



Treasury Committee

Oral evidence: [Shifting Sands: An inquiry into UK tax policy and the tax base](#), HC 314

Tuesday 14 June 2016

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Members present: Andrew Tyrie (Chair); Mark Garnier, Stephen Hammond, George Kerevan, Chris Philp, Mr Jacob Rees-Mogg,

Questions 153 - 223

Examination of Witnesses

Witnesses: **Michael Devereux**, Director of the Oxford University Centre for Business Taxation, **Paul Morton**, Head of Group Tax, RELX Group, and **Steve Edge**, Tax Partner, Slaughter and May, gave evidence..

Q153 **Chair:** Thank you very much for coming to see us this morning; I am sorry that the start of the hearing has been somewhat delayed. We have a serious group of experts before us on a tricky subject which, while technical, is replete with a lot of tension and controversy out there and has been now for some years. I would like to start by asking a few questions about BEPS. Perhaps I could start with Mr Edge. What do you think the impact of BEPS is going to be? I will just ask that to start with, and then I will ask you something about what used to be called tax havens.

Steve Edge: Initially, when BEPS started, it could have been an excuse for all Governments facing difficult problems internationally—and inevitably there is a wrestling match between jurisdictions as they compete with each other commercially, and tax is part of that package—to kick the problem into the long grass and have the BEPS group reflect for five or 10 years, during which time the problem would have gone out of the very high public image that it had. That has not happened, and that is in large part a credit to the OECD team that worked on it and the Governments that supported it, but also, if you talk to the BEPS officials, due to the large amount of support they have had from business, the tax professions and the tax academics. That has meant BEPS has been a more successful project than it might have been.

Within some areas of BEPS, there have been some quite major successes. There is greater clarification on transfer pricing and a common position—although there is a debate on one-size-fits-all—as to how much interest individual jurisdictions should allow

multinational corporations to deduct. There has been agreement on transparency. It has been bedevilled a little by the fact that America has been a non-playing participant. There has been great uncertainty as to how much of BEPS the US would implement, and yet it has been a major player in the debate and, one might say, a major factor in the controversy that we have had with untaxed profits around the world—the Obama comments.

If you go back to what I see as the fundamental theme on BEPS, which is to try to make sure that profits are taxed where there is activity and that you cannot have pockets of profits in jurisdictions where there is no activity to support those profits, that is a good thing. There has certainly been a behavioural change. Overall, while I might have said quite cynically at the beginning that BEPS was bound to be a success because it had to be a success, in fact I think many parts of BEPS will be regarded as having been a success.

I have one small last point. Inevitably, there are areas where there will be turf battles. If you look at one aspect of BEPS in particular, which is the anti-hybrid rules on debt, there is a principle there that says, if you do not tax income—interest paid to jurisdiction B—we in jurisdiction A will not give relief for it. That gets you right back into the area that bedevils a lot of international taxation at present, which is one jurisdiction taxing someone else's profits. That has happened in the anti-hybrid area. It will be interesting to see what the reaction to that is.

Q154 Chair: We are into some quite technical stuff already, which we might come on to in more detail in a moment. Are tax havens a relic that we should be trying to clamp down on or do they confer any net welfare?

Steve Edge: I suppose you first of all have to define what a tax haven is. Is a tax haven a low-tax area where you might have business activity?

Chair: Let us define it as a neutral tax environment.

Steve Edge: Then I would say that, for jurisdictions that have lesser economic advantages—in that they do not have natural resources, are not geographically well placed or in terms of transport and communications—

Chair: We are talking about developing countries.

Steve Edge: Correct. They have to compete in the world to get business. The pressure other more developed jurisdictions might put on them by saying, “You must have high tax rates like we have. You must have a corporate tax rate of 20% or 30%”, strikes me as unhelpful and unrealistic. If you are offering a different package from a major European, Far Eastern or US jurisdiction, then you have to compete in some way. If you impose the same amount of tax but do not offer a package that competes with other jurisdictions, you just will not get the business.

There is a bit of a tendency, which we have seen in Europe and are seeing in the US at present, that jurisdictions that have a tax rate of less than 15% on corporate profits should be blacklisted in some way and dividends from those jurisdictions should be taxed, whereas dividends from jurisdictions that have higher rates should not be. That immediately impugns those places as places that are not carrying on proper business but are helping multinationals elsewhere to avoid tax.

I would say, coming back to BEPS, that the BEPS proposal, and lots of international tax regimes, should make sure that profits are taxed where they really arise, where they are generated by the activity carried on or by the ownership of assets. That should apply equally to developing jurisdictions, even if they have low tax rates.

Q155 Chair: Do you think that the Channel Islands, the Isle of Man, the Caymans and the Virgin Islands are arrangements that have had their day?

Steve Edge: For any arrangement where they are acting as a pure conduit and there is no substance there, yes, and they have had their day for a little while, because there have been lots of tax changes across the world. The US system is different. The US encourages the retention of profits offshore by its multinationals, so it does not look at profits in its subsidiaries in the same way that we do.

Q156 Chair: As a result of which, it gets less money in.

Steve Edge: Correct. Deferral has been a big issue over there. Here, we have a CFC regime that is sensible and says, if you do not have substantive support of foreign activity, those profits will be brought back to the UK. From that point of view, yes, they have had their day. But to the extent that these jurisdictions have bona fide businesses—the Channel Islands, for example, has quite a big asset management business with real people there doing real work—I think they will carry on having those businesses. They have found their place in the world economy, as have places like Luxembourg.

Q157 Chair: Why is it that the world economy needs them?

Steve Edge: That comes back to your comment about tax neutrality. If you are trying to set up an investment fund, for example, that is attractive to people throughout the world—I do not do a huge amount of work in this area, but I used to at one point—then you want to make sure that you have, in your phrase, a tax-neutral jurisdiction, so you can say to investors, “Come and invest in this company. When we pay dividends to you or distribute the profits, you will pay tax in your home jurisdiction, but you will not pay tax more than once.” It is about avoiding double taxation. That has generally been the basis on which they have built up their investment fund business, to try to create an environment under which retail investors in the UK, for example, can pay the same amount of tax investing in an international fund as they would have if they had invested in a domestic fund.

Q158 Chair: Mr Morton, have you seen this article in the *FT* today by Sarah Gordon about tax heading the list of worries for FTSE 100 companies? Among the concerns expressed is one about the new international rules on base arrangements.

Paul Morton: I have, yes.

Q159 Chair: I just wanted to make sure you had seen it before I asked the question. It strikes me that, if many of these companies are listing this as a major worry, it tells us that they think there may be some tax loopholes they are taking advantage of at the moment that are going to be closed down by BEPS. Is that not telling us there is some uncollected tax?

Paul Morton: Yes. May I begin by saying that all my comments are made as a member of the CBI and the 100 Group tax committee, so I am trying to convey a sense of tax directors across a broad range of British companies? Perhaps I could begin by saying that the view I perceive is that the BEPS project so far has been very successful. One could hardly have expected the OECD to have produced so much, so quickly, in two years, with so much consensus reflected in the final reports, which were published last October. It was a reflection of political consensus that something needed to be done but also, in my opinion, a remarkable degree of consensus among the administrators and policymakers who were present at the OECD and the OECD secretariat itself. The fact that they invited many other countries, non-OECD members, to join the debate on an equal footing has added weight to the recommendations the OECD has published.

Everything, however, contained in the reports of the actions under the BEPS plan is no more than a recommendation, a best practice, a minimum standard or a call to engage in negotiations on multilateral instruments. In a sense, the beginning is now behind us, but the hard part, which is the implementation of the BEPS proposals, mostly lies ahead. There will be an even greater need for consensus and consistency as countries implement, within their own domestic tax systems, measures that reflect the BEPS conclusions.

To answer the question about the report this morning, it is uncertain at this point how the BEPS recommendations will be implemented country by country—although some have been implemented either fully or partly already, most have not. Companies are looking at the recommendations in the BEPS proposal and forming a view at this point as to how they may or may not be impacted. We are seeing reflections of that in companies' statements on risk and in their financial statements. It is very early days, but, if there is a consistent theme apparent in the financial statements that companies feel there will be more tax to pay, then I would say that the BEPS process has been successful in its objectives.

Q160 Chair: After all, we are not talking here about changing the law to make tax rules stiffer. We are talking about collecting the tax under existing law for the most part. Therefore, this must be tax that they are currently avoiding.

Paul Morton: Well, I am very confident that, as far as the larger corporates are concerned, the tax collected has been the correct amount of tax collectable under existing law. The BEPS process has developed new standards and applications, particularly in the

areas of transfer pricing and financing. Applying those new standards and changing the law appropriately is what will result in a slightly increased corporate tax take.

Q161 Chair: I have one last question, on the digital economy. It has been drawn to my attention that no specific action on the digital economy is intended to be taken, but the OECD has left it open for countries to act unilaterally, as I understand it. Is that the right way to go for something as important as the digital economy, given its long-term scope as a source of yield?

Paul Morton: The OECD established a digital economy taskforce, chaired by the US and France. The quality of their analysis and thinking was excellent. The report itself is thoughtful and very comprehensive, and includes a survey at a business level of the digital economy. They concluded in particular that the digital economy cannot be compartmentalised, but it is everywhere and all business is part of the digital economy. Whatever rules are developed to address the digital economy, they need to apply to all businesses.

The conclusion reached by the taskforce was that the other BEPS action items would probably be sufficient to address the problem of BEPS. Therefore, the specific digital economy actions proposed by some were not ready for implementation; nor was it necessary to implement them at this time. However, some countries have decided that they will proceed with implementation, and they rely on the referenced description of the proposals in the action 1 report as a sufficient basis to proceed with their own legislation. For example, many countries are looking to increase the scope of their consumption taxes to tax inbound digital services, even in cases where the provider of the service has no local presence. One or two countries are beginning to look at ways of taxing profits of a company, even when, again, the company has no local presence, either through some form of withholding tax or, in the case of the Indian equalisation levy that has been introduced, a 6% levy on the price paid on certain implemented digital services.

I will conclude very briefly by saying that there are considerable challenges lying ahead here, because unco-ordinated actions to tax profits from digital businesses are quite likely to result in some degree of double taxation. Unless a consensus approach results in a reduction of the tax base in the jurisdiction from which the service is being provided, the additional tax is simply an extra layer of tax imposed on a digital business.

Chair: Can I just say that it is so refreshing to have witnesses before us who are trying to answer questions? We do not always get that—thank you very much. I know that Michael Devereux has not been given a chance, and he may buck the trend, but we will see. I am sure Chris will bring him in.

Q162 Chris Philp: Perhaps I can start with Michael Devereux. Good morning and welcome. I would like to start with country-by-country reporting, which of course, as part of the BEPS process, is mandatory to tax authorities but not in public, whereas, in April this year, the EU Commission proposed public country-by-country reporting for multinationals. Can you clarify, for the Committee's benefit, the test for which companies that applies to and which portion of their profits and turnover will fall into the public disclosure rules?

Michael Devereux: I am not sure I can give you the precise details. This is the EU proposal you are talking about.

Chris Philp: Yes, the EU one. The public reporting, not the reporting to the tax authorities.

Michael Devereux: My recollection is that it was for companies with a turnover of €750 million. I would need to check that and get back to you, to be precise on the rules.

Q163 Chris Philp: For the Committee's benefit, is it a test on turnover in the EU or a test on where a particular entity is domiciled?

Steve Edge: I am not sure that many of us have taken the EU proposals so seriously at present, because there is quite considerable doubt as to whether they will come in.

Chair: Could you just say that again? I missed it.

Steve Edge: There is some considerable doubt as to the form in which the EU proposal will come in. We get mixed messages as to exactly what will happen on that and whether that is a final proposal or not.

Q164 Chris Philp: You put a question mark over whether these proposals may indeed be implemented at all.

Steve Edge: The public side of it, yes. If I can go on to the benefits of public disclosure, I looked at what the Commission said, which was based on the public having a right to know. Of course, the approach taken through BEPS has been that people should disclose the information to the tax authorities. If you pick up Paul's point about uniform disclosure, it would seem to be a very bad idea if companies operating within the EU put on public display information about their business and the profits they were making on their business, but their competitors in other parts of the world were not subject to that discipline. The tax authorities would get the information anyway; they would be able to follow up with any questions. If you were giving your competitors information about your business that they could use to their advantage, that would not be a good thing from the point of view of the developed jurisdictions within the EU.

If you are trying to make transparency effective, you have to consider how information should be disclosed in order to make the collection of taxes most effective. For me, at present, either everybody does it across the world on the same basis, in which case that is fine; or, if it is within the EU, then I would say, if across the world the BEPS results in it being given to tax authorities, which in my view should be enough, then that would be sufficient.

Q165 Chris Philp: You make the point that, if the EU acted on its own in requiring public disclosure, that might place companies incorporated in the EU at a disadvantage compared with companies incorporated elsewhere. If the test for public disclosure were to be not where a company happened to be incorporated, but whether it, for example, had sales in the EU, or indeed in the UK, of over a certain significant threshold—for example,

€100 million per company—is it not the case that that would not confer a disadvantage? Google, for example, might not be incorporated in the EU, it might simply sell into the EU, but it would be required to make a public disclosure. That would then avoid this problem of creating a disadvantage to EU-incorporated companies, would it not, Mr Devereux?

Michael Devereux: Yes. In my understanding, that was the proposal: any company with a significant operation in the EU would be required to publically disclose this information.

Q166 Chris Philp: Operation or sales?

Michael Devereux: Sales, I believe.

Q167 Chris Philp: Even if it was incorporated elsewhere?

Michael Devereux: Yes.

Q168 Chris Philp: That would then avoid this problem you are highlighting.

Steve Edge: I am not sure. It depends on the relative size of EU sales to rest of the world sales, because of course many of our multinational companies here compete globally, and you may well have a company that does not have such a significant proportion of EU sales but is very interested in how well its competitors are performing in the EU market or elsewhere. I do not think it necessarily stops the problem.

Michael Devereux: It would reduce the problem but not solve it. I would agree.

Q169 Chris Philp: The only remedy that the company would have would be to not sell into the EU, which would have quite a dramatic effect. Would you not agree that disclosure to tax authorities goes so far; it helps the tax authorities, but it does not help the public debate? There is a lack of confidence and a lack of understanding among the wider public about whether multinationals pay appropriate tax. This very transparent public disclosure, country by country, of a large multinational's tax affairs—for the larger companies, not for all companies—would aid public understanding and improve the quality of the public debate on these topics.

Take, for example, the Google settlement, the £130 million. People have made various assertions about that, but, in the absence of a full disclosure of how Google's tax works globally, it is impossible to reach a view as to whether it is a reasonable deal or not. Therefore, it is very hard for the system to command public confidence.

Michael Devereux: There is a clearly a problem of public confidence, and I would not object to data being provided to the general public as a matter of principle. Whether it could achieve what you would like it to achieve, which is that the public have some reassurance that the right amount of tax is being paid, is another thing altogether. If you

take the Google example, Google paid £130 million of tax. The amount of information that would be needed in order for a member of the public to look through that and decide for themselves if that was either appropriate or not appropriate is really phenomenal. They would need a great deal of information on that. Simply a spreadsheet showing, “This is the profit we made in the UK and this is the profit we made in France” would not be sufficient for that.

I am not against the general disclosure per se, but I really do not think it would give you that much more information about whether companies are paying the amount of tax they ought to be paying.

Q170 Chris Philp: Since you mentioned Google as an example, let me come on to the question of permanent establishment and taxable activity. If I understand it correctly, the reason Google was able to pay so little UK tax was that it essentially claims not to have a UK permanent establishment, notwithstanding the fact it employs something like 3,000 very highly paid people near King’s Cross. It manages to get its European profits, via Ireland, into the BVI or Cayman—I forget which, but it is one of those two—which it claims is the repository of its intellectual property. Both of those claims appear to confound common sense. First of all, would you agree with that common-sense analysis? Probably not, because clearly tax experts have taken a different view. Do you think the BEPS process will change either of the two issues that I referred to specifically?

Steve Edge: I do not really want to comment specifically on Google’s position, because I do not know anything about it and I think it is wrong to comment; as Michael said, without knowing more about the fact pattern, you do not know. The permanent establishment question has been a big issue in the banking sector for many years, because banks that operate globally and are doing deals with global customers will have different parts of their organisations making a contribution to a particular transaction. Then they have the issue of having to agree, so a deal might be brokered in New York, negotiated in London and booked in Tokyo, just depending on what sort of transaction it is. Each part of the bank, in that rather selfless way that bankers have, will want a share of the profit from that, from a personal remuneration point of view. Also, the tax authorities in each jurisdiction will want to do that.

Having a regime that says, “Well, that is the place where we are going to tax all those profits”—the permanent establishment question—so, in my example, you concluded this transaction in Tokyo, so we are going to tax all the profits there, is wrong, because the deal actually started off in New York. There was a customer relationship in New York, and the guys in London have done the deal. The tax system, in order to be fair to the different jurisdictions involved, which are bearing the costs of the people working in London and in New York, needs to apportion those profits. You do not necessarily need to cross the magic Rubicon point of having a permanent establishment to reflect that. In my example, there will be people in New York and in London who have made a contribution to the global bank’s profits in doing that, and the company that employs them should be remunerated for the contribution it has made.

Again, I do not know what Google’s fact pattern is. If you have a number of people in the UK who are being employed and are facilitating transactions that the parent company in the group, maybe in the States, maybe in Ireland, is entering into, the current

tax system allows you, without a permanent establishment, to recognise the profit that has been generated for the group by that company, and the transfer pricing rules should impute a fee to that company to capture that profit, so I do not see the permanent establishment point as being as important as has been represented.

On your point of whether BEPS will change that, BEPS is going to change some things. It is going to change the definition of an establishment in action 7. It will change some of that. But if you go back to my point about what BEPS is all about, it is all about trying to make sure that profits are taxed where they are generated, and that can be done with or without a permanent establishment.

Michael Devereux: Can I put that into a broader context? Steve has given an example of a complicated multinational company. The existing system asks questions like, “Is there a permanent establishment in this place or this other place?” There are different ways of taxing the company depending on whether there is or not. The broader question is, “Where should this company be taxed?” If you ask the question of Google or any other company, it is very difficult, within the international tax system as it stands—and as it will be, even after the BEPS modifications of it—to answer that question. The OECD has, as Steve says, tried to focus attention on trying to tax profits where they are made, but there is no real answer to that question. Profits are made everywhere. They are made where the shareholders do the investment, where the head office is, where the R&D is done, where the sales are made, where the salespeople are. To allocate them across all those places is really very difficult.

I would say it is the fundamental problem of the international tax system that we really do not know what the answer to that question is, even conceptually. Playing about on the edges with the definition of the permanent establishment rules is not going to get us very far.

Chris Philp: I think my colleague George Kerevan is going to be asking you about some of your more radical ideas later on in the session.

Paul Morton: I have a quick comment on the permanent establishment rules. The BEPS programme has made a very big change in widening the definition of permanent establishment. We need to be thoughtful that there is both an inbound and an outbound aspect to that. Whereas the new definition will capture more inbound business than may have been the case in the past, we have in Britain many multinationals that export all kinds of services, including digital services. To the extent that other countries broaden their definition of permanent establishment, we will see profits that were previously taxed in the UK being taxed in a very large number of countries, which, quite apart from the administrative aspect of having multiple potential claims for profits from the same activity, will potentially result in double taxation. Countries, as they approach the consensus building on permanent establishment, need to be quite thoughtful.

Q171 **Chris Philp:** Bearing in mind what you have said about the UK’s knowledge-based economy—pharmaceuticals and software are two particular sectors that might be affected by this—do you think the UK Exchequer is likely to be a net beneficiary or a net loser from the widening definition that you are describing?

Paul Morton: That is a very interesting question. I certainly do not know the answer to that. I do not know whether anyone knows the answer to that at this time.

Q172 Chris Philp: On the question of the current system, is it not the case that multinationals are abusing the permanent establishment and transfer pricing rules—the ultimate test is economic activity, if I understand it correctly—to game the system and make out that their economic activity is occurring in low-tax jurisdictions, by a combination of claiming not to have a permanent establishment in markets like the UK and, to the extent they do, using transfer pricing to shift the profits into low-tax jurisdictions? In the Google case, it claims all its IP, and therefore most of its economic activity, is in the Cayman Islands. In other cases, it uses transfer pricing in relation to royalties, to ship profit out to Luxembourg or Switzerland. Fundamentally, even if you accept the principles of the current system, are those principles not being abused, misapplied and not appropriately policed by HMRC?

Michael Devereux: If you take the principles as given, suppose there is research and development done in country A, and that is effectively generating profits in country B; it seems reasonable that a royalty should be paid back to the people who created that intellectual property in country A.

Q173 Chris Philp: Yes, but Google's IP was not created in the Cayman Islands; it was created in California.

Michael Devereux: Right. However, if the IP is created in California but it turns up and is taxed somewhere else, the problem is: how did this IP shift? Then you have to look at the more detailed elements of the tax system to see how IP gets shifted around and ends up in a low-tax jurisdiction. That is the weakness of the system, in a way. The general principle is fine, but it is not working in those cases.

Q174 Chris Philp: Country-by-country reporting would shine a light very directly on that sort of shifting. This is my final question; I can feel the Chairman's laser-like gaze. I referred to HMRC. People I have spoken to in the industry have a low regard for the capability of the people employed at HMRC. The brightest and the best probably end up in private practice, either in accounting firms or in the tax practices of firms like Slaughter and May, being paid significant amounts of money. It has been suggested to me that the multinationals advised by the magic circle firms or the big four firms run circles around their counterparts at HMRC. In your experience, is that the case? Is HMRC being outgunned? I am not sure I can rely on you to answer, Steve. Perhaps Paul and Michael will comment.

Steve Edge: That is fine. I will follow them.

Paul Morton: We see very talented people at senior levels in HMRC and, indeed, engage them on all kinds of issues very effectively. I am personally very impressed with the people I meet in HMRC at the senior levels. At the junior level, as with people who work at the junior level in commerce and industry, there is a need to understand how business works, how industry works, and the more we can do to share that perspective and

enable people to have experience of how large businesses operate, the more effective they will be in the work they have to do.

Michael Devereux: I do not have direct evidence of how these kinds of deals work. I would say that there is a tendency in the public debate, where people think the amount of tax collected is too low, to blame HMRC. In many cases, that is unfair. I broadly agree with what Paul has said.

Q175 Chris Philp: Mr Edge, honestly speaking, if you are negotiating on behalf of a multinational client with your opposite number at HMRC, is it a conversation of equals?

Chair: This really is your last question.

Chris Philp: Are they your match?

Steve Edge: Yes, very much so. Be sceptical if you want to.

Chair: Are you doing yourself justice there?

Steve Edge: Yes, I am. I think the Revenue does a good job. I used to say at one point that it was starting off in a difficult situation, because at the end of the day you are trying to work out where a profit is generated and the value of the intangible assets. People within companies know that, because they are doing commercial deals all the time. To get a big commercial merger, people know what the value of their assets is and whether their people are adding value. Within companies, they have a lot of information. They are therefore the ultimate insiders on their own business, in the same way as if they were negotiating with a commercial counterpart. At one stage, I would have said yes, they had that advantage over the Revenue.

I personally think the Revenue does a very good job. The governance process, which has been changed after the National Audit Office report and the Public Accounts Committee hearings, means that the revenue officials have far more frightening people to deal with than me, and that is their internal governance. They have to take whatever they agree with me through their internal processes and make sure their senior management understands it and agrees it, knowing that the public are standing on their shoulders. Personally, I think the Revenue does a good job and it has a lot of respect. Actually, the most important thing in this country is not that we have a competitive tax system, but that it is also properly and sensibly administered. The Revenue does a good job for the UK in that respect.

Q176 Chair: Is it the view of all three of you—challenge this or qualify it in any way you want to—that there is a gap between the way Parliament and the public are perceiving HMRC and the way those who are dealing with it on a professional basis perceive it; that gap being that we think, or it is said that a number in Parliament think, that it is not doing its job as well as it should, whereas you are basically saying it is doing its job and doing it as well as it should?

Steve Edge: In the business tax area, which is the area I am speaking to, it is doing its job.

Q177 Chair: No challenge to that at all. That is very significant. We always have to look at where people are coming from in all this, but even so.

Steve Edge: I can accept that. I live here and work here, and my primary interest is in the UK economy working well.

Paul Morton: Perhaps I could add that we deal with tax administrations all over the world and one of the most professional is HMRC.

Chair: Yes, that is an interesting comparison.

Steve Edge: Particularly—and we will come on to this, I know—in the transfer pricing area, if you are involved in international transfer pricing disputes, what the UK Revenue has concluded, despite what we read in the papers from the French about Google, for example, usually carries quite a lot of clout because it is respected for having done a good job and come to an objective conclusion.

Q178 Mark Garnier: Mr Edge, can I carry on with some of the questioning that you were having with the Chairman a bit earlier about offshore tax havens? I have an incredibly simple question, which you have possibly answered. Do you accept the allegation that tax havens serve absolutely no useful purpose whatsoever?

Steve Edge: Again, it depends—tax haven or low-tax area. There are advantages, in global terms, in having a place where you can set up a company that is tax-neutral; in other words, it does not result in intermediate taxation on income that is going to be taxed somewhere eventually. I see that, as I said, in the investment management area, which is not an area I deal a huge amount in, but I read the papers and I see what people say. In the business tax area, I do not think tax havens perform any significant role for multinationals, apart from the US, which has a very different tax regime at present and you could say is part of the current problem. From a UK company point of view, I would not see them having a great use for a tax haven jurisdiction that has nothing in it.

Q179 Mark Garnier: I might divide up the use of tax havens into two or three different uses. Take the first one, which is the investment management industry. Just to be absolutely clear about this, the investment management industry creates funds that are based in tax havens so as not to incur yet another level of taxation.

Steve Edge: Correct.

Q180 Mark Garnier: What would happen if those funds were domiciled in the UK? Why can an asset manager not domicile it in the UK? Is it because it would incur corporation tax?

Steve Edge: Not necessarily. They could be based here. But from an international point of view, you would have to persuade people that, having been used to investing in internationally based vehicles over the years, they were as happy to take the risk that the UK might change its regime at some point in the future. Yes, you could be subject to corporation tax or income tax within the vehicle—not always. We have a very successful hedge fund management business in the UK, which operates under the existing investment manager exemption arrangements, so we encourage some activity here as well.

Q181 Mark Garnier: On that particular point, to declare an interest, I used to run a hedge fund myself and we used some of these arrangements, but they were obviously completely declared. That is the key point, which I think people find quite offensive. If you are a UK-based hedge fund manager, you are paying UK taxes on the income you are generating.

Steve Edge: Correct.

Mark Garnier: But you are contracted to run a fund that could be domiciled in the Cayman Islands, the British Virgin Islands or indeed now Dublin, which is the new one. The reason you have that fund there is because that is the most internationally attractive level. Therefore, the product that is being run by a UK-based asset manager is now desirable to the widest possible range of international investors. You are nodding.

Steve Edge: I am, yes. It is not a big area of practice for me personally and has not been for many years, but what you have said is correct.

Q182 Mark Garnier: The key point here—and I think this is where the general public get slightly confused—is that, if you are an investor in these funds, clearly you can hopefully make profits, because our UK hedge fund managers are good at their jobs, but it is up to you to declare that taxable benefit that you have gained. Again, you are nodding, for the record. Where the problem would arise is if somebody then chooses not to. Let us say you have a US investor who decides they do not want to declare this. Therefore, that person is now guilty of tax evasion in their own domicile. Similarly, if a person in the UK owned a hedge fund investment based in the British Virgin Islands and they did not declare it, they would then be guilty of tax evasion and all the force of the law would come down on them.

Steve Edge: Indeed.

Q183 Mark Garnier: It strikes me that the key thing that people find offensive, when it comes to the investment management industry, is the disclosure of who owns it. Could you describe the disclosure arrangements when it comes to the investment management industry; I know it applies to different areas, but in the loosest possible terms?

Steve Edge: Sorry, you are in an area that I am really not an expert on.

Mark Garnier: Is anybody else?

Steve Edge: I do not think we are, unfortunately.

Mark Garnier: But in your experience?

Steve Edge: The funds will vary and the obligations will vary. At the end of the day, the real obligation is on the individual who has received the money to put it on their tax return. If you then have a fund that has an obligation to register with the UK Revenue, for example as a distributed fund, and that gives information to the Revenue, that is great. But there are going to be lots of offshore funds that are not in that area, in which case you are relying on the basic honesty of the citizen to do what they should do, which is to return their income. We would all frown on jurisdictions that are established and are in business to try to launder or to assist people to not make disclosures of their own tax affairs. At the end of the day, no system is going to be total proof against outright dishonesty.

Q184 **Mark Garnier:** Not even the British system. That is very helpful. The Irish, of course, have now created this tax-free status, and that seems to be doing very well.

Steve Edge: Yes, exactly.

Mark Garnier: International investors do not seem to be worried about this. Do they have any disclosure requirements there? No? None of you are aware of them—that is very helpful.

Steve Edge: You can clearly, under the cloak of BEPS or international co-operation, introduce rules that would do that. The US FATCA regime goes, in part, down that road.

Q185 **Mark Garnier:** That is very helpful. When it comes to corporates, again, you suggested that there was no real reason why any corporate would want to use a tax haven. Do you want to expand on that?

Steve Edge: Not particularly. If somebody came to a UK-based multinational and said, “Here is a great opportunity. There is a tax haven here. You can put the ownership of some intellectual property in that jurisdiction, take lots of income from it and not pay tax on it”, the response from clients I deal with and from the corporate world in the UK—things have changed—would be, “First, we do not do that. That is aggressive tax avoidance and we do not do it. Secondly, by the way, it would not work.” If, in that jurisdiction, all we have is the husk of a company with no one there managing that asset, from a UK point of view, the UK Revenue would say, “Well, that asset cannot be being managed on its own. It must be being managed by somebody. Somebody is deciding what

licences for the IP get entered into, what risks need to be protected in relation to the IP. Where are those people?”

You follow the line to the people who are really managing the asset, and that might then come back to a permanent establishment question or to a straight transfer pricing question. Those guys, who are located maybe in the UK, maybe in Switzerland, maybe back in the US or somewhere else, are the people who are really generating those profits. You would then attribute the profits in the tax haven, where there is no one, to the jurisdiction where the activity has been carried out, so it would be a waste of time. Our transfer pricing and CFC rules would pick that up and say, “That is not good offshore income that should escape the UK tax net.”

Q186 Mark Garnier: Is there not a practical sense to this? If you are parking your profits on this intellectual property in a tax haven—forget the rules for a moment—what good is that to anybody within the company? I can understand how you can start lending it within the company, but is it not ultimately the case that, notwithstanding using that money to buy back shares, assuming it is a listed company, and thereby enhancing your earnings per share, if you come to a position where the company winds up, then the tax would be paid? It is not necessarily a tax avoidance; it is a tax deferral, to an extent.

Steve Edge: That may be true. People used to focus very much on earnings per share, which is an after-tax number, and still do. Coming back to the Chairman’s question earlier about the outcome of BEPS, particularly with US-driven changes—because an awful lot of UK multinationals invest in the US—BEPS might well result in effective tax rates for UK companies increasing. As long as that happens across the world, that is fine.

From a UK point of view, you do not want—this is why our competitive tax regime was introduced, really from 2010 onwards, although the territorial regime had come in before then—to have a situation where it is in the interests of, for example, a US multinational, which needs not to pay tax on the cash that it has offshore and can only not pay tax if it reinvests it, to come and buy a British company, one of our national champions, because it can look at the UK tax system that that company is subject to at present and say, “I can do a better effective tax rate for those profits.” Then the UK loses a major company and another jurisdiction picks it up. Tax rates as between competitors in the same sort of business are important. That is why the competitive tax regime that we have had in place in the UK has been so important.

Q187 Mark Garnier: Getting back to tax havens, I have a final point. You mentioned having a regime in a tax haven that deliberately allows people to hide money, so it becomes very secretive. I think we would all agree that is quite an offensive way of running a tax business. Assuming that tax havens are moving towards a full disclosure-type system, is it conceptually a good idea that we still have these tax havens? It allows them to compete against each other, but, nonetheless, is it a virtuous thing to have? It is trusted by investors the world over. As long as you know what people are doing and you make sure that you do not create a situation where people can avoid or evade tax, why not let them carry on? Does anybody have any thoughts about that?

Michael Devereux: I would generally agree with that, in the sense that, if a tax haven wants to have this particular tax regime, then that is its choice, in effect. The issue for a country like the UK would be to say, if we are worried about our own tax base disappearing into a tax haven, then we should look to our own tax rules and have tax rules that would prevent it from disappearing into the tax haven. I would not blame the tax haven; I would not set up sanctions against the tax haven. I would look to our own tax system to solve any problems that we might perceive to be there.

Q188 Mark Garnier: Finally, on looking after our Crown dependencies and overseas territories, if you are the British Virgin Islands, the Turks and Caicos or wherever, what would you do economically if you were not providing offshore financial services? These territories do not have much to offer apart from a bit of fishing and perhaps a piña colada on the beach, which is not exactly going to make up for a substantial industry. What would they do?

Steve Edge: They have to decide what their offering is, beyond tourism and whatever natural resources they have. Clearly, in the current world, they will not be able to operate on the basis of being a jurisdiction where people will not care where the money comes from or how it gets invested. If I were in charge of finance in a jurisdiction like that, I would want to be part of the new world, but to have my position accepted that I will not be able to get people to go and do business there, given what else I can offer, unless I have an even more competitive tax rate than the UK or other places have.

Q189 Mark Garnier: The key thing I extract from that answer is that there is a financial or economic incentive for all these tax havens to bring themselves into line with the popular opinion of the rest of the world, in order for them to survive.

Steve Edge: I would say so.

Mark Garnier: Does anybody disagree with that? No? Fair enough.

Q190 Stephen Hammond: Good morning, gentlemen. Could we turn to the document produced by the Government in March this year, the *UK Business Tax Road Map*? In particular, it sets out the Chancellor's strategy for business taxation out to 2020. The Committee would be quite interested to hear your initial observations on where you see the strengths and weaknesses of that document.

Steve Edge: We had not been told we were going to be asked about that document, although I do remember looking at it at the time when it came out. It is difficult to say on the individual strengths and weaknesses. The UK comes under some criticism in the rest of the world, particularly in the US. We have had a lot of companies leaving the US and coming to the UK, in just the same way that in 2007 and 2008, before we changed our rules, we had companies leaving the UK quite publicly. The US criticises us for being, as it describes us, "a tax haven", which is clearly wrong. It thinks we have put out a tax regime that is intended to attract companies to leave the US.

That is not true. The regime we have was intended, when it was first launched in 2010—and the road map has come out this year—to make the UK an attractive place to do business, in order to keep our UK multinational companies and make them less vulnerable to takeover. As I explained earlier, if you have a more penal regime in the UK, particularly on the taxation of profits in offshore subsidiaries, then foreign companies will look at UK companies and say, “I can buy them and I can make more money after tax, just by restructuring the group.” That is clearly a bad situation for the UK to be in.

We also want people who come to the UK to feel that, if they invest in a business here—and we have had some successes in manufacturing and other areas over the years, particularly the motor industry—we are using the tax rate to say to them, “Bring your successful businesses to the UK, and we will not tax the profits you make here at a very high rate internationally. We will take a reasonable amount of tax for the facilities used.” That is a good thing, it seems to me. The road we are on at present, recognising that the UK is a very open jurisdiction and people can come and go, as European rules require, is a good one.

Michael Devereux: It seems to me—and the Government acknowledge this, I think—that there is a twin aim. One is to be competitive along the lines Steve has been talking about, and the other is effectively to make sure businesses pay the right amount of tax—the anti-avoidance agenda. The difficulty for the Government now, in the past and in the future, is the balance between those two. If we take an example of their recent proposals for restricting interest relief, which is part of the BEPS process as well, the Government have made a quite dramatic shift of emphasis from the previous coalition Government. The previous coalition Government emphasised the fact that we had relatively little restriction on interest relief, and that was part of the competitive agenda. Now the Government are very much focused on the other side of that, saying that businesses are using interest relief to avoid tax, and we need to restrict that.

There is not much argument being made by the Government as to why they have switched from one to the other, or indeed what the optimal position for the country is, but this particular tension is always going to be present, really, given the way that the tax system is at the moment.

Q191 Stephen Hammond: That leads neatly into where I was going to go with the next set of questions. If you look at what has been laid out in this document, it is effectively about maintaining the tax base by ensuring that people pay their tax. There is an argument being put forward that the tension at the moment is towards competitiveness rather than maintaining the tax base, and that the measures outlined will not actually maintain the tax base.

Michael Devereux: In a way, it is hard to say where the balance point is. On the one hand, the Government are aggressively reducing the corporation tax rate. We now have the lowest rate in the G20 and it is still going down. On the other hand, we are introducing more and more measures against avoidance: the interest restrictions, the diverted profits tax. In a way, we are going in both directions simultaneously, and that is why it is hard to see where the balance is really lying at the moment.

Q192 Stephen Hammond: Is there a Laffer curve for corporate taxation, as there is for personal taxation?

Michael Devereux: Not on this particular issue, I do not think, no. There is certainly a Laffer curve in the sense that, if you increase the tax rate, that will have an effect on revenue. There is going to be a revenue-maximising tax rate, which is essentially what the Laffer curve was. I am not sure that helps us very much, in terms of identifying the strategies that the Government should use at the moment.

Q193 Stephen Hammond: You have some caution of the argument that runs: if there were a very low rate of corporation tax, there would be no need for reliefs to be exploited, and people would not try to.

Michael Devereux: If the rate comes down low enough, there is not much point in avoiding the tax; that is true. 17% is still 17%.

Q194 Stephen Hammond: Do you have any idea what that rate might be?

Michael Devereux: No, it is hard to say. It is all relative to the tax rate you may pay in other countries. We are still above Ireland, with a 12.5% rate; we are still above jurisdictions with even lower tax rates; but, by and large, we are a long way below most other countries that are like the UK.

Steve Edge: Say, for example, you are a large UK multinational investing in the US. As Michael said, in terms of expectations in 2010, we did say that this was one of the attractions of the UK. That was a decision reached quite reluctantly at the time, but it is quite clear that, if you are in the UK and you have a rate now south of 20%, but the US has a rate of 35%, and you are trying to decide where you should put your debt and claim interest relief, the UK wins hands down.

Paul Morton: I might add that businesses welcomed the corporate tax reform road map, and that of the previous Government as well. We have seen the evidence, in that, as Steve has said, when companies are considering where to locate activities, people and functions, the UK would be very high on the list. As we discussed earlier, tax is only one of many considerations for companies, and probably a secondary one at that. There is no doubt, though, that we are seeing the effect of having a very attractive UK regime and a conversation among multinationals around the decision making on where functions should be located. That is very good.

One also hears abroad some concern and confusion about the messages from the UK. On the one hand, Britain is very clearly open for business. On the other hand, the anti-avoidance legislation Mike was describing, the diverted profits tax, conveys a certain message, which creates a little confusion. In my view, it will probably dampen the enthusiasm, which would otherwise be very great, for transferring business into the UK.

Q195 Stephen Hammond: Broadly speaking, I am hearing from all three of you that while there is an argument that by reducing to 17.5% we are leading a race to the bottom, actually you are saying we are leading a race to being a more competitive economy.

Steve Edge: Correct.

Q196 Stephen Hammond: I want to pick up two other points from this document, and I recognise that you may not have known we were going to ask these questions. You obviously will have seen the section on simplifying and modernising the tax regime. Do you think that lacks ambition?

Paul Morton: I might make a very short comment on simplifying at least the corporate tax regime. In my opinion, the corporate tax regime is a reflection of the business world on which it sits. The business world is extremely complex, and the patterns of transactions within and between multinationals are tremendously complex. It does not surprise me that an international corporate tax system, which is as consistent and clear as it can be, is as complex as it is. While it is not desirable that it is so complex, I think it is understandable.

Michael Devereux: I take that point. I think the complexity arises because Governments on the whole have no clear idea of what it is they are trying to tax, or where they are trying to tax, and we have a number of different rules. We tax some forms of income in one place, and other forms of income, which are very similar to them, in another place. Then we spend a lot of time trying to mark that boundary between the two, to make sure the two kinds of income are taxed in the different places. Those kinds of complications in the tax system arise from a lack of understanding of the principle of what it is we are trying to tax and where we are trying to tax it.

Q197 Mr Rees-Mogg: Good morning, gentlemen. First of all, really following on from Mr Garnier's questions, may I make reference to my declaration of interests? I am chairman and partner in an investment management company, which has funds with a variety of domiciles.

What I want to come on to, actually, is the fundamental of corporation tax. Mr Devereux, perhaps you could answer first. It has been falling as a percentage of overall tax yield. Is it worthwhile retaining or would it be better to move away from the concept of corporation tax?

Michael Devereux: That is a good question. In the short run, we still raise quite a lot of revenue in the UK—£40 billion or so. That money would have to be replaced by something. If we take a step back from the short run and ask the question, “Is there a good reason for collecting this proportion of the tax revenue—8% to 10%—from corporation tax?”, it is not clear that there is a good answer. This comes back to the principles we were talking about a moment ago.

We could say, on the one hand, that corporation tax is a proxy for personal income tax, in a sense. If I own shares in a company, it is easier to tax that company's profit than to tax me directly, but the company that I own may be in Venezuela, and then it is much harder

for HMRC to tax the profits of that company, so I do not see that as a particularly strong argument. The other main argument that some people would use is to say that there is a business operating in the UK, using publicly provided goods and services, and it ought to make a contribution to the cost of those services. That seems like a reasonable principle. It is not clear that the use of those publically provided goods and services is necessarily that correlated with profit, so there may be other ways in which one could make a charge for businesses operating in the UK.

Q198 Mr Rees-Mogg: It is quite interesting in that context, is it not? I saw from the paper we have that 51% of the retail sector's tax is paid in rates, and a very high proportion of investment management companies' tax is paid in irrecoverable VAT, so it is part of the whole process of corporation tax becoming a less important but also non-exclusive means of extracting money from corporations.

Michael Devereux: That is right. Business rates in particular raise a lot of money. There is an advantage in principle to taxing profit, because that is a proxy for income. That is what the system is based on for personal taxes as well. As soon as you start taxing some other aspect of the business, you tend to create economic distortions. Business rates may create distortions to property, for example. It is certainly true that there are other ways of collecting tax revenues, either from individuals or from businesses.

Q199 Mr Rees-Mogg: Do you think the distortions would be greater or that they would reduce if you moved away from corporation tax, particularly in the international context?

Michael Devereux: Under the existing corporation tax, I think the distortions are particularly severe, and that is partly because it is quite complicated and partly because things like the location of economic activity depend on where taxes are. This is why we have been reducing our tax rates, in order to try to attract activity. There is plenty of evidence that corporation taxes have quite a significant impact on businesses' behaviour. That leads to economic inefficiencies and distortions, and costs to society as a whole. The academic literature would say that corporation tax has more of those kinds of social costs than other taxes do. Therefore, we could look for other taxes, VAT for example, that do not have such high costs. In general, we would be better off if we raised more money from other sources.

Q200 Mr Rees-Mogg: Putting aside the money that is raised at the moment, because it is always problematic and politically complex finding other sources, how acceptable would it be in the international arena if one major G7 country suddenly said, "We are abolishing corporation tax"?

Michael Devereux: I do not think it would go down very well.

Steve Edge: The Americans think we have. Sorry, I didn't mean to interrupt, but the Americans do think we have abolished it, because the rate is so low now that it is half their

rate. It would not be well received. Also, from an investor point of view, having most jurisdictions across the world, as Michael said, taxing this illusory thing called profit—I think I used to understand accounts at one point, but I am not sure I do now—creates a level playing field for people to compare what they are doing in different jurisdictions. From a business point of view, having a corporation tax system, which is something we know and do not quite love but have got accustomed to, but having a low rate so it is not so intrusive and we can be competitive, would be a good thing.

The other aspects, then, are the creation of jobs here and the yield that you get from people spending money, paying VAT, earning money and paying income tax and national insurance, which are much bigger contributors to the economy. Those are important.

Paul Morton: I have two comments on that, really. As Steve has said, the international position is important. There are several thousand double tax treaties in place around the world, to prevent double taxation of the same profits, and there are many anti-avoidance regimes that would be triggered if the UK were to abolish its corporation tax. There is a risk that, if the UK were not to have a corporation tax, but to have something in its place, there would be much more double taxation of the same profit or tax base than we see at the moment. That international consensus has grown slowly, almost painfully, over many years. I would offer the thought that, if the UK and other countries were to explore other tax systems and apply the same degree of consensus that we have seen in the BEPS process, that would be well worth looking at further. If the UK were to act alone, it would be very troublesome for British business.

The other observation is that it is very unclear to me who bears the burden of corporation tax. Mr Devereux is one of the very few people who have looked at this question in some detail. My understanding of his work is that one group of stakeholders that bears more of the burden than others would be the workforce. If that is the case, the debate as to whether increasing or lowering the corporation tax rate is of benefit to the workforce is one that really ought to be had.

Q201 Mr Rees-Mogg: Perhaps that tees you up nicely to expand on that point, Mr Devereux.

Michael Devereux: Shall I expand on that? The issue of who ultimately bears the cost of corporation tax is a controversial one, as we say in academic terms. I do not think there is any clear view, but there is certainly evidence that at least part of the cost gets passed on to the labour force, to support what Paul said.

Q202 Mr Rees-Mogg: Is this in lower levels of employment or lower wages?

Michael Devereux: It could be either. It reduces the demand for labour. I have certainly seen evidence that wage rates are lower because corporation tax rates are higher. In a way, the issue then is that corporation tax has to be borne by individuals ultimately; if it is not the labour force, it is going to be the customers or shareholders. A problem with corporation tax is that the process of extracting tax revenue from those individuals is quite distorted, because it goes through the company and it is very complex as we do it. It would

actually be more straightforward to tax those individuals directly, to tax the labour force. It may be politically more unacceptable, but to raise the rate of personal income tax and reduce the rate of corporation tax may have a similar kind of effect, even though it would probably not be seen like that by the general public.

Q203 Mr Rees-Mogg: What about shifting corporation tax into a sales tax? You also mentioned VAT.

Michael Devereux: There would be distortions with other kinds of taxes as well. If it was just a sales tax, then that would have a disproportionate effect on a low-profit company that had a lot of sales, compared to a high-profit company with relatively few sales. That could cause competitive distortions as well. There is some benefit to taxing profit relative to sales, as a tax base. Looking at VAT as a whole, because it is the same rate, more or less, across all goods and services that people buy, I would see it more as a tax on consumers, rather than companies.

Q204 Mr Rees-Mogg: If I can draw out what I think all three of you agree, it would reduce distortions if corporation tax were abolished, but it would be impossible, because of international treaties, and make life much more complex in the short term for British business. Can I therefore ask: how low do you think corporation tax could go before the rest of the world squealed to a level we found impossible?

Michael Devereux: The rate has been coming down for decades. This is not new. Back in 1984, it was 52%, so we are now at a third of that level, or we are about to be. Other countries have also reduced their rates. I do not think we should see where we are now as the settling point. We are still on the way down. Exactly how far we will go is very hard to say, but, if we come back in 10 years' time, my prediction is that the corporation tax rate will be less than 17%.

Paul Morton: 15% has a certain computational attractiveness to it.

Chair: Even in the age of the calculator, they prefer a round number.

Steve Edge: Interestingly, 15% is the rate that some US Treasury policy officials have been talking about as an acceptable rate below which you must not fall, otherwise you are in tax haven territory. 15% has been repeated in the European draft directive recently. I would say that, but I think the world is likely to be countries that have been competitive in the 10% and 20% range; countries that are perhaps in the upper echelon and playing poker with their investors in the 20% to 30% range; and whether the US sticks at 35%, who knows?

Q205 Chair: When Toad of Toad Hall is being sentenced, on grounds of tidiness, I think his sentence is increased from 19 to 20 years. You seem to be suggesting we should reduce corporation tax to a nice round number, rather than the rather awkward 17%. I just want to pick up one question, which came out of something Stephen Hammond was talking

about when we were having a discussion about the Laffer curve. Another point was made, I think by Paul Morton, which is obvious conceptually but important to have in mind, that there is a rate at which avoidance becomes not worth bothering with—lower than 17%. We know that it is worth bothering with at 17%, because people are still engaged in it, although part of the industry for avoiding tax, once built up, tends to have a lower marginal cost than the average cost to recreate it. Maybe Mr Devereux is the right man to answer this: if all the reliefs on CT were removed, have you seen any estimate at which you could reduce the CT rate, while remaining yield neutral?

Michael Devereux: That is a very difficult question to answer.

Chair: I know. That is why we have highbrow people like you.

Michael Devereux: Let me explain why I am not going to answer it properly. It is a question of what we mean by reliefs, and therefore what it is that we are trying to tax. For instance, let us take interest deductibility, if we count that as a relief. If we got rid of interest deductibility altogether, we could certainly reduce the tax rate by—I do not know the numbers off the top of my head—two or three percentage points. The more fundamental question, then, would be whether we think profit gross of interest or profit net of interest is the right thing to tax.

Q206 Chair: Once we are down to these very low numbers, we have to put in capital reliefs, such as they are.

Michael Devereux: Right, so we give capital allowance on capital expenditure. If we said, “We are not giving any capital allowances at all”, then a large part of the expense of a business would not get any relief at all. We are then moving away from a tax on profit towards something that is much more like a tax on turnover.

Q207 Chair: We are on to a very low tax on everything, which is distortive, but we are agreed that the current system is highly distortive. That is what we have heard in evidence—not that it was new; everyone knows it is.

Michael Devereux: If we wanted to go far enough down that road, I would suggest we should think seriously about VAT, in that case, because then it is a sale and we do not give relief for anything, effectively, apart from bought-in costs.

Q208 Chair: The political controversies of going down the indirect tax route are sizeable. It would be extremely interesting to a number of people around this table if you were to have a go at thinking through a more thoroughgoing answer to the question I have just asked, if you had a spare moment. We would be very grateful.

Michael Devereux: We could think about reliefs at various levels, then—interest deductibility, capital allowances, wage costs.

Chair: We would have to do it at various stages.

Michael Devereux: Yes.

Chair: I will leave it with you.

Q209 George Kerevan: There is still time to say good morning.

I want to go beyond the present discussion, looking at hypothetical alternatives to corporation tax, as difficult as that might be. Obviously, I will start with Mr Devereux. Could you run us through the advantages and disadvantages of destination-based cashflow as an alternative tax base?

Michael Devereux: This is a proposal for a tax that differs from the existing corporation tax in two dimensions. One is that it gives relief for all expenses, so capital expenses would get immediate relief. That is one thing. The more important thing is the question of where the tax would be levied. As I see it, one of the problems with the existing system is that it is very difficult to identify where the profit is made, and hence where it should be taxed. Then we have this problem of competition: more or less, if the profit is taxed in the place where the activity takes place, that creates the competitive problem. It also means that the location in which businesses actually do their activity is affected by tax.

The idea, moving away from that, is to ask what we could tax that is less mobile and will not respond quite so easily to differences in tax between countries. Notwithstanding concerns about immigration, people are relatively less mobile than businesses or parts of businesses, which makes you think, “Can we try to levy tax on the profit in the place where individuals are, rather than the place where businesses want to locate their activities?”

That leads to two extremes. You could say that it is a proxy for a tax on shareholders, so is there any way we can take that profit, allocate it to shareholders and tax the individual shareholders? That would be one option. The other option would be to say that there is a place where the business makes its sale to third parties, and those third parties are in a particular location and are generally not going to move because they are buying this product. The idea of the destination-based tax—by destination, we mean where the consumers are, essentially—would be to tax the sales in the place where the sales are made and give relief for expenses in the place where the expenses are incurred. So an asymmetric tax, if you like, on that property.

This is quite similar to VAT. We have a destination basis for VAT in exactly the same way. Really, the only difference between VAT and this proposed tax is the treatment of labour costs. With VAT, for an individual business, we are trying to tax value added, and one way of thinking about value added is that it is equal to total profit plus total labour costs. The idea here is that we give relief for labour costs and end up with just a tax on profit, but by and large in the place where the consumers are, which is the idea in the first place.

Q210 **George Kerevan:** We are capturing the sales element, but we are also giving relief where the labour was employed in order to make the product.

Michael Devereux: Indeed.

Q211 **George Kerevan:** That gets you over the issue of high-tech companies making big sales where they have a relatively low workforce.

Michael Devereux: That is right. You would not be giving relief for royalty payments based on IP somewhere else, for example.

Q212 **George Kerevan:** Now tell me the disadvantages.

Michael Devereux: It is a big change from where we are at the moment, so clearly would require a different way of doing it. There are two ways of moving to this system. One would be to gradually reduce the rate of corporation tax and gradually increase the rate of VAT. The second part of that is taxing profit and labour income, so you would also want to reduce payroll tax—national insurance, for example. That would move in that direction, although it would suffer from the problem of being seen as an increase in indirect tax, even though it is economically equivalent.

Q213 **George Kerevan:** Can I just clarify? You could implement this simply by, as you reduce the headline rate of corporation tax, raising VAT, as has been going on, and taking away employers' national insurance contributions.

Michael Devereux: Yes. That is the economic effect of what this tax would be.

Q214 **George Kerevan:** The public perception would be that it was falling on the consumer.

Michael Devereux: That would be correct, actually. This tax would primarily fall on consumers. As we said earlier, it has to fall on somebody. This particular tax would be falling disproportionately on consumers, but, if you like, spending out of profit, not spending out of wages. It would fall on those who are spending from the profits in this particular jurisdiction. For example, if you owned no shares and made no profit, and you just had a wage income, then it could not possibly fall on you, because you would not be taxed. If you were receiving dividends and spending those dividends, then, in effect, the amount of spending you could do out of those dividends would be smaller.

Q215 **George Kerevan:** Indeed, but, since most people are not spending income derived from dividends, we would have a problem.

Michael Devereux: If we broaden it, it would not just be dividends in this country. It would be any dividends, any capital gains, that anybody would make.

Steve Edge: It would also be acting on pension funds, so some of it would filter down to other people.

Do you mind if I ask a clarification question, which I think might be helpful? Michael, when you are saying you give relief for labour costs and you impose a tax on the sales proceeds, if the labour costs are in jurisdiction A and the sale is in jurisdiction B, where do you give relief for the labour costs?

Michael Devereux: Can I answer that in the context of the second way of doing this? One way of implementing this would be through the VAT route; the other way would be reforming corporation tax. The key element of that would be as we do with VAT, which is effectively to zero-rate exports but to tax imports. Then we are turning it from a tax where the activity takes place, to a tax where the consumption takes place. In that context, you would still be giving relief for labour costs in the place where they are incurred.

Steve Edge: In jurisdiction A?

Michael Devereux: Yes.

Steve Edge: Jurisdiction A would be giving relief, but not taxing the profit. Jurisdiction B would be taxing the sales proceeds, but not giving relief for the cost.

Michael Devereux: Indeed, so if you look at that from a—

Q216 Chair: Why do you not write down the proposal and send it to Mr Edge? Mr Edge can offer a commentary, and then we would like to take it as written evidence to the Committee.

Michael Devereux: As a matter of fact, we are having a conference in a week and a half's time, where Mr Edge has been invited as a commentator.

Chair: We are happy to wait a fortnight for the return. We are busy for the next nine days.

Q217 George Kerevan: It seems a bit more complicated than the first explanation. Let me just tag on a couple of the other options that might appear as a replacement for corporation tax. Mr Morton, Mr Edge, whoever feels moved to answer, what about taxing accounting profits as opposed to inventing something we call profit and taxing that narrowly? Why do we not just tax accounting profits? Is that not simpler?

Paul Morton: Perhaps I could answer that question and then follow with a very short comment on the other proposals as well. Taxing accounting profits, in principle, makes good sense, but there are some differences between the purposes for which profit is

calculated for financial statements and those for which profit is calculated for tax. We might begin with the accounting profits but make appropriate adjustments, so where for example there is an expense or an item that is recognised for accounting purposes but not appropriate as part of the tax base or vice versa, that can and should be adjusted, and we are moving very much in that direction. Taxable profits in most countries are probably closer to accounting profits now than they would have been in the past.

Perhaps I could add a short comment. The proposal to tax on a destination basis leaves me feeling slightly faint, on the basis of the practical difficulties that we might encounter, both in establishing where the destination is and how much should be attributed to each particular destination. I also have some concerns about the position for the UK; if we were to move to a destination-based tax system, then all of those knowledge-based industries based in the UK would have a tax base outside the UK—or not, if other countries did not follow suit. The international consensus, or lack of it, would be a very, very real blocker to making progress towards a different kind of tax system.

George Kerevan: I will not go back to that. What seemed a rather nice, simple proposal on dissection needs to be looked at.

Steve Edge: It is a nice idea; it does make life easier. Politics has intervened in the past, certainly in the period when we were giving large capital allowances to encourage people to invest in car plants up in Sunderland and the like. That overrode the accounting profits; that was politics coming into it. Unfortunately, the accountants tend to have more of a substance-over-form view of the world, so we have found, in areas of tax where taxation has followed the accounts, that the eagerness with which that is greeted has been somewhat dissipated when the Revenue have discovered that the accountants do not always do what they expected them to do. Then you have to have add-backs to say, “No, we really meant to tax that, even though you do not recognise it in the accounts.”

Q218 George Kerevan: It is a simplification and a possibility for the here and now, but, like anything else, once we have it—

Steve Edge: We might fail.

Q219 George Kerevan: Finally, a unitary tax has also emerged. Parties of the left have raised that as a simple approach to taxing business profits. What are the pros and cons of a unitary tax system?

Paul Morton: If I could make an observation on unitary tax, it is seen as a potential simplification compared with corporate tax, but I question whether it would be. There are two aspects of a unitary tax. The first is establishing taxable profit, and all countries involved in the unitary system would need to agree a single tax base, or else double taxation results. That involves the application of keys to allocate the profit to the various countries, and the traditional keys are staff, revenues and physical assets. Increasingly, physical assets are not the only assets. Intellectual property assets would be extremely difficult to use as keys in a formulary apportionment methodology. It would be very, very

difficult, even if there were consensus as to how it should apply, for it to be applied in practice. We are not even at the beginning of a consensus, internationally.

There is a very interesting example of formulary apportionment at work in the US, where the state income tax in many—but not all—states is calculated by reference to the allocation keys on the basis of formulary apportionment. Most US multinationals and most UK multinationals with substantial US businesses have quite large teams of people in the US, who grapple with the formulae applicable to each of the states. It is an extremely untidy and inefficient system. The only saving grace is that the rate of tax is very low, 6% to 8% or so, so the inefficiencies are lost in the rounding errors. If one takes that as an exemplar, it portrays a very difficult picture for extending formulary apportionment globally.

Michael Devereux: It might be worth pointing out that, in the US states, each state can choose its own formula. They are not necessarily consistent with each other, which no doubt creates further problems. It is certainly true that, if you were trying to do this on an international basis and you were trying to avoid that, you would need some international co-ordination, which so far has not been forthcoming, certainly over the last decade or so.

Q220 George Kerevan: It falls at a political level.

Michael Devereux: The European Commission has been working on proposals for this for the last 15 years. It deserves credit for having tried to work out how to do it. It has not yet got the political backing to actually introduce this anywhere.

Q221 Chair: I have one last point about the administrative cost of collecting the tax, which goes to the point that you were making, Mr Morton. Are there any reliable figures at international level that can act as comparators, not for the cost of the revenue services, but for the full compliance cost, including the cost to the counterparties, the businesses from which they are collecting the CT?

Paul Morton: I am not aware of any reliable numbers, no.

Q222 Chair: We do not really know whether we have a relatively efficient system or a relatively inefficient system. That would seem to be the core indicator, I would think, looked at from a home economy perspective. When people say that we have a relatively efficient or inefficient system, they are guessing.

Michael Devereux: There are two kinds of efficiency. When I was talking about efficiency, I was talking about economic efficiencies and distortions, as opposed to the cost of collection per se. There are two ways you could think about those kinds of cost. There is probably more evidence on the economic distortions than there is on the administrative costs.

Paul Morton: Corporate tax is a relatively expensive tax to administer.

Chair: This is what I am trying to get into. This is the territory that I am trying to probe.

Steve Edge: You could probably get at that by looking at the number of people within the Revenue who are engaged in corporate tax collection, for example, compared with people who are involved in employer withholding or VAT, which are both self-collecting taxes. If you look, then, at US tax departments, in my experience, they tend to be a huge amount bigger than UK ones, as Paul was saying earlier. Continental European ones vary a bit, but I would guess that our current business tax system is more efficient than in the US, but less efficient than the amounts of tax we collect through VAT and income tax.

Q223 Chair: It is a very important question for Parliament to examine. From what I can tell, you are all reconvening in some nice watering hole for a conference very shortly. It would be extremely helpful, as a consequence of any discussions you have there, if there is any material of this type, if that could be sent to the Committee.

Steve Edge: We will see what we can find.

Chair: Thank you very much for coming to give evidence to us. We are very grateful. We have picked up quite a lot and, as I said earlier, it is refreshing to have witnesses who are trying to