Towards a 21st Century Corporation Tax

Would a corporation tax regime fit for the 21st century look anything like the current UK corporation tax? No.

At the heart of the issue are two questions about geography: Where is profit located? And where should it be taxed?

Consider a domestic company whose owner lives in Birmingham, which has plants in Manchester and Bristol, a head office in London, and which sells its output in Glasgow. In which city was its profit made? This question may have been relevant in the 19th century, but given the 20th century corporation tax we are living with, fortunately we don't need to answer it.

But now replace this with a simple 21st century example: the owner lives in Paris, the plants are in Madrid and Budapest, and the output is sold in Berlin, though the head office is still in London. Now ask the same question: in which city was the profit made? This time the international tax regime appears to require an answer.

And to an extent we can answer it, thanks to existing principles of international tax. These were first developed in the 1920s by the League of Nations, where, among other things, four experts introduced the concept of "economic alignment". Of course, the principles have been continuously refined ever since, up to the ECJ declaring the importance of "genuine economic activity".

But do these terms help to answer the first question? I would argue that there is genuine economic activity in all the locations listed above. Without the owner supplying the funds for capital, no economic activity would have taken place. Supplying capital is a necessary part of that activity. Purchasing the output is also necessary – without the German consumer, no profit would have been made. Both of these reflect genuine economic activity.

But if genuine economic activity is in all these locations, then the first question cannot be answered. Profit is not located solely in any of these cities; in fact the profit may even arise precisely because of the international nature of the operation. If the first question cannot be meaningfully answered, then trying to answer it will not help in answering the second – where should profit be taxed?

If this is the case, then where does that leave us? It may seem as though it is leading us to a consolidated tax base. If the EU's Common Consolidated Corporate Tax Base (CCCTB) ever comes into being, at least companies subject to it will not have to identify where profit is located within Europe. Taxable income would be allocated to countries on the basis of an arbitrary formula, rather than an assessment of where profit is actually made. That may be an advance, but the basic principles on which a CCCTB would be based would be the same as the existing principles. The CCCTB would help only insofar as it would create a larger jurisdiction, so some allocations of profit between member states need no longer be made.

The argument here is more fundamental. If we cannot identify where profit is located, then the criteria for deciding where profit should be taxed cannot rely on an answer to this question. Instead, the criteria should be the same as with other taxes: efficiency, equity, simplicity and certainty. An individual country such as the UK should tax income or expenditure according to these criteria.

Does the UK corporation tax meet these criteria? It is difficult to assess equity, since to do so we need to understand who is actually worse off as a result of the tax; and this may be consumers or employees, as well as owners. But the tax does not score very well on efficiency, simplicity or certainty.

Is there an alternative? One worth considering is a destination-based tax: tax profit where output is bought and consumed. If adopted everywhere, such a tax could avoid distortions to the location of international investment, greatly reduce opportunities to shift profit between countries, and largely eliminate tax competition. If adopted in the UK alone, the incentive to locate business operations in the UK would be greatly enhanced.

Before you dismiss this idea as too fanciful, think about VAT. Although it appears to be based on sales, the cost of sales is effectively deducted: what is left is a tax on value added – hence its name. But value added is equal to profit plus labour income. Increasing the rate of VAT, and making offsetting reductions in the rate of national insurance, would leave us with a destination-based tax on profit. The rise and rise of VAT throughout the world is one of the striking features of the latter part of the 20^{th} century. In the 21^{st} century we should perhaps also begin to view it as a way of taxing profit.

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