another country were able to exclude from UK taxes income earned outside the UK, so long as they had a clear intention to return to their home country. Income earned by these taxpayers in the UK was taxed at normal rates, and any overseas income they remitted to the UK was also taxed at normal UK rates. This regime was attractive to mobile international individuals located in the UK as many of them could enjoy tax free income on their investments held outside the UK. Approximately 130,000 ’non doms’ benefitted from this provision in early 2008.

²¹ http://www.kpmg.co.uk/pubs/Fifty_percent_tax_rate_May09_Accessible.pdf.
However, with effect from 6 April 2008, non doms who have been resident in the UK for seven years (out of the last ten) are now required to pay a £30,000 fee each year in order to retain this tax status. The alternative is to have their overseas earnings taxed in the UK.

Previously, the non dom regime was very attractive to the highly-skilled, highly-paid international talent that help maintain London’s attractiveness as a financial centre. Such people also make a significant contribution to the UK’s tax revenues. While the regime is still attractive for those arriving in the UK, it has lost its attractiveness for most non doms who have been in the UK for more than 7 years and therefore face the prospect of paying £30,000 annually to maintain this status.

In the June 2010 budget, the Government also announced that it will conduct further review of the taxation of non doms “to ensure that nondomiciled individuals make a fair contribution to reducing the deficit, in return for greater certainty and stability for those bringing skills and investment to the UK.”22

Commentary of interviewees on the Non doms changes

Many interviewees lamented the loss of the original non dom regime, which they considered had been a key factor in attracting the best talent to the City from all over the world, and keeping it there, for many years. General concern was also expressed over the new Government’s decision to further review the non dom regime and the tone of its announcement.

We also understand from interviewees that certain continental European countries are offering non dom type arrangements to their nationals, based in London, in order to attract them to return home. This demonstrates that tax competition is occurring at the level of personal taxation as well as in corporate taxation.

4.2.4. Capital Gains Tax (CGT) – impact on individuals

Two key changes have also occurred in the taxation of capital gains that affect high earners selling their investments, particularly in the Private Equity sector.

Firstly, with effect from 6 April 2008 ‘taper relief’ was eliminated so that, for example, Private Equity executives would pay the then prevailing full CGT rate of 18% on the profit they made on selling their company investments, regardless of how long they kept them. Previously, to incentivise the holding of these investments, the rate would have reduced to 10% after two years.

Then, with immediate effect from midnight of Budget day this year (23 June 2010) the new Government increased the CGT rate from 18% to 28% for such individuals, where their total taxable income and gains are above the upper limit of the basic rate income tax band (i.e. £37,400 for 2010/11).

There had been speculation that the rate would be lifted to 40% or even 50% in line with the top rate of income tax.

22 June 2010 Budget announcement
The Government noted that this was aimed at partly funding an increase to the personal tax allowance, increasing fairness and to reduce tax avoidance from the conversion of income into capital gains.

**Commentary of interviewees on the increase in CGT**

The comments made on the increase in CGT were not purely restricted to those of Private Equity firms we spoke with; there was general concern regarding the impact of the increased rate on the investments of higher earning employees, in addition to the host of personal taxation issues outlined above.

Although the full CGT rate was not in the end aligned with higher income tax rates, it was noted that the 28% rate is not at all competitive internationally and would discourage investment in the UK. It moved the UK from 9th position in the world to 15th, just behind the USA. That the rate increase was introduced with immediate effect, during a tax year, was also noted as an unwelcome “surprise”.

On the positive side, one interviewee noted that it was important that the approach finally adopted was at least simple, being a straightforward change in the rate, however that it is critical that the rules remain stable over time given the negative impact on investment decisions of such changes.

**4.2.5. Commentary of interviewees on the overall UK personal taxation regime**

Combined with the increase in the top rate of income tax to 50% and the new pension relief restrictions, most saw these changes as severely restricting the City’s ability to attract talented individuals in future, in addition to presenting real issues with retaining staff in the UK now. Cumulatively, these changes are significantly increasing the remuneration costs for some firms as they attempt to remain competitive in the global financial services labour market.

As noted previously, some of the financial services businesses we spoke with are highly mobile in the sense that they rely on relatively small teams of highly qualified and experienced staff, for example in the fund management sector. Some of the major financial institutions with thousands of staff in London also observed that their smaller, but high value-adding units were also mobile, e.g. fund management teams. One interviewee noted that “Almost anything that is done in the organisation that is of value can be based anywhere”, with one firm noting that out of 70-odd front office staff, only one had a role that was UK-market focused.

It was also noted that for many internationally mobile staff, although London is an attractive destination for many reasons, they generally only spend part of their careers here. Some noted that the above changes had significantly affected the attitudes of some existing staff towards being in the UK, with many reported as now feeling increasingly “unwelcome” and being treated as “foreigners”. Examples were given of staff that had either left earlier than they otherwise would have done, or who had chosen not to come to the UK at all. One interviewee noted that “Employees do not want to come to the UK and the bank does not want to send them to the UK”.

The impact of the changes on the more junior front office staff who would provide the future generation of UK senior management, and for whom £30,000 plus a >50%
effective marginal tax rate represent a major reduction in their disposable annual income, was of concern to all – particularly given the already high cost of living in London.

The current importance of the UK personal taxation regime for UK competitiveness was summed up by one interviewee as follows: “For anyone who cares about doing business in the UK, [personal tax] is the biggest issue”. The view was also expressed that the Government had not yet made the proper and comprehensive link between corporate and personal taxation necessary to fully support the UK services economy, which of course is principally reliant on human capital.

4.3. Other Significant Developments

A number of new, additional taxes are being consulted upon, or have been mentioned as possibilities by the Chancellor or other government sources. These are discussed below.

4.3.1. Financial Activities Tax (FAT)

Background

The leaders at the G-20 Summit in Pittsburgh in September 2009 tasked the IMF with preparing a report setting out the range of options countries had adopted or were considering adopting to make the financial sector contribute towards the cost of the financial crisis.23

The IMF released an interim report in April 2010, which proposed the new FAT, which would be based on the profits and the pay structure of the firms. It was reported at the time that the IMF report was "radical and in line" with what the then government had argued for at the subsequent G20 meeting held at St. Andrews in the UK in November 2009, when the Prime Minister had “surprised his Treasury team by promoting the idea of international levies”24.

The IMF’s interim report for the G20 on “A Fair and Substantial Contribution by the Financial Sector” proposed two new taxes: (i) a Financial Stability Contribution (FSC) to fund the direct cost of future bank failures and (ii) a FAT levied on “high levels of remuneration” and “excess” profits to cover the “wider costs associated with financial crises”. Both the FSC and the FAT would apply to all financial institutions, including banks and hedge funds. The IMF interim report leaves options open as to the FAT’s precise design and parameters. The report is now in the hands of G20 governments who will have to decide upon next steps, including the size and scope of the IMF proposed FSC and FAT.


In October 2010 the European Commission outlined its stance on the FAT. In its view banks are "under taxed", however it noted that a FAT should only be introduced on a global basis given multinationals’ mobility.

The new UK Government has stated that it “will also consult … with international partners [to] … explore the costs and benefits of a Financial Activities Tax on profits and remuneration.” It has indicated, however, that it is unlikely to proceed with this tax in the absence of international agreement.

Commentary of interviewees on a FAT

Our interviewees did not particularly focus hard on the potential FAT. It was felt unlikely that there would be international agreement to impose such a tax, and that in the absence of such agreement the UK government would be unlikely to act upon it. Interviewees also noted the observation of many analysts that such a tax would be extremely difficult to specify and apply in a coherent manner. It was felt, nevertheless, that the FAT could not be totally dismissed, and that it therefore contributed to already high uncertainty about the future evolution of the UK tax regime.

4.3.2. General Anti-Avoidance Rule (GAAR)

In the June 2010 Budget, the new Government announced that it would examine whether a GAAR would be appropriate for the UK, beginning with an ‘informal’ consultation in the summer.

A GAAR provides tax authorities with a non-prescriptive means for challenging a company’s tax arrangements where they feel they represent tax avoidance, when there may be no specific legislation that addresses the arrangements they have identified, i.e. it is a ‘catch-all’ approach. Such legislation could give HMRC broad powers to make judgements on issues that they perceive as tax avoidance.

Commentary of interviewees on a GAAR

Interviewees who expressed an opinion on a potential GAAR noted that it could create even greater uncertainty for UK taxpayers and is “the last thing that is needed.” They also questioned whether it was necessary given the comprehensive anti-avoidance legislation already in place in the UK.

If a GAAR was introduced, it was noted that a very efficient clearance procedure through which they would be able to get a speedy decision from HMRC on whether a particular arrangement fell foul of the GAAR would be essential. Scepticism was expressed as to whether such a clearance system was feasible. We note the comment of the Chartered Institute of Taxation below:


26 June 2010 Budget announcement
“We do, however, have to question what it is that the introduction of a GAAR would really achieve. What is the problem that a GAAR would solve and which cannot be solved by more traditional means? Given the extensive developments on the anti-avoidance front in recent years – especially DOTAS and the use of TAARs – coupled with the GAAR-like attitude of the Courts, we cannot see that there is an obvious gap for a GAAR to fill.”

4.3.3. Further restrictions on the deductibility of interest

The Chancellor has recently suggested the possibility that the deductibility of interest might be reduced. Such a measure would represent a tax increase on businesses to the extent they are debt-funded. It was stated that this measure would usefully reduce incentives to employ debt. Financial institutions and firms (such as private equity firms) that are naturally highly leveraged are extremely concerned by these statements. No specific proposal has emerged from Government, however, as to whether this proposal is definitely going to happen, or in what form.

Commentary of interviewees on interest deductibility

One interviewee noted that further restrictions to interest deductions for UK companies could be “catastrophic” to business in the UK, a view that was echoed by several others.

There is a belief amongst some firms we interviewed that the Government has an intention to fund the reduction in corporation tax (i.e. from 28% to 24%), or perhaps the costs associated with a ‘benign’ revision of the CFC rules in 2012, with the increased tax receipts that could be raised by further restricting interest deductibility. Senior government sources denied, however, that the reduction in the Corporation Tax rate, for example, will be funded in this way or that this connection exists. They stated that the reduction in the Corporation Tax rate is already funded. They made no forecast on the inevitability, or not, of a reduction in interest deductibility as a future revenue raising measure.

4.3.4. Deferred compensation

The Financial Services Authority (FSA) is working on new remuneration rules for banks and other financial services companies that would defer 60% of compensation for up to three or more years. This is not a tax issue. It has been suggested by interviewees, however, that a strict interpretation of proposals currently being consulted upon could be very awkward for partnerships. Many private equity firms and hedge funds are structured as partnerships. The awkwardness would result from the imposition of 50% tax on partnership profits (compensation) when FSA rules only permit 40% of compensation to be paid in the year this tax was due. Obviously, this could place individuals in financial difficulty as there would be more tax due than compensation actually available to pay it. There are also tax complexities for firms as regards accruals for deferred compensation and the associated tax treatment.

27 Chartered Institute of Taxation (CIOT) letter to HMRC, 15 September 2010.
Commentary of interviewees on deferred compensation

The respondents in industry sectors that could be affected by these rules were deeply concerned. They stated that the FSA rules were designed for a certain kind of employee of a bank, not for partnerships operating under an entirely different set of accounting and tax rules. The attempt to extend the rules to non-bank sectors such as hedge funds and private equity firms was viewed as naïve and demonstrating a lack of knowledge of tax and accounting issues.

A further comment by many interviewees on the issue of remuneration rules was that the UK was seen, as is so often the case, to be zealously and thoroughly implementing guidelines agreed in international forums, and aggressively imposing them on firms, while other countries are seen to be ignoring the same guidelines, or seeking a much less rigorous implementation.
5. KEY TAX CONCERNS BY FINANCIAL SECTOR

The following section of the report summarises the tax issues raised by sectors within the financial services community. These tended to vary depending on whether we were speaking with a bank, an insurance company, an asset management firm, etc.

5.1. Banks

Banks had many concerns about the UK tax regime. Comments regarding the bank payroll tax, the bank levy, tax on transactions, financial activities tax, the possibility of reduction in interest deductibility, and high personal rates of tax have already been discussed. The uncertainty of the regime is particularly acute for them as a number of new tax proposals are still to be confirmed or defined in detail (the levy, transactions tax, financial activities tax, interest deductibility). All of these have potentially huge consequences for the profitability of banks in the UK.

The view was also stated that the tax environment has been politicised in an anti-bank manner. The role of the UK government in creating this situation, and of advancing harsh measures in the G20 that have actually been resisted by other countries, was noted by a number of banks. Foreign banks, who were not rescued by the UK government, and whose financial health and compensation policies are ultimately looked after by “home” authorities, resent the stance of the UK government towards their operations in the UK, and especially the expensive political taxes they have been required to pay.

While all respondents accepted that banks had played a key role in causing the financial crisis, they also felt the UK government had created an environment in the tax realm that was unilaterally negative in nature compared to other countries. This has caused the UK to deteriorate significantly in any estimation by bankers of its tax competitiveness.

5.2. Insurance companies

Insurance companies noted, like other sectors, that the unpredictability of the UK tax regime was a major negative. They were also concerned about the high rates of personal taxation, and about the pension regime. Constant tinkering with tax relief on pensions was an example of uncertainty that affected their pension provisions business, but also an instance of high tax rates. Changes by the last government to tax relief on pensions for higher rate taxpayers could, for certain highly paid executives, lead to an effective rate of 60% on overall income. Finally, the impact of Solvency II on capital was raised by a number of firms in terms of the desirability of not fragmenting capital across many subsidiaries. A branch network would therefore be preferable, but was not efficient for tax reasons. Much depended on the UK government’s current review of branch exemptions.

5.3. Asset management firms

Asset management firms stressed the positive aspects of HMRC’s attempts to improve the regime affecting funds. Most funds are domiciled in Luxembourg and Ireland for tax reasons. All players we spoke to in the funds management industry,
including hedge funds, commended the UK tax authorities for their efforts to rectify the problems that have created this situation, and the solutions that have now been put in place, which have led one or two firms to start putting some funds onshore. The generally supportive attitude of the specialist funds team in London and the Sheffield collectives team was also mentioned favourably.

Asset management firms were also concerned about the issues that other sectors were concerned about. These included the high rates of personal taxation and the uncertainty in the tax regime. Senior management in the asset management industry is highly paid and very internationally mobile. It is therefore now seen as increasingly difficult to attract and retain top talent in the UK when such people can, effectively, work anywhere in the world. Some of the most strongly expressed comments we heard about “hollowing out” UK operations, or of not growing in the UK but growing elsewhere, came from asset management firms. As an industry sector whose metier is to analyse economic impacts on firms, and to understand economic trends, asset managers tended to see the recent UK environment in a holistic fashion, and to judge it, in many cases, quite harshly.

5.4. Hedge funds and private equity firms

Concerns in these firms clearly focused on high rates of personal taxation, the non dom rules, and capital gains tax. These concerns reflect the highly “personal” nature of these firms which are very often partnerships. HMRC’s perceived pursuit of highly paid individuals in these firms was cited as an obvious reason to move to Switzerland or some other low tax regime. Again, key individuals in these firms are internationally mobile and can work from almost anywhere.

Private equity firms were concerned about the 28% capital gains rate, which was seen to be uncompetitive relative to many other countries. The possibility of a reduction in interest rate deductibility was also seen as a key issue, and one firm stated that changes in this realm could render the private equity firm business model virtually untenable.

A critical issue for partnerships, and, hence for these firms, is the deferred remuneration arrangements currently being worked on by the FSA. These were seen to be “naïve” and to have a “taxation black hole” at the heart of them. What was meant by this was that partnerships are taxed at 50% when profits are declared by the partnership, regardless of when the compensation is actually taken out of the firm by the partners. Under the current FSA proposals, however, partners would only be able to take 30% or 40% of their compensation in the year it is earned. This could lead to the extraordinary situation of individuals owing more tax than the compensation they have available to pay it (51% tax versus 30 or 40% of compensation available). Needless to say, this issue was of considerable concern to the many firms in these two sectors structured as partnerships.

5.5. Retail brokerage and funds

This is one of the few, or perhaps the only, sector to escape from radical tax change in the past few years. The sector does not generally pay at the same levels as experienced in some of the other sectors mentioned above, so concern over high
personal tax rates was less marked. Nor has it experienced the same kinds of radical events of some of the sector such as the imposition of the bank payroll tax. That said, some small firms in this sector had to work hard to demonstrate to HMRC that they were not banks, as they had some very small banking operations that permitted them to hold client money.

5.6. Exchanges

Interviewees from exchanges noted that they have been relatively unaffected by the tax turmoil affecting so many other financial services sector. A perennial issue, however, is stamp duty. This is seen to affect cost of equity and favour use of debt.
6. GOVERNMENT VIEWS ON UK TAX COMPETITIVENESS

In this section of the report we review key documents published by the new Government relevant to the issues discussed in this report. We also report on views expressed by senior government officials we met in the course of the work. It can only be said that these documents, and the individuals with whom we spoke, display full awareness of the issues raised in this report.

6.1. Roadmap for corporate tax reform

In its June 2010 Budget document the Government set out a “Roadmap for corporate tax reform” and stated its aim of making the UK “the most competitive corporate tax system in the G20.”

“As a first step”, a package of corporate tax reforms was announced, led by the progressive reduction in the headline Corporation Tax rate. The package also included CFC reform and moving to a more territorial basis for the taxation of foreign branch profits, as we outlined in Chapter 4.

Going forward, the Government noted that “it intends to develop its view that in general a broad tax base, a low rate and a more territorial approach will improve competitiveness.” A more detailed programme for reform is due to be published this autumn.

6.2. Tax policy making: a new approach

In the document accompanying the Budget announcement, “Tax policy making: a new approach”28, it is prominently noted that the Government recognises that “major tax reform is necessary to restore competitiveness of the UK economy”:

“The Government is committed to creating the best possible environment for a private sector led economic recovery. A competitive tax system is at the heart of our approach, and the Budget sets out a significant package of reforms to the corporate tax system. But a competitive tax system is not only about the level of taxation and the policy choices that determine its incidence. It is also about the quality of our tax law and the way in which we make tax policy.

I am frequently told by businesses and the tax profession about the importance of predictability, stability and simplicity in the tax system. Business and tax professionals have previously criticised the tax policy making process as piecemeal and reactive, pointing to the wide range of policy announcements in recent years that have been unexpected and insufficiently thought through.

I want a new approach to tax policy making; a more considered approach. Consultation on policy design and scrutiny of draft legislative proposals

should be the cornerstones of this approach. The Government will always need to maintain flexibility to make changes to the tax system. But in doing so, it should be transparent about its objectives, and open to scrutiny on its proposals.

Also that in addition to the structural reform needed, reforms to the way tax policy is made are required to restore the UK tax system’s reputation for predictability, stability and simplicity.”

The Government then outlines what its new approach to tax policy making will comprise, in order to support greater predictability, stability and simplicity:

- providing taxpayers with clarity on its approach and certainty on the future direction of the tax system;
- slowing down the rate of change to the tax code, focusing on fewer and better developed proposals supported by improved processes for changing tax law; and
- to increase simplicity, creating an independent Office of Tax Simplification.

6.2.1. Commitment to improved consultation and greater transparency

Improved consultation is placed at the heart of establishing “a longer and more considered policy cycle”:

- Consultation on tax policy – the Government notes that there has been greater consultation on tax policy in recent years, and some notable successes. Going forward the Government commits itself to ensuring that all tax consultations are conducted to a high standard and will publish a statement on its approach to tax consultations later this year. Further, it notes that it will consult at each identifiable stage of the process for all tax changes, where proportionate and practical to do so, although only where revenue is not put at risk. However it commits to explaining why it does not consult in these cases.

- Consultation on tax legislation – the Government asks for views on a new convention akin to that put forward in an earlier report, which in practice would result in the vast majority of the Finance Bill being published, in draft, three months before formal publication. This is also aimed at enabling greater parliamentary scrutiny of tax legislation to improve it. There would be exceptions to this timeframe, including where changes to rates, allowances and thresholds were straightforward, and also in relation to revenue protection measures and areas where forestalling presents a significant risk.

To support effective scrutiny of tax policy and legislation, the Government states that it is also committed to greater transparency. As a general principle, the Government commits to providing more information on the underlying rationale for tax policy changes. It also commits to improving the evaluation of the impact and effectiveness of tax policy reforms after they have been implemented.
6.2.2. Stance on tax avoidance

The Government states that it is committed to tackling tax avoidance and that it will continue to take the necessary steps “to protect the Exchequer and maintain fairness in the tax system”.

However it also states that it will take a more ‘strategic’ approach and acknowledges that “the way in which tax avoidance has sometimes been tackled has contributed to instability and complexity”, particularly as a result of frequent announcements of legislative change and because “detailed anti-avoidance rules have contributed significantly to the complexity of the tax code”.

In addition to a commitment to finally revising the CFC rules and considering whether a GAAR would be appropriate (see Chapter 4), the areas the Government notes it will address include:

- Reviewing areas of the tax system in which repeated changes have been necessary to close loopholes.
- Looking critically at the need to announce legislative changes that take immediate effect.

6.3. Business Forum

In the June 2010 Budget it was also announced that a Business Forum would be established, to be chaired by the Exchequer Secretary to the Treasury, which would consult with multinational businesses on the UK’s tax competitiveness.

In a July speech, the Exchequer Secretary to the Treasury announced his chairmanship of the Business Forum and re-iterated many of the points made in the Budget documents. He also made a number of comments that are particularly relevant to repeat here in light of the comments made to us by the financial services interviewees.

In relation to the competitiveness of the UK tax regime the Chairman noted that it:

“has taken a dive over the last decade. For example, in 1997 the UK had the tenth lowest main rate of corporation tax among the current EU27 countries. But other countries have cut their corporation tax rates further and faster than we have. We have now slipped to twentieth.

Compared to Germany, our rate was nearly 24 percentage points lower in 1997, but is now less than two percentage points lower.

We need to show that Britain has an attractive tax system and is open for business.”

The Chairman noted that it was also necessary for the Government to have “the courage to put economics ahead of politics”:
“It’s often politically tempting to raise taxes on business, but in the long run good economics is good politics, as we reap the fruits of reform in the years that follow it.

This informs our approach in the Budget and particularly our approach to reforming business taxes. It might be the easier in the short term political choice to put up taxes on business rather than those that seem to hit closer to home, but we need to take decisions from which we see the rewards when we look back in 5 or 10 years time.”

In relation to tax avoidance he noted that:

“We are also discussing a general anti-avoidance rule and we are encouraging HMRC to take every possible step to clamp down on avoidance activity.”

Whilst in relation to creating future tax legislation the Chairman noted that:

“we really do want to get it right. We want to talk to all interested parties about how best to build a framework for making tax law that is:

- Not haphazard but predictable - based on a clear strategy which produces greater certainty about the future

- Not disorderly but stable - focusing on fewer, better developed proposals; getting legislation right first time through proper consultation and allowing time for better scrutiny

- Not opaque but transparent - explaining our rationale, sharing our analysis and assumptions.”

6.4. Interviews with HMT and HMRC

We met senior officials of HMT and HMRC as a part of this research project. We described the issues arising from our interviews with financial services firms and discussed these with the officials. We believe the following points summarise much of the discussion.

There was a recognition that some of the criticism might be fair, particularly as regards unpredictability of the tax regime over the past few years. There was a desire to improve in this respect, although it is clear that civil servants ultimately do not drive the agenda, ministers do. In this regard, it was stated that the new Government was much less “interventionist” than the old government, and business should therefore expect to see a more measured and predictable policy making process. There would probably be much less tinkering, and much less tax legislation. A desire was expressed to constructively engage with the City over tax, and to understand in depth issues and concerns and to seek acceptable solutions. The interviewees here felt that some of the statements made by our City interviewees about government intentions were simply incorrect, and that a better dialogue could temper some of these concerns.
An aspect of the discussions was a tendency to refer to political realities which limit the freedom of action of government in dealing with tax issues affecting financial services. There seemed to be an implicit feeling that the financial sector must simply accept these realities as an unavoidable constraint in the current environment. What was not fully recognised, perhaps, was the current depth of feeling in certain sectors of the financial services industry about taxation, and the damage that has been done.

In both case, the representatives were very forward-looking and emphasised the clear framework that the new Government had outlined for achieving substantive reform of the UK tax regime to improve the competitiveness of the UK economy.

6.5. Commentary of interviewees on the prospects for UK tax reform

During most of the interviews with financial services firm representatives some optimism was expressed as to the prospects for tangible improvements in the UK tax regime under the new Government.

The general change in tone around the importance of tax competitiveness that has been emanating from the new Government was acknowledged and the June 2010 Budget was broadly recognised as reflecting a step in the right direction.

However, there were a number of reservations including whether achieving meaningful simplicity in the overall legislation is possible ("a Herculean task"), whether the Government’s stated aim for the UK to be the most competitive in G20 was realistic. There was also concern over the continued strength of the references to tax avoidance in the Budget announcements and the significant deterioration in the personal tax regime from the City’s perspective.

There was also general concern as to how much real, positive change would be achievable in practice across the lifetime of a single Parliament, particularly in the prevailing political climate.

Despite this, there was a general hope that by setting out the issues that are of main concern to companies in the financial services sector in a clear manner, through proper consultation business would be able to help the new Government achieve its goal of a material improvement to the UK’s tax competitiveness.
7. IMPROVING UK TAX COMPETITIVENESS: RECOMMENDATIONS

On the basis of interviews across a broad range of financial services, the following issues are recommended as needing to be addressed if the UK is to maintain and improve its comparative attractiveness to international financial services as a place with a predictable, competitive and constructively applied taxation regime. Many of these are likely to be shared concerns with other international business sectors:

**Predictability.** Predictability and consistency are critically important features of a stable and attractive tax regime. The interview evidence is very supportive of the Government’s commitment to consultation and dialogue in the development of new taxation measures. Openness and dialogue foster industry buy-in to Government objectives, and are effective in mitigating against uncertainty. Respondents considered, furthermore, that:

- All areas of taxation policy development should be consulted upon, particularly anti-avoidance policy. This is a part of the regime that has greatly exacerbated unpredictability in the development and application of tax policy in recent years;

- Government should aim to develop tax policy within existing established frameworks and administrative structures so as to increase significantly the certainty of the entire tax regime.

**Attitude of tax authorities.** The interview evidence suggests that HMRC specialist technical groups can be sometimes unnecessarily adversarial and a number of respondents also noted the depletion of tax expertise and experience within HMRC, and strongly urged that both trends are reversed. However, the evidence also highlighted a clear success in the HMRC Large Business Service’s Customer Relationship Manager (CRM) programme. The CRMs are seen to be pragmatic, helpful and quick in resolving problems within their remit. It was considered that:

- HMRC should nurture and harness the success of these programmes, and reinforce this success by spreading the positive lessons throughout HMRC.

**Overall tax burden.** On this critical measure of competitiveness, the UK has fallen behind in recent years. Interviewees welcomed the commitment by the Government to restore, over time, the UK’s competitiveness in tax versus key competing locations. Respondents noted that:

- In future, impact assessments of new tax policy should include competitiveness as an explicit criterion;

- while the movement on the corporation tax rate was welcome, it is also important to recognise that personal taxation is a critical aspect of international competitiveness, and of the ability of the UK to attract the best international talent.

- Competitor jurisdictions are introducing special (favourable) tax measures in order to attract senior internationally mobile staff, and that this has eroded the
UK’s competitiveness. This needs to be taken into account as the UK develops its tax policy in the short and medium term.

Policy co-ordination. Respondents pointed to the need for greater efforts to be made to construct a coherent and consistent taxation regime, and also to create consistency between the tax and regulatory regime where appropriate. Respondents considered that:

- The remuneration proposals being developed by the FSA, and that flow from CRD3, do not fit easily in the international environment in which the industry works;
- The development of the Bank Payroll Tax appears to have little reference to the G20 and FSA’s remuneration treatment and approach on, for example, Long Term Incentive Plans;
- Firms are more sensitive to some taxes (particularly where an unfavourable international comparison is readily apparent) than others, and a taxation regime that recognised this would be welcomed;
- The recent and potential tax measures directed at the sector, especially banks, when taken together with the extensive regulatory changes in prospect, gives an appearance of insufficient fiscal and regulatory coordination. This is beginning to raise concerns about overloading the industry.

Contribution of the financial services sector to the UK economy. The debate which focuses on the financial services sector being “big” or “small” or “too big”, is simplistic and short-sighted. Financial services are completely interdependent with other parts of the economy, and the health of one is very much a function of the health of the other. This is one of the main lessons of the crisis, and the perspective from which respondents believe these sectoral issues should be viewed.
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