



HOUSE OF LORDS

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Questions 1 - 17

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Witnesses: Professor Steve Bond and Malcolm Gammie CBE QC

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Members present:

Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean
Lord Hollick
Baroness Kingsmill
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord McFall of Alcluith
Lord Rowe-Beddoe
Lord Skidelsky
Lord Smith of Clifton

Examination of Witnesses

Professor Steve Bond, Nuffield College, University of Oxford, and **Malcolm Gammie CBE QC**.

Q1 The Chairman: Good afternoon. Sorry about that delay, but we had a few domestic matters to attend to. Welcome to you, Professor Bond, and Mr Gammie, welcome back yet again. We are very glad to see you, and thank you both for coming. Since this is your first time, Professor Bond, can I just ask if you would speak loud and clear for the webcast and the shorthand writers? This is a study we hope to complete before the end of the summer, so we are focusing it very much on the issues that I think you are both expert on. Would you like to make an opening statement, or can we go straight into questions?

Professor Bond: I think you can go straight into questions.

The Chairman: Straight into questions?

Malcolm Gammie: Yes, indeed.

The Chairman: I want to start with the Institute for Fiscal Studies's Mirrlees report, because both of you worked on the Mirrlees Review. That is, as we know, into the overall tax regime for corporation tax. It proposed the introduction of what is called an allowance for corporate equity. Can you explain what this is, and why you proposed it?

Professor Bond: I will maybe start on that. It is probably best to start by just mentioning some of what we think are the key problems or distortions associated with corporation tax as we currently have it. Some of those are raising the cost of capital; raising the required rate of return that is needed on business investment projects; and doing that to a greater extent when investment is financed by equity sources than when investment is financed by debt sources, thereby giving firms an incentive to use more debt and less equity. That really stems from having a deduction for interest payments that provide tax relief for the cost of using debt finance, and no corresponding deduction available for costs associated with using equity finance.

So the ACE allowance would provide tax relief for costs associated with using equity to finance investment: that is both retained profits and new equity issues. The basic idea is to level up the treatment of equity and debt sources. That obviously deals with the differential treatment of debt and equity. In fact, a well designed ACE allowance could go much further and, at least in principle, eliminate the impact of the corporation tax on the cost of capital: that is, the required rate of return for all types of investment, regardless of the source of finance. As a welcome by-product, it could also introduce indexation against inflation without having to think too much about it.

There are alternative ways in which some of those goals could be achieved. We believe that it would work in practice. Versions of this have been implemented both in Belgium and Italy in recent times and, as far as we are aware, appear to be functioning quite well.

The Chairman: Mr Gammie?

Malcolm Gammie: Yes. The ACE system was originally proposed by an IFS committee that I chaired back in the early 1990s. At that time, it seemed to fit particularly with the system of corporation tax that we had. It envisaged that the relief that was given under our dividend imputation system at the time would effectively be transferred into an allowance for

the company, to have the effects that Professor Bond has just outlined. In the context of the Mirrlees report, the corporate tax system and dividend taxation, of course, has moved on quite a lot since the early 1990s. Nevertheless, in the context of Mirrlees, where we were trying to give a holistic view to both the taxation of company profits and savings and the tax system as a whole, the ACE system worked well with the equivalent proposals that we were making for the taxation of savings under the Mirrlees Review. That was at least one factor that encouraged the Mirrlees Review to arrive at its conclusion on that.

Of course, one of the aspects of many of these proposals, whether it is ACE or otherwise, is that they tend to be domestically focused: in other words, they are dealing with the issues that arise for taxing profits within your own jurisdiction. As, I think, some of your subsequent questions indicate, some of the major issues that arise about taxing corporate profits are international rather than national. In that sense, I am not sure that the ACE system offers an international solution, but it does have the effects that Professor Bond has just described.

Q2 The Chairman: We will come on to the international aspects shortly. How far would the corporation tax rate have to rise if an ACE were introduced and the Government aimed to collect the same amount of revenue?

Malcolm Gammie: If I can, I will answer that initially, and then perhaps Professor Bond can put me right afterwards. Under the Mirrlees Review, we accepted that the introduction of the ACE allowance would in fact lead to some reduction in corporate tax revenues, but we considered that an appropriate outcome, on the basis that what you are looking at is the tax system as a whole. Effective tax reform is much better conducted on the basis that you are looking at the entire tax system rather than just trying to look at individual parts of it and achieve purely tax-neutral effects within that small part of the tax system, which does not necessarily provide the best answer.

At the time at which we originally proposed the ACE system, the corporate tax rate was 35%. I think we calculated that it would need to rise to something above 40%; in fact, the committee's proposal in the early 1990s was to increase the corporate tax rate from 35% to 40%, which was consistent with international corporate tax rates at that time. If you want to raise exactly the same amount of revenue from the corporate sector while giving an additional allowance for equity capital, then that, of course, implies some increase in the corporate tax rate. As for how much that increase would be, I think that when we did the work in Mirrlees—and Professor Bond can probably speak to this better than I—we calculated that some of the efficiency gains would actually counteract the need for an increased rate, but some increase would probably be required.

Professor Bond: Very ballpark calculations suggest that if you were to just introduce the ACE, you would be giving up somewhere between a quarter and an eighth of corporate tax revenue. If there were no favourable behavioural reactions on the investment side, you would be looking at something like a quarter. If you look at evidence in the academic literature on how much additional investment you might expect to get, you could probably get that down to one-eighth. That would be the kind of ballpark you would be looking at.

The Chairman: Interest payments on debt, of course, are a matter of factual record. How should the tax-free rate of return be determined under the ACE?

Professor Bond: That is a very good question. In principle, it should correspond to a risk-free, nominal rate of return: that is, the rate of return that you could get on a completely safe, un-indexed security. In the old days, we used to think that government bonds satisfied that requirement, and we would look at something like a medium-term, 10-year government bond yield. In the UK and most countries, you could do that. In the likes of Greece, you would not advocate that principle.

In so far as there should be any risk premium component, or any allowance for shareholders bearing risks, the only argument in principle in favour of that is in so far as loss offset provisions within the proposed tax regime would be less than perfect. In the Mirrlees Review proposals, we advocated full loss offsets, in which case you would get back to just the pure risk-free interest rate being the rate at which you should give the rate allowance. In practice, you are very unlikely to get to that ideal, so you might want to add on a per cent or two.

You certainly should not be aiming for anything like the required rate of return on equity. The only risks that are relevant here are the risks of tax reliefs that you expect to get in the future not being given, because the firm is no longer around or no longer making profits in the future. If the future capital allowances associated with the investment decisions are almost certain to be claimed at some point in the future, then you get back to the risk-free interest rate as the appropriate rate.

Q3 Lord Forsyth of Drumlean: I can see the attraction of this idea of having a level playing field between the tax treatment of equity and debt. However, since this work was done, we have had an explosion in the use of gearing in companies. We have had a number of large companies that have effectively become zombie companies, just continuing mainly due to private equity investing and very high levels of gearing. Some of them are quite substantial: companies like Yell, for example, which have got very substantial borrowings. I just wonder how one would make the transition towards a more balanced system, given the practicalities that have arisen because of the other distortions, not least the treatment of debt but also the treatment of carry and other distortions in the tax system. These have created a landscape that it seems to me might create particular difficulties in trying to move to the ideal.

Professor Bond: The issues are very different, depending on whether you are proposing to equalise the treatment of debt and equity by making the treatment of equity more generous to companies, which is the ACE proposal, or whether you are proposing to level the treatment of debt and equity by making the treatment of debt less generous than it currently is, which is the other way in which you could do it. I think the transitional problems of trying to go the other way—of eventually eliminating deductions for interest payments—would be formidable. I do not think the transitional problems associated with introducing a new allowance for new equity-funded investment from now going forward would be such a challenge at all. That was another reason that led us to favour that approach.

Lord Forsyth of Drumlean: Yes, but it does not deal with the distortions that have been created because of the debt relief.

Professor Bond: It does not deal with debt overhang problems. That is correct.

Q4 Lord Hollick: What has been the impact of this change in those countries where it has been introduced? I think you said Belgium and Italy have introduced variants of ACE. What behavioural changes have there been? Has it made it easier for companies to raise more equity? Has it altered the price of equity and debt? Is there sufficient evidence to show what this actually does, apart from the theoretical and practical effects that you referred to?

Professor Bond: I think the honest answer is “not yet.” The introduction in Italy is very recent, within the past couple of years, and obviously it is not the ideal time to be doing any tax reform in Italy and looking for steady state impacts. In Belgium, it has been around since about 2008, if I remember correctly. Belgium is a little bit different, in that it replaced another tax relief that had previously applied in Belgium specifically for headquarters of multinational firms located in Belgium. The reason why the Belgians introduced this tax relief was rather different from the reasons we might be contemplating here: they did not

want to raise much revenue. They were not raising it before, and this was another way of not raising it in their context.

Malcolm Gammie: And not raising it in a way that was compatible with European Union rules, whereas their previous co-ordination centre regime had been “caught”, if that is the right word, within the harmful competition initiative by the European Commission. They had to undertake to remove their co-ordination regime and the ACE regime that they introduced was their way of maintaining some of the advantages for headquarter companies in Belgium. The other jurisdiction, which may be one of the earliest examples that had an ACE regime, was Croatia. It had it between sometime in the 1990s and, I think, the early 2000s, where it seemed to work reasonably well and achieve its particular objectives. However, if I recall correctly, the Croatian government at the time removed it for not very well articulated reasons, but partly to enable them to reduce their corporate tax rate.

Lord Hollick: On the question of the rate of tax, did either or both Belgium or Italy increase the rate of corporation tax to meet the shortfall implicit in this ACE structure?

Professor Bond: I do not think they did, no.

Malcolm Gammie: Not that I am aware of.

Lord Hollick: So it was a tax cut.

Lord Skidelsky: ACE presumably would apply equally to retained and distributed profits. Is that right? I am wondering whether there is a case, in your view, for distinguishing between the two. The thought behind it is that there has been a huge increase in corporate saving in recent years. I do not know what has caused it, exactly, but it is not very good for the growth of the economy that that should be so.

Professor Bond: The ACE proposal would not explicitly distinguish between retained and distributed profits. In so far as it makes spending money on capital, equipment and buildings more attractive to firms, then one would hope that it would have some impact on the

accumulation of corporate savings that you refer to. There may be times when it looks like a good idea to have different tax treatments of retained profits and distributed profits: if one looks across countries, and over time, there have been higher tax rates on either of them at various different times. My view is that the long-run arguments for wanting to make that distinction are not very strong.

Malcolm Gammie: Presumably, if you were going to have that sort of differential, you would need to have rules that prevented companies distributing profits and then raising new money that qualified for the allowance. That is, I suppose, an obvious tax planner's reaction to the idea that you might have a differential between the two.

Q5 Baroness Kingsmill: Good afternoon. I have to declare an interest: I am a non-executive director of a number of international companies, including EON, SE, International Airline Group, which is listed in Spain, and APR Energy, which is a US company, together with some UK plcs as well. They are all listed in the Register of Members' Interests, if you need to see them. With that in mind, there has been so much debate recently about the tax avoidance activities of various international companies, and I think it would be quite interesting to understand from you how easy it is for these companies to avoid paying tax in the UK on the profit that they generate here. The follow-on from that is: "Has corporation tax effectively become a voluntary tax?" Companies can decide where to pay tax, where to allow their transfer payments and their allowances, and that sort of thing.

Malcolm Gammie: I think within that question there is quite a lot of unbundling to be done.

Baroness Kingsmill: Indeed.

Malcolm Gammie: I suppose an initial starting point is to pose the question: "What do we mean by profits earned here?" In a sense, that is at the heart of many of the issues, particularly those that have had a lot of publicity in recent months. There is, in much of the press and other comment, an implicit assumption that the profits are here and can be taxed

here. Of course, wherever you are dealing with multinational companies that are operating in several jurisdictions, the fundamental question is how do you decide where the profit is actually earned and, therefore, who has the capacity—or who should have the capacity—to tax it?

The current international rules operate principally on two ideas. First, if you are dealing with a company that is not actually established here in the sense of being incorporated or having some nexus within the United Kingdom—for example, a UK plc, so you are dealing with a Spanish company or a US company or whatever—then there has to be some permanent presence in the United Kingdom before the United Kingdom asserts any taxing rights over any profits that company may earn. That concept of a permanent establishment is one that is laid down principally by our double-tax treaties. Of course, a lot of that is based in the past, in the sense that it does not take account of recent developments in digital economy and the like. However, it has always been the case that somebody who, for example, produces services or goods or manufactures or whatever outside the jurisdiction can sell into the UK jurisdiction without actually paying any tax here, unless they have an establishment.

The other aspect, of course, is if they do have an establishment here, or if their nexus is here because they are a UK company, how should you determine what is the element of profit that should be attributed to the United Kingdom for its tax?

Baroness Kingsmill: My point is, Mr Gammie, that given these loopholes, as the press would call them—these opportunities to borrow cheaply and heavily in one jurisdiction because you get a tax advantage for so doing and to use transfer payments to make your purchases of your capital items and so on—does this therefore mean that corporation tax is something that you can manipulate to the benefit of the company and, effectively, as the end part of my question was, becomes a voluntary tax?

Malcolm Gammie: I do not think that corporation tax has quite become a voluntary tax. Of course, to the extent that you are dealing with a foreign company, which now through the Internet and other mechanisms has the ability to sell its services or products into the UK without actually being established in the UK, the current rules would not envisage that it should pay any tax in the United Kingdom. The scope to do that, of course, has increased significantly with the Internet and digital economy. Previously, to take a simple example, if you wanted to sell your goods, you had to have a shop in the high street, stocked with your goods, and you would pay tax on the profits attributable to that shop. Now the Internet effectively gives you the facility to advertise and sell your goods into the UK without having a shop. That is just a simple example. In that sense, it has become a voluntary tax.

Q6 Baroness Kingsmill: There is more to it than that though, is there not, Mr Gammie? When I was Deputy Chairman of the Competition Commission, I did a big inquiry into car manufacturing in the UK, and the sale of new cars. The fact was that most of the car companies went along to the Inland Revenue and negotiated with the Inland Revenue a flat rate of tax, because the complexity of collecting that tax was so great that it was better to get some income, rather than spend an awful lot of time struggling to get what was perhaps appropriately due. Again, it looks to me, from this point of view—and I am challenging you a little bit on this—that it is the companies themselves that decide exactly what level of tax they are going to pay.

Malcolm Gammie: I cannot comment specifically on that type of case. Of course, when you are dealing with complex manufacturing or business operations with large companies, they may have discussions with the Revenue as to how the profit that is attributable to the UK should be determined. We have formal agreements. The Revenue recognise that you can have something called an advance pricing agreement: there is legislation to deal with that. There is provision for Advance Thin Capitalisation Agreements, and, inevitably, arm's-length

transfer pricing works to an extent in complicated situations by way of negotiation with the Revenue as to how you calculate the arm's-length transfer price, because these are not things that can be litigated or argued about all of the time. The Revenue have to collect some amount of tax or work out some profit.

As to how effective the Revenue's monitoring and application of transfer pricing is, if you are having Revenue witnesses to this Committee, that is possibly a question that you should be asking them. Of course, you are absolutely right that the way modern business has developed and the way in which, in particular, multinationals have become far more integrated operations has opened up a great deal more scope for debate and negotiation, and arriving at the sort of arrangement that you have outlined. Most multinationals, as I am sure you are well aware, do not organise and run their businesses on country-by-country lines. They run them internationally, so if you are dealing with, for example, mobile telephone manufacture or something like that—with which I dealt some years ago when I did have to litigate something for the Revenue—they organise their business in terms of North America, Europe and the Middle East, and Asia. They just did not recognise any jurisdictional boundaries between countries, and that obviously presents quite a lot of difficulty in working out how much profit should be attributable to each particular jurisdiction.

Baroness Kingsmill: Do you think that gives a competitive advantage over British companies to foreign companies operating in the UK, because they are able to have more aggressive tax planning? That is a populist question, but—

Malcolm Gammie: Let us take the simple example that has appeared in the press, Starbucks and Costa, or something like that. I do not act for either Starbucks or Costa and I know nothing about their businesses, other than what anybody might know as a member of the public. However, to the extent that you are Costa and your only base of operation is the

United Kingdom and so on, then there is no issue about how you allocate profits across borders. Their profits are their profits, as determined. In relation to Starbucks, because they are a multinational and operate in many jurisdictions, they really have two particular issues that arise. First, you have got to decide, in relation to their aggregate profit, how this gets allocated. They do, of course, through intellectual property, brands and the like, have some opportunity to organise their affairs in the United Kingdom in a certain way. When I say this is done in a way that “reduces their profit”, I mean that it allows them, operating in the United Kingdom, to take account of the value of the brand, for example, that is elsewhere and for which a royalty otherwise might have to be paid. Those are the sorts of differences that arise.

Baroness Kingsmill: Can you envisage another means by which you level the playing field a little bit, in terms of foreign companies and British companies, or is it a case of large companies and small companies? I am not sure. Is there a way of levelling the playing field?

Professor Bond: It is clearly a distinction between international companies and domestic companies, and that would apply in other countries, as well as Britain. Just to comment on what academic research suggests about this, the balance of evidence clearly suggests that some degree of shifting of profits across borders by multinational firms is going on. For an obvious example, just look at the reported profitability of subsidiaries of multinational firms operating in low-tax countries versus those in high-tax countries. There are differences in the direction that you would expect if they were acting to minimise tax. Of course, it is a long way from there to saying that every multinational company has complete discretion over where it pays its tax. It is easier for firms in some lines of business than others. Royalty payments on intangible assets like brands and patents are probably very important.

Baroness Kingsmill: It is interesting how many major international companies are listed in Luxembourg.

Q7 Lord Hollick: It is quite interesting that a number of the spokespeople for these large companies—most recently Mr Eric Schmidt, who is the chairman of Google—have made no bones about the fact that this is effectively a bit of a free-for-all, and certainly low-tax-for-all, if you plan it sensibly and correctly. They see no reason, because their only duty is to their shareholders, not to take full advantage of the opportunities to transfer. That clearly places domestic companies—and you have mentioned coffee, but you could say the same with Waterstones and Amazon—at a substantial disadvantage. For the nation-state, large or small, there is quite a threat, not only to its tax base but to the strength of its economy, if there is a substantial and enduring disadvantage. Have any countries taken this up? Have any countries said, “This is a competitive landscape that acts against our long-term economic interests, and we intend to take steps to remedy it,” or, “We are taking steps to remedy it”?

Malcolm Gammie: No, I am not aware specifically of that. You can look at these things the other way around. You can say, “Well, if it means that you can go and buy a cup of coffee or get a book cheaper by going to Amazon or to Starbucks, do you actually want to raise the price of doing that by enacting measures that insulate your own industries from international competition?”. I do not put that forward as a plus or otherwise; I just mean to say that what you are talking about in a sense could be cast in the light of being a protectionist approach, as against an international, open-economy approach.

Lord Hollick: I can tell you that in Notting Hill the coffee prices are the same, and you can get books at the same price as well.

Malcolm Gammie: That would be slightly odd if they were, would it not? If what you are saying is that the international business has a competitive advantage, you would at least think that they were using that to provide their goods and services at a more competitive price than some of their competitors.

Baroness Kingsmill: Or they are just collecting more revenue.

Lord Hollick: And making more money.

The Chairman: Do you want to move on to the next subject?

Q8 Lord Hollick: Yes. In a report on base erosion and profit shifting, the OECD recently stated that it is important to revisit some of the fundamentals of the existing standards for the allocation of profits between countries. What do you understand by that, and do you have any proposals for fundamental reform of the allocation of profit?

Professor Bond: There are probably two aspects of that. There is what I understand the OECD to mean, and what I might understand by the same words, so I should just distinguish between those. As Malcolm described at the beginning, the way in which countries seek to allocate the profit of multinational firms between countries currently is based on rules that determine cross-border transfer pricing on the so-called arm's-length principle, which has been developed over 60 years or so at the OECD and is embodied in OECD model treaty arrangements that we sign between countries. There are some fundamental problems with that approach. Fundamentally, as Malcolm mentioned a moment ago, it is a very artificial activity to seek to allocate the profits of a global business to different territories. It is not typically the way that businesses manage their affairs. In extreme cases, there is no right answer: if the only way profits are generated is the result of multiple activities taking place in two or more locations, and without each of the activities there would be no profits, then there really is no logically correct answer as to how you divide up the profits between the different activities in the different locations.

Even in less extreme cases, there are extraordinarily difficult practical challenges to finding similar prices in similar transactions between unrelated parties, which is the basic idea underlying this OECD approach. The OECD report clearly thinks that the solution to this is to beef up its existing approach, and so it says that proposals to update the OECD transfer pricing guidelines in the area of intangibles should be advanced quickly. One could caricature

that as applying patches to the current system where it has become too leaky, or where the leaks have become too visible. There is a fundamental logical problem at the heart of this, in that in many cases, there is no right answer.

What I would understand by fundamental reform would be to completely accept that, and move away from trying to measure exactly what share of Amazon's profits is related to its activities in the UK or elsewhere. I would be in favour of a set of arbitrary but simple-to-apply rules for achieving the same objective: allocating its global profits, on which we might be able to agree more straightforwardly, between the various locations in which it is operating. That kind of radical alternative approach goes under the heading of "formulary apportionment", and within large countries like the United States, that is the kind of mechanism used to allocate profits at the individual state level for corporate income taxes. As the world becomes more integrated, one might see in the very long run—if we still have a corporate income tax in the very long run—that that may be the only workable solution. That is the kind of idea for fundamental reform that would need to be considered, rather than just patching up the status quo system.

Malcolm Gammie: The only thing I would add to what Professor Bond has just said is that within Europe, the Commission's proposal for a common consolidated corporate tax base would envisage some form of formulary apportionment as a way of dividing profits between the member states who participated in that system. Of course, once you move outside a system where you have a common currency, common accounting, and effectively common determination of profit, the application of formulae becomes more difficult. However, as Professor Bond indicates, the basic aim of it is to accept that there is no right way of allocating profits between different jurisdictions where you have a highly integrated corporate enterprise, and that therefore you just select some ultimately arbitrary characteristics as a way of achieving an overall effect.

The example I always give is, if you think of the United Kingdom, it of course comprises four countries. We do not have this problem at all, because we have a single corporate tax that applies to England, Scotland, Wales and Northern Ireland. If we move to a situation where Scotland has a separate corporate tax rate and Northern Ireland has a separate corporate tax rate, we will have the same issues of allocation between the different countries of the Kingdom as you find internationally.

Lord Hollick: Given the complexities, and what you, Professor Bond, describe as putting patches on the current system, is it not surprising that Mirrlees did not actually look at some more radical alternatives, even if only to put them up and then say, “This would not work for these reasons?”.

Professor Bond: We did look at them rather briefly, but our conclusion at the time—and I think this is probably still my view—was that it is not going to happen in the foreseeable future. The big obstacle is that this would require fairly comprehensive international agreements on, first of all, what the global tax base should be for transnational corporations and, secondly, how we are all going to agree on how we should each determine our share of that. Even with recent pressures at the G20 level and so on, I think the prospects of getting that kind of international agreement are fairly remote. Indeed, one only has to look at the difficulties that the EU has experienced with its common consolidated corporate-tax-base proposal, which has been going on for years and is still slowly progressing towards some possible end point. This has raised controversies between member states, and there have been extreme difficulties in getting agreement on what the basis should be and how to allocate it, even within a relatively politically co-ordinated group of countries such as the EU. Getting global agreements on that seems the obvious starting point.

Lord Hollick: You do not think we should have high expectations of the Prime Minister’s efforts at the forthcoming G8 in Northern Ireland to make progress on this matter?

Professor Bond: I would be very surprised if there were much progress.

Q9 Lord Lipsey: This may not be something that is going to pop out in short order, but it is worth pausing for a minute on the question Lord Hollick raises at the end, which is this: why are we trying to do corporate taxation at all, given that so many people get out of it? There is a clear political reason, which is that when the public reads about corporate taxation, they think it is painless taxation levied on bodies that are nothing to do with them and that will not cost them a penny, and therefore comes free of charge. They therefore get very cross when Starbucks try to get out of it. In reality, taxation can only be paid by individuals of one kind or another, at the end of the day. There is therefore an interesting question as to whether corporate taxation falls progressively on individuals, or aggressively on individuals, or neutrally on individuals. I think there is a question that one ought to ask in theory, even if it is not going to lead to immediate practical implications, as to why we try to tax corporations at all when it is so bloody difficult.

Professor Bond: Yes, I agree. It is worth noting that corporate tax rates are falling. They have halved over the last 20 years or so in developed countries. Revenues, for a long time, looked as though they were not following suit, but actually I think the outlook for revenues is not so great either at the present time. One upside of that is that these problems are perhaps getting less serious.

Malcolm Gammie: One could observe that, of course, there are certain areas where we have actually given up trying to tax profits. The obvious one is shipping and the tonnage tax, where we do not impose corporate tax on the profits at all; we just use a measure of the shipping tonnage. In a sense, this is a reflection of the fact that that is not something you can tax. In exactly the same way, highly mobile elements of the corporate tax base such as patent or intellectual property income are increasingly subject to even lower rates of tax than the standard corporate tax rate. We are probably already in, or certainly heading

towards, an era where possibly the corporate tax base becomes far more fragmented, so that you tax what you can and you stop trying to tax things that you cannot tax. The real issue is whether you reach a point where you actually decide that you do not tax it at all, or you at least find other mechanisms for taxing everybody in a slightly different way.

From the Mirrlees perspective, I do not think that the Mirrlees Review was particularly sold on the idea that we should continue to keep on taxing corporate profits in the way that we do. As Professor Bond says, we did not think looking forward that it was realistic to suggest you should just get rid of it, on the basis that there was unlikely to be a consensus around that sort of proposal, within the medium term at least.

Lord Lipsey: I think that is a very good answer.

Q10 Lord Skidelsky: Allocating profit between countries is extremely complex and costly. Should we consider taxing a base that is more easily observable and less mobile? Well, I think we have discussed that quite a bit already.

Let us go on to the next one, which we have not discussed. What constraints are there on the UK acting unilaterally to move to a different system of allocation of profit? What would be the best way to seek an international agreement for fundamental reform? You have explained why international reform is so difficult, but are there any ways we could move in that direction?

Malcolm Gammie: However unsatisfactory you think the current situation is, and however much you may think it is threatened looking into the future, I suppose one can at least say that out there there is, or has been, some degree of consensus as to the type of principles that should be applied. However much we might criticise arm's-length transfer pricing or the like, the reality is that the OECD has an established set of guidelines that are used by the majority of countries. Even if one can make a great deal of criticism, or point out problems that they raise, there is to that extent a sort of international consensus. While there is

nothing to prevent any country just breaking away and saying, “Well, we will do our own thing”, I am not sure it would be attractive—certainly to a country such as the United Kingdom—to be seen to be making that sort of move and breaking what international consensus exists. Of course, one has to observe that the BRIC countries—Brazil, Russia and China and to an extent India—are maybe not as committed to the current international system as the long-term members of the OECD are. In that sense, there may be a natural breaking-up of the international consensus. Once China becomes the largest economy in the world, one can see that perspectives are going to be rather different from the way they have been in the past.

There is nothing to prevent a country acting unilaterally, although that would clearly raise issues about how other countries would react to your unilateral move. If your unilateral move were, for example, to say, “We are abolishing corporate tax”, you might have a slightly different international reaction to one that said, “We are going to start allocating more profit to the United Kingdom than length principles would ordinarily require”. In one case, you would just be saying, “Well, we are giving up taxing it”, and the other way you would say, “We actually want to tax rather more”. The international reaction to that is likely to be somewhat different. In terms of not wanting to disturb what little international consensus exists, there are considerable incentives for the United Kingdom to continue within the system and try to work to improve it, so far as that is possible and international consensus can be achieved.

Lord Skidelsky: Would you say that we should propose that suggestions for reform should be pursued within organisations like the OECD? Are these the right fora to be discussing reform of corporation tax?

Professor Bond: That is the only practical way forward, but I would not hold your breath expecting a rapid resolution of what you might perceive to be the problems.

Malcolm Gammie: There are really three fora out there, I suppose. There is the OECD, which is the principal one, because it is effectively the holder of the existing arm's length transfer pricing idea. There is the United Nations, which has had an expert committee working on similar issues, and which has produced its own guidelines of sorts along these lines but is still very much within the transfer pricing arm's-length field. Then, of course, there is the European Union. If the European Union were successful in implementing a common consolidated base with formulary apportionment, that would to an extent change the landscape, because the European Union represents so many of the existing OECD member countries. Of course, it would still leave arm's-length transfer pricing in place between the members of the European Union and other countries.

Q11 Lord Shipley: I am interested to know what you would recommend should happen. There is a serious lack of public confidence over tax collection, and deep concern, now, about tax avoidance. You know all the reasons for that. From what I have heard so far from you, I am not clear about what you would actually recommend should be done to restore public confidence. I am trying to approach this from the perception of the general public that people who should be paying their fair share of tax are not doing so. They see, on a very regular basis, headlines in newspapers and broadcast media reports that say some people are avoiding paying their share. My question is: what would you do about that, to restore public confidence?

Malcolm Gammie: I think that much of the public debate that is conducted involving multinational companies and the taxation of profits does not really get to the heart of the issue, or debate the issues in a particularly informative way. In a sense, I would like to see a far better informed debate out there as to the issues that are raised, so far as taxation of profits and multinational companies are concerned. I just think it is wrong, and I think that Lord Lawson said in one of his Budget speeches in the past that there is no such thing as a

“fair share” for corporate tax, because companies do not bear the tax anyway. It seems to me far better to talk in terms of having a fair tax system, rather than talking about it in terms of people paying their fair share, because everybody’s idea of a fair share is somewhat different.

In terms of restoring confidence, that actually goes far more to the personal tax system than to the corporate tax system. Of course, there has been—quite understandably—a lot of public revulsion at some of the tax arrangements that have been entered into, whereby people have taken large bonuses or other salary and not paid, or not been seen to pay, the appropriate amount of tax on that. That is the kind of arrangement that the current Finance Bill, with the general anti-abuse rule that it includes, ought—if it is properly presented—to go some way to provide some answer to. However, what we actually need is better informed debate about how we tax multinational companies.

Professor Bond: I fear there is no easy answer. For the foreseeable future, we are likely to have more or less the kinds of international arrangements with other countries for allocating profits of multinational businesses between jurisdictions that we have currently. They are, in many ways, unsatisfactory. They create opportunities for international firms to pay less tax globally than would otherwise be the case. That is the reality, and it is not just a misperception, so it is going to be hard to counter it purely on the perception side. If you thought it was serious enough, the only real solution within the constraints of the current system is to make all of the rates lower, which you could say is what is happening. We are on our way from 28 to 20, and if that trend continues, people will presumably worry about this less. I suspect that the rates will have got sufficiently low that we stop worrying about this before any more coherent international solution is applied.

Q12 Lord Rowe-Beddoe: That leads on to the next topic that we would like to explore with you. How successful do you think HMRC has been in dealing with, and tackling, large international business in this area?

Malcolm Gammie: That is quite a difficult question to answer at a general level. Of course, as we have already discussed, dealing with multinational companies and these particular issues is not straightforward for the Revenue. To an extent, it involves a necessary degree of negotiation or interaction between the Revenue and the companies to ensure that an appropriate amount of tax is collected. It seems to me that there has been a whole variety of different factors pulling upon the Revenue in this. On the one hand, the Revenue in recent years has put a huge amount of effort into establishing better relations with companies, and dealing with companies' tax affairs more efficiently, to the general satisfaction of both sides. It has been an interactive process, which they have engaged in very sincerely and, I think, very effectively.

Lord Smith of Clifton: That in itself has attracted a lot of public criticism of too cosy relationships and, as we sometimes say, of agency capture.

Malcolm Gammie: Indeed, and that was what I was going to come on to. In a sense, there was the thrust towards building up better relationships, and then they ran into the problem of Goldman Sachs and Vodafone and other companies, and all the criticism that that attracted. If you are going to take a more aggressive approach, from the Revenue's perspective, to these sorts of issues, then of course this has resource implications from the Revenue's perspective. Because in a lot of these areas there are no easy answers to what it is you are trying to tax and how much you are trying to tax, to be able to take a more aggressive view on companies' arrangements involves resource implications. At the same time, you have to present a friendly face to business that encourages business, because you particularly do not want international business to say, "Well, I would not go to the UK,

because the Revenue are likely—having shaken your hand to welcome you there—to hit you over the head with a bat to extract the maximum amount of profit.” There is a very delicate balance to be achieved there.

Lord Smith of Clifton: It is rather like police commissioners dining out with press barons. There is not a lot of difference.

Malcolm Gammie: I do not have much experience on that to be able to comment.

Lord Rowe-Beattie: You were going to go on, Mr Gammie, were you?

Malcolm Gammie: My impression is that, of course, the Revenue have had this issue over Vodafone and Goldman Sachs and all of the other cases. However, if you looked across the board, I think you would feel that—generally speaking—the Revenue have been very successful in the initiatives that they have implemented to build up their relations and handle large companies’ tax affairs in a more efficient manner, which ensures you reach a point of finality in terms of the tax issues that arise at an earlier point in time.

If I may be permitted one anecdote, I acted for a large insurance company over many years. I remember the tax director telling me that, when he took up his position in, I think, the late 1990s, they had their tax affairs open back to 1956. I am pleased to say that that sort of situation would not happen now, because things are conducted on a far more efficient and effective basis.

Baroness Kingsmill: Is that because the resource available to a large international company absolutely dwarfs what is available to the Inland Revenue, in terms of advice and in terms of professionals?

Malcolm Gammie: Yes. If the Revenue are engaged in a transfer pricing dispute with a large multinational, I think you could probably assume that the large multinational can put a great deal more resource into the dispute than the Revenue can.

Lord Smith of Clifton: It is not just the resource in terms of expertise, is it? You have got this revolving doors thing, where gamekeepers—if they are any good—get bought by poachers, and then the gamekeepers are weakened when they are faced with all the tax inspectors who have gone into private practice. It is a revolving door problem, is it not?

Malcolm Gammie: There is that issue. Certainly in the 1980s and early 1990s, it was a big issue. I think it is impossible to avoid that, because inevitably the private sector tends to pay better than the public sector for these particular services.

Lord Smith of Clifton: They are not paying tax. That is why they can do it.

Malcolm Gammie: Hopefully they are paying tax on salaries, even if they are not on profits.

The Chairman: In view of what you have just been saying about the Revenue, do you think the House of Commons Public Accounts Committee's criticisms of HMRC were unfair?

Professor Bond: I am afraid that I do not know enough detail of the particular comments.

The Chairman: I was really asking Mr Gammie.

Malcolm Gammie: I think they were, to an extent, but I think that is a very general question. Obviously, the Public Accounts Committee is to an extent there to hold the Revenue to account and to put them under a certain amount of scrutiny, and I think they certainly did that.

Q13 Lord Rowe-Beattie: Sorry, can I just finish my little question? Thank you. I find it interesting, in listening throughout this whole thing—and I will look at the record—that I think we have only talked about tax revenues once or twice. We have talked about the rate of taxation, and the question really is, “What is happening to the revenue side?” because we need the revenue, never mind what the rate is. I would also suggest to you, and I would like your comments—and I have been involved with large, professional organisations and international organisations—that what they needed was clarity, professionalism, and the other thing is transparency. We need transparency. I do not think a major international

company wants its affairs in this area, which is of such interest to everybody, to be anything but transparent. What do you feel about that?

Malcolm Gammie: Of course, there is one way of putting this, in the sense of asking a company whether its arrangements are such that it would be happy for them to be made fully known, in exactly the same way you might ask any individual who is thinking about some form of tax planning, “Is it something that you would be happy to be known generally, or are you only happy to do it behind closed doors?” One of the answers that you would get from some companies would be that, actually, the publication of more information about what they do would not necessarily cast greater light on what it is, or enable informed views to be formed about what it was they are doing.

The reality is that, because multinationals have to operate across many jurisdictions, the structure of international groups can be immensely complicated. It may not be complicated purely for tax reasons; it may be complicated for regulatory reasons, or for a whole raft of different reasons, and it is quite difficult to get to the bottom of it just by publishing more information, for example. PricewaterhouseCoopers gives awards to companies each year according to how transparent they are in their accounts, for example, about what their tax arrangements are. If I remember correctly, Legal and General won the award this year. I think that was probably right. Companies are, generally speaking, happy to provide more information in the sense of more explanation of what they are doing. This is not necessarily achieved just by prescriptive rules saying, “You have got to tell everybody how many companies you have got here, there, or everywhere.” That does not necessarily tell you why they have got companies here, there, or everywhere.

Lord Rowe-Beattie: Would you agree, however, that from the Government’s viewpoint—or, indeed, everybody’s viewpoint—the rate of tax is secondary and less

important to the amount that the Revenue can get hold of? You can play with the rate, but it is what you actually get out of the company or the corporation that is most important.

Malcolm Gammie: Of course, from the Government's perspective, how much revenue it can actually raise from this source appropriately is a very important issue. What one would like to see is a system where companies earning equivalent profits are paying equivalent amounts of tax, because that would be a sensible basis on which to have it, but I am not quite sure that I can add more to that. Maybe Professor Bond can.

Professor Bond: Very often, the size of distortions to company behaviour will depend more on rates than the actual amounts being handed over. If I can avoid 50p in the pound by doing something, I have got a much stronger incentive to do it than if I can avoid only 10p in the pound by engaging in the same kinds of activities. I think rates are rather important from the economist's view of how efficient, or otherwise, the tax system is. Obviously, at the end of the day, the Government has objectives on how much it wants to spend, and that has got to be financed. However, I am struck by how a lot of the discussion that we have had this afternoon illustrates that, if your objective is to raise another £5 billion in government revenue, this is one of the hardest ways in which you can go about doing it. You are going to have to spend a lot more on beefing up the resources of the HMRC to engage successfully in battles with these well resourced international companies. There may be lines of lesser resistance that one might want to pursue, if the objective is to raise additional aggregate revenue.

Lord Rowe-Beard: So do you think the rate has little to do with the ability to actually recover the tax? If I were to suggest to you that this country would have a 5% corporate rate, do you think it would actually recover more revenue from an international perspective?

Professor Bond: I would hesitate to say that, but I would be quite confident that we would raise more than one-quarter of what we would raise at 20%, in current circumstances. There is a limit to that argument when you reach zero.

Q14 Lord Hollick: I would like to come back to Lord Rowe-Beddoe's original question, which was really about the efficiency of HMRC. Are there any international data available, or any substantial anecdote, that can help us to see whether HMRC performs well, less well, or very well? I think a lot of tax directors would say that the IRS is a stiffer, more vigilant and tougher adversary, if you look at it in that way. I am thinking—and maybe this is a particular issue about the way that American tax statutes are set up—that in the context of transfer pricing, they are far less accommodating than the UK. You only need to look at the experience of offshore insurance companies in the Cayman Islands and Bermuda to see how rigorous they are. Can you give us any colour at all around the international comparisons?

Malcolm Gammie: I must say that I am not aware of any empirical research that has been done on this, but anecdotally what you say is probably correct. The IRS has historically been regarded as a tougher nut to crack than the UK Revenue, if I can put it in those terms. When you look internationally, the anecdotal comparisons that tend to be made are between the Netherlands, for example—where you can go along to your inspector and negotiate an agreement—the UK, where that was less possible, and the US, where that was impossible, or something like that. In a sense, much of the move in the UK to a better relationship with large business was, to some extent, more a move towards the Dutch model, if I can put it that way, than the US model. Of course, in the US, you are dealing with a much larger economy where, in a sense, a lot of the relationship between the IRS and corporate taxpayers is presumably with domestic taxpayers, in the sense of operating in the US. I do not know of any work that has been done to compare how the IRS matches up

with international business relative to the UK but, of course, things are on a slightly different scale in the US given the different size of the economies.

Professor Bond: Just one counterpoint would be that, in international comparisons of corporate tax revenues, the UK actually is collecting rather a lot of revenue from its corporate tax, given its rate.

Lord Hollick: Is there a table that you could give us?

Professor Bond: I dare say that we could produce one.

Q15 Lord Smith of Clifton: The drift of your answers has been that it is all very complicated and solutions are a long way away, and anyway they all get together in the end and it is not that bad, so do not get excited about it. What about the DOTAS scheme? It seems to me that the DOTAS scheme was really the Inland Revenue saying, “Look, we cannot do much about this. Let us try to morally nudge them into telling us what they are up to.” Is DOTAS likely to be any more effective than any of the other things you have talked about?

Malcolm Gammie: I think the DOTAS scheme has been effective across the board. Of course, it is much wider than corporate tax. However, if you are thinking in particular in relation to corporate tax rather than personal tax, DOTAS has operated slightly differently, in the sense that the DOTAS application to personal tax in particular was widely sold schemes among individual high-net-worth taxpayers. In the corporate sector, and particularly the large corporate sector, DOTAS operated on what are called “bespoke” arrangements, in the sense of specific tax planning that was entered into by companies to avoid tax on their profits. Its principal effect—and, I think, its principal benefit—has been to inform the Revenue far earlier than would otherwise be the case about tax planning arrangements, and has therefore enabled the Revenue to take steps to counteract tax avoidance arrangements. In that sense, the general output of anti-avoidance legislation of

one sort or another in recent years suggests that it has been reasonably effective in achieving its purpose.

Lord Smith of Clifton: Presumably it has put up the price of constructors of ingenious devices, so it has not been that bad. Thank you.

Q16 Lord Forsyth of Drumlean: I should declare my interest as a director and shareholder of a number of companies that are on the register. Could I ask you what you think about the proposal, put forward by NGOs and others, that the solution to the problem that we have been discussing is to have more sunlight, and for multinationals to provide more information about the tax that they are paying in various jurisdictions and, presumably, other aspects of all of their transactions to make that sensible? Do you think that is a sensible or a practical idea?

Malcolm Gammie: The various objectives of some of the NGOs are not terribly well articulated, nor is it clear what precisely they intend to achieve. Of course, you can see that what they are interested in is to enable developing countries, in particular, to raise effectively more tax revenue, which makes them less dependent upon aid. They have that sort of aim, as well as reducing local corruption and the ability to divert what should otherwise go to the general good as tax revenue into the private pockets of individuals in those jurisdictions. As I have said before, just the greater publication of more information does not necessarily get to any solution of the sorts of issues that we are dealing with. Indeed, one observation one can make is that developing countries frequently offer specific tax incentives to attract activity to their jurisdictions that, in a sense, work in the opposite direction of raising more tax revenue. I personally think that some of the articulated objectives of the NGOs are a little bit unclear, and that the greater publication of information is not necessarily the solution to the problems that they are trying to address.

Lord Forsyth of Drumlean: To take an example that you touched on that was somewhat controversial in recent months, there was the issue of whether the Starbucks royalty payments for the brand and the franchise were justified. If one had more information about what costs had been allocated and how they had been arrived at, would it not have been easier to form a judgment as to whether something was being done that was not appropriate or, indeed, whether companies—I am not saying this is the case for Starbucks—were being tempted to place an excessive reliance on the value of their brand or their franchise in reaching these assessments?

Malcolm Gammie: If you accept the basis that some amount can be paid for a brand that has been developed somewhere else, and therefore is being sold in to a particular jurisdiction, the existing rules—whether you have transparency or not—should answer that. The question is, “Are you paying an arm’s length price for that brand or not?” To the extent that an amount is being overpaid for it, the existing rule should prevent a payment of that level being made. I am not quite sure. You have got to ask yourself the more basic question of: “Is an allocation of profit on the basis of paying for a brand an appropriate way in which to determine whether or not the profit belongs in one jurisdiction or another?”

Lord Forsyth of Drumlean: I think my question was: “Would it help if that information was publicly disclosed?”

Malcolm Gammie: Underlying that, is there not a question as to whether or not the amount of the payment that is being made is correct? If I am buying in a service from somewhere else, and I am paying the right price for it, does it make any difference whether that is public or not? The question is: “Am I paying the right price for it?” If implicit in your question is the view that I can persuade the Revenue that 10 is the right price, but if I had to make it public, everybody would say, “Hang on a second, 10 is far too much to pay; you

should only be paying 6,” or something like that, then in that sense publication operates as some sort of check on what the Revenue are or are not prepared to agree to.

Lord Forsyth of Drumlean: Or alternatively, you avoid reputational damage, because it is perfectly clear that what is being done is perfectly proper.

Malcolm Gammie: Yes, of course.

Professor Bond: Just briefly on that: I think that greater disclosure may not be a bad thing, but it is unlikely to be a good substitute for getting the rules right in the first place. The Starbucks case illustrates another aspect of this: you mentioned the reputational concern. The impact of disclosure is going to be much greater on the kinds of companies that are directly dealing with the general public, and rather less on companies that are doing mainly business-to-business transactions. It might help a little bit on the one side, but I would not see it as a panacea.

Q17 Lord Hollick: Lord Shipley asked a very important question earlier on, when he referred to the lack of public confidence. It seems to me that it would be consistent with Mr Gammie’s desire for a more informed debate. If this information were made available, it would deal with both of those issues. It also has the by-product that Lord Forsyth has just mentioned: that public-facing companies are very jealous of their reputation, and may actually decide to play by slightly fairer or less aggressive rules if, in fact, they had to make this information available. It would seem to me that this would be a very clear public good.

The Chairman: We are about to vote. Could you answer that one very quickly?

Malcolm Gammie: I think, as Professor Bond says, it depends very much on the circumstances. Public-facing businesses are far more likely to be influenced by that than those that just deal business to business.

The Chairman: Gentlemen, there was one other question that we had. We do not have enough time now, because we are going to have to vote, and I do not think it is worth

coming back. I wondered if you could give us the answer in a written answer. I am going back to the earlier part of our discussions in relation to the Mirrlees Review. What other options are there to remove the tax advantage of debt finance, and why did the review reject them? We would appreciate it if you could just let us have a written response to that. Thank you very much indeed for coming. It is clear that we have got quite a lot of work ahead of us, but you have given us a good start. Thank you very much.

Malcolm Gammie: Thank you.