"Is there a need for regulation within EU corporate taxation?"

- The Case of the UK and Ireland

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I would like to thank my mentors Jens and Cecile for guiding me through this journey for which I hope we have all enjoyed. Also I would like to say thank you to Josefin who listened to my words from the beginning until the end.

A spectre haunts the world's governments. They fear that the combination of economic liberalization with modern information technology poses a threat to their capacity to raise taxes[1].

--The Financial Times, July 19, 2000

[1] Cited from "The Heritage Foundation Backgrounder" – 2000, P1. The Financial Times, "Wooing the Global Taxpayer: Governments Must Ensure They Provide Value in the Face of Porous National Boundaries and Technological Change," July 19, 2000.

Abstract

This paper focuses on the subject of regulation of corporate taxation within the European Union with reference to the relationship between the United Kingdom (UK) and Ireland. In this paper, the UK's tax system is analysed from an economic perspective and a legal perspective. First the relationship between the statutory corporate tax rates is shown. Then, the foreign direct investment flows in and out of the UK are presented with additional evidence from an effective tax rate analysis which supports the fact that statutory tax rates cannot be singled out on there own but need to be integrated into an overall investment perspective.

The economic analysis finds that the UK has managed to use its 'Core' title to retain its attractiveness as an FDI location up to the mid-90's. However, the manufacturing industry has been relocating out of Europe at a faster rate since the opening of the single market and there is also support for the growth of Ireland which seems to supersede its 'peripheral' image by becoming one of the UK's top four investment destinations.

On a legal basis, the UK has managed to escape the scrutiny of an EU Commission investigation into some of its tax incentives but the UK but has also been found in breach of discriminatory accounting methods, and it is being taken through the national court system in conjunction with national rules on forced repatriation of profits and a discriminatory 'group relief' system. This paper found that Ireland became such a threat to the UK after the Mid-90's that the UK removed its economic ties from its Celtic neighbour by enforcing Controlled Foreign Company (CFC) legislation upon them.

In conclusion this paper finds that as the corporate taxation policies within the EU are not regulated, tax competition exists, and though it seems that this competition can be beneficial to the member states, it is changing the dynamics of the game. Smaller countries, such as Ireland, are becoming bigger players and are having effects on an increased number of bigger economies, namely that of the UK.

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2 Introduction

In 2004, after 30 years of negotiation, the European Union (EU) will enforce the European Company Statute, a marvel to be appreciated, and in the following year all European businesses will adopt the International Accounting Standard for preparing company accounts. These two events are big steps towards the idolised goal of a truly single market.

However, a contributing factor to this goal is the much discussed and deliberated subject of tax harmonisation. The signing of the single market programme in 1992, the Ruding report 1992, the Monti package in 1996, and the Lisbon Council 2000 all considered the prospect of producing a single tax base for use within the EU.

It can be viewed that the emergence of a European company (SE), is almost ineffectual, without the accompaniment of a European tax. There has already been talk of member states offering special tax regimes for the SE to promote its use, which goes against the fundamental principles of the EU with its wish to abolish harmful tax practices, such as these.

Currently, the member states prerogative of controlling their national tax system can be seen as an obstacle to establishing a true single market. Such knock-on-effects as the ‘race to the bottom’, tax burden shifting, and economic distortions have pushed tax specialists into discussing possible remedies, such as a European Corporate Income Tax (EUCIT) and Optimal Common Base Taxation (OCBT)[2].

The Ecofin agreement has been a positive step in the short-term to focus on a closer co-operation within the tax circle, involving a voluntary code of conduct, and a mutual sharing of information between tax authorities, but the long term approach is still unaccounted for.

[2] EUCIT: replacing the current country specific corporation tax system with a single European corporate income tax. OCBT: Allows companies the option to take EUCIT tax system or choose any domestic EU country tax system, Radelli, Claudio, Klemm, Alexander, “EU corporate Tax Reform”, P.35

The issue of the 'race to the bottom' concerns the fact that member states will strive to attract the most foreign investment by lowering there corporate tax rates. To counteract this decrease of corporate income tax, member states have the ability to shift the burden over to the taxes onto labour or consumption within the country. This appears to be the most common model, shifting the tax burden from the mobile factor to the immobile factor. The point of concern for theorists is the fact that by continually lowering tax rates, the member state is going to suffer as it can only shift its burden to a certain degree. After this the welfare state will suffer due to the lack of funds to provide the member states population with the resources that they require.

However, recent studies have integrated the theory of economic geography into pure economics and have counteracted the argument that the 'race to the bottom' will produce poorly financed welfare states. Economic geography has supplied theorists with the possibility that agglomeration factors could possibly be the saviour to the aforementioned problem. Agglomeration factors are the geographic concentration of an industry over and above that what would be expected given the extent of industrial concentration in the industry. Empirical evidence and economic models have shown that agglomeration factors do in fact allow the member state to increase the tax on certain tax bases due to the immobility of the industry. This has sparked theorists to derive the theory of the 'race to the top', as agglomerated industries cannot move from the location due to essential factors of production.

Now the background to this thesis has been introduced, the core part of the project can be addressed which concerns the UK, Ireland and their respective corporate tax rates. The original theory stemmed from economists[3] who observed that governments were attempting to shift the tax burden within their tax base to alleviate pressure on the corporate tax level. The main culprit of this in recent times has been Ireland. They instilled a corporate tax rate to manufacturing companies in 1981 at 10% for which the EU commission reacted to in 1992 by stating that the rate must be increased after 2010, as it was seen as a breach of EU tax competition laws.

[3] Harberger, 1962, Mclure, 1974, Pechman and Okner, 1974, Musgrave, 1974, Zodrow and Mierzkowski, 1986 extract from Metcalf, Gibert, Fullerton, Don, "The distribution of tax burdens", 2002, P.2 - 7

Ireland has been chosen as the main comparison with the UK in this report due to the fact that Ireland were once heavily dependant on the UK economy, yet through admission into the EU they have been seen as a rising business capital of western Europe and through a series of concentrations of internal investments they have managed to produce a skilled and educated workforce, with respect from the business community and now offer Europe's lowest corporate tax rate whilst not working on a deficit of national funds, such as France or Germany.

Ireland has one of the lowest corporate tax rates in Europe, with the exception of Estonia[4], and has been the subject of head office and subsidiaries investments throughout Europe. The Irish corporation tax currently stands at 12.5% and with a 10% rate for manufacturing companies and companies located in the IFSC[5].

Foreign Direct Investment (FDI) is a reason why the tax competition exists, and is a core part of this paper. FDI is defined as "*the establishment or purchase by residents of one country of a substantial ownership and management share-usually measured by a minimum equity stake of 10 percent-of a business in another country*"[6].

The United Kingdom with its corporation tax at 30% has an important tie to the USA when concerned with foreign direct investment, but it is not separated from Europe when wanting to attract more business. With Ireland's corporate tax rate at 12.5%, less than half of the UK's corporation tax, Ireland threatens to steal a large majority of the foreign investment right from underneath the UK's nose. This paper will analyse the economic situation of the UK from the beginning of the 1980's, when Ireland's manufacturing and IFSC corporate tax rate was reduced to 10%, up to the present day and attempt to show if there was any effect on the UK in terms of tax reforms, tax revenue and FDI locational factors. The paper will then try to identify the agglomeration factors within the UK and through analysis attempt to present the evidence that the UK has or has not been affected by Ireland's corporate tax system.

[4] "In Estonia only distributed profits are taxed, while all retained earnings are not taxed at all.", Bernadi, Luigi, "Tax policy in EU new members: Estonia and the other Baltic's", 2003, P.3
[5] IFSC:International Financial Services Centre, located in Dublin
[6] Wells, Louis T Jr, Wint, Alvin G, "Marketing a Country - Promotion as a Tool for Attracting Foreign Investment", P.8

By analysing the previous reaction that the United Kingdom took to Irelands tax cut in 1981, and by then comparing it to the current economic situation we can see if the unregulated tax systems of the selected European countries are still working, or if economists will have to find another way of providing for the welfare state whilst making the UK's foreign direct investments look attractive enough to potential companies. After the economic situation has been analysed this paper will be directed to a more legal side of the arguments. These arguments will be centred around the constraints on a member state when attempting to attract foreign direct investment from within and outside of the European Union. It is obvious that the UK will have countermeasures in order to compete with other member states on a tax front, so it needs to be ascertained if these counter measures, such as state aid and tax incentives, are legitimate under EU rules or whether their could be problems with them in the future.

Previous ECJ rulings which are relevant to the subject of tax competition will be presented to highlight the type of incidents that have occurred in the past. These incidents may then be likened to the situation in the UK or Ireland. Along with the ECJ cases, tax regimes which have been outlawed by the EU and the tax systems in the UK which have come under scrutiny but have passed an initial investigation will also be analysed. The EU code of conduct on harmful tax competition will be the main choice of literature to analyse the UK situation. Ireland's special tax regimes have already been assessed by a previous theorist[7], so the main focus will be if the UK has legitimate means to attract the investment and if the tax competition between the two countries is benefiting the UK. The paper will attempt to add to the arguments centred on the erosion of tax bases. It is believed that the erosion of tax bases has intensified as tax rates have increased, and and an important part of the tax-base erosion is the threat posed by the increasing geographical mobility of tax bases.

The scope and method of this paper is described as follows, as well as the basic outline of how the paper is set out in the Disposition.

[7] Turley, Gavin," Is Irelands corporate tax system creating tax induced distortions on the location of investment?", 2002, P1-30

2.1 Scope

This paper is going analyse the corporation tax rate set by the UK and Ireland and discusses the relationship between the two. Indirect taxes, such as VAT, are not focused on within this paper, neither are taxes on consumption or labour. When analysing the Foreign Direct Investments, portfolio investments were not included. Other countries beside those mentioned, were not focused on in this paper as the aim was to isolate the relationship between the two countries in question.

2.2 Method

The method used in this report was a collection of empirical studies carried out by other economists and tax specialists cited within this paper. No first hand data was collected for this study, due to the complexity, cost and time scale involved on creating original data within the area of tax.

2.3 Disposition

The paper starts with a literature review of both sides to the argument of tax competition. The UK situation is then presented with an analysis of the tax rates and tax reforms over the past twenty years. Then, the foreign direct internment analysis occurs looking at the pattern of investment in to the UK. This is followed by an agglomeration analysis highlighting clusters of industry within the UK and why these industries are concentrated. Then an analysis and discussion of effective tax rates follows with a brief outlining of indirect effects on Investment. After this the economic section is summarised and concluded then the Legal section of the paper begins. The legal section outlines previous case law regarding taxation. It then continues to highlight tax practices which have been outlawed by the EU commission. After this those practices which are under scrutiny in the UK are highlighted including tax practices which have been investigated but deemed harmless. The legal section is then summed up and concluded followed up by an overall conclusion.

3 Literature Review – Tax Competition

A change in the views of taxation has occurred over the last few years as economic geographers have sent a shockwave through economists throughout the world, but more specifically Europe, over the fact that the theory of countries racing each other to offer the lowest tax burden may be a falsehood and in fact this race may be in reverse.

Tax competition is not a purely negative stance; it can also be seen as a positive occurrence. In support of tax competition, Mason Gaffney[8] wrote that "*a more efficient government would offer superior public services without higher taxes; or the same services with lower taxes…Those who sanction competition to regulate private enterprise to attract suppliers and customers, and undercut monopolies, should by the same reasoning also endorse competition among governments to attract people and capital. Such competition is a major line of defence against the tyranny that a monopoly government could exercise*". It is not this papers choice to choose one side or the other, but an assumption is made which is then followed throughout the papers analysis. This assumption is that corporate tax rates are decreasing on average over the last twenty years but whether this threatens to outweigh the advantages of having competition between countries is not confirmed. This assumption is also further explained by the use of economic geography supporting the case that though the statutory rates are decreasing this is not producing the threat of inefficiently funded welfare states due to the fact that corporate tax is a lot more complicated than merely the statutory rate.

This review shall first discuss traditional economic evidence and arguments of a race to the bottom (Delaware effect)[9]. Then, an argument of inefficiencies between taxation and government spending shall be placed to back up the first perspective. This section will be displaying the findings and thoughts of economists who believe that taxation is dependent upon the action of other countries and that it has been

[8] Gafney, Mason, "The Worldwide Benefits of International Tax Competition – The Progress Report", 1998, P.6

[9] Vogel, David, "The Law and Politics Book Review" Vol. 9 No. 3, 1999, P. 102-103 http://www.bsos.umd.edu/gvpt/lpbr/subpages/reviews/baker99.htm

spiralling down and is continuing to fall to a sub-optimal level. The review will then look at the other side of the tax competition argument involving such factors as agglomeration, and national policy which seem to defy the existence of the race to the bottom and even go as far to say that there could be grounds of argument for a race to the top (California Effect)[10].

Krugman's definition of subdividing Europe is 'key' to understanding the actions by both Ireland and the UK and so will be stated as a means to be used. Europe is divided into two parts namely the Core (i.e. UK) that benefits from agglomeration economies who are associated with being an established centre and the Periphery countries (i.e. Ireland) who do not[11].

3.1 Opposing Viewpoints

The traditional perspective on tax competition views the actions of government as being similar to the actions of private businesses. "Competition forces each firm to offer its goods at a price that is higher than necessary to cover costs and earn a reasonable return on investments"[12]. Competition also forces firms to cut costs to a minimum. This cost-cutting can be seen as a good thing for society as it promotes efficiency and offers reasonable prices. "Governments are forced to offer a combination of public good services, such as schools, infrastructure and legal system"[13], and to also offer taxes which are high enough to accommodate these. Then, there is the other aspect of the offering, the government wants to have the most attractive offer to bring in investment into the area but if the tax offered is to low to cover the cost of the public service then the welfare state will start to suffer[14]. Governments want to increase inward investment as FDI has a positive impact on the profitability of domestic investment when foreign investors are directly involved in the provision of infrastructure such as telecommunications and transport or when they transfer technology or create clusters of co-operating firms. The basic concept stems

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[10] Vogel, David, 1999, P. 102-103.
[11] Baldwin, Richard, Krugman, Paul, "Agglomeration, integration, and tax harmonisation", 2000, P.3
[12] Baldwin, Richard, Krugman, Paul, 2000, P4
[13] Ibidem, P4.
[14] Ibidem, P4.

around the need for governments to have a high tax rate if a small number of firms exist or to create a trade-off by taxing more firms at a lower tax rate, in an attempt to find the optimal level of inward investment and optimal tax rate.

Before the analysis can begin it would be favourable to attempt to define what is meant by normal tax competition. Wilson and Wildasin[15] (2001) define it in its narrowest form as "uncooperative tax setting by independent governments, under which each government's policy choices influence the allocation of a mobile tax base among "regions" represented by these governments". The EU commission has created an extensive definition of what tax competition which is "*tax measures which affect, or may affect, in a significant way the location of business activity within the community'*

3.2 Negative Viewpoints

3.2.1 Tax System Evolution

Though policy making is a vital component of tax competition, the origins of why theorists are arguing from separate standpoints needs to be established. It is believed to have stemmed further back to a time when financial integration was in its infancy. When World War II came to an end, the countries involved increased the social security contributions by an enormous scale for to be able to recreate the once prosperous welfare states that had existed. Yet this redevelopment took place in separate market places, closed off by trade barriers, such as tariffs and capital controls. These control barriers were imposed by national law, which restricted the mobility of tax bases, making it a national concern and prevented any outside influence having an effect on the national levels.

As the European Union became more of a singular entity, through the single market at the end of the eighties, these aforementioned restrictive boundaries were almost depleted. This elimination of trade and capital barriers allowed the four freedoms to

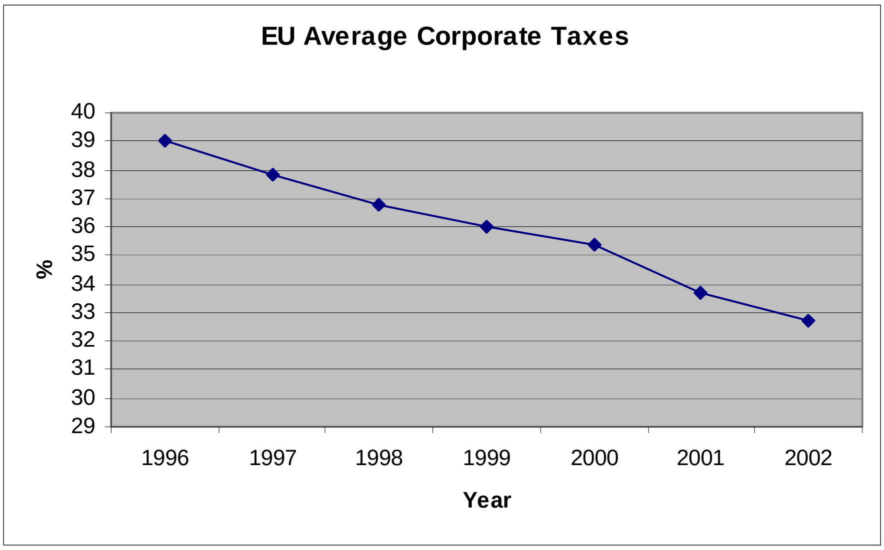
[15] Wilson, John, Wildasin, David, "Tax competition: bane or boon?", 2001, P.3

flourish, with capital, labour, services and businesses having the freedom to roam all over Europe. This meant that national governments were now competing to attract as many of these factors as possible, in the hope that, for taxation purposes, they can maintain their welfare and respect among the community.

The Italian economist 'Tanzi' will be held as the main theorist who believed that tax competition would result in lowered Corporate Income Tax (CIT) rates. Tanzi initially carried out a study in 1987 in which he made such predictions for the corporate tax rates of fourteen countries. The study was continued to 1999[16] and the results were along the lines as Tanzi had predicted, in the fact that CIT had lowered, in some countries in a very dramatic fashion and this spurned the arguments for the dangerous spiral.

The KPMG annual corporate tax survey 2002 data, figure 1, displays a graph which highlights the average EU corporate tax rate from 1996-2002. It visually replicates the results that were found by Tanzi. It would be easy to make a snap judgment if this was the only factor being considered; it would seem like very clear evidence that corporation taxes are spiralling down.

FIGURE A – EU AVERAGE CORPORATE TAXES



Source: KPMG Annual Report Survey 2002

[16] Wunder Haroldene, "Tanzi – a retrospective 1987", 1999, P.764

Scholars such as those who have been mentioned and others have warned of “beggar-thy-neighbour policies”[17] and have been cautious over the fact that this race to the bottom would force down Government revenues which have been generated by corporate taxes. There was a lot of fear that the tax on capital and businesses would be driven to zero in each member state destroying the respective welfare states of each country.

This leads the paper into its first question surrounding the UK and Ireland:

Question 1: “*Have the statutory income rates for the UK and Ireland been continuously declining, and what is the relationship between them?”*

3.2.2 Welfare inefficiencies

The conclusion held by theorists that tax competition can one day lead to a sub-optimal welfare society opened on the “assumption that the policy makers are benevolent”[18]. Krugstrup defines the benevolent government as the one who wishes to “maximise the welfare under the resource and behavioural constraints of the economy”[19]. The opposing end of that perspective is the Leviathan[20] government whose objective is to maximise the tax revenue generated by the member state. The tax competition acts as a downward force on the tax rates creating an optimally efficient tax rate, otherwise the benevolent government would be able to charge sub-optimally high rates and create wastage in consumption. Zodrow and Mierszkowski, 1986, stated that this waste of consumption effectively creates inefficiencies, as tax revenue will be spent in a manner in which it was not supposed to, this may result in a tendency towards inefficiently low tax rates and an associated too low level of public good provisions.

[17] Tanzi and Bovenbourg, 1990 Extract from Genschel, Phillipp, “Globalisation, tax competition and the fiscal viability of the welfare state”, 2001, P.1
[18] Krogstrup, Signe, “What do theories of tax competition predict for capital taxes in EU countries? A review of the tax competition literature”, 2003, P13
[19] Krogstrup Signe, 2003, P.13
[20] Krogstrup Signe, 2003, P.15, Turley, Gavin, 2002, P.7

3.3 Positive Viewpoints

So even though the previous argument is compelling there is still room to falter as the emergence of geographic factors in the economic field have spurned theorists to maintain that they believe that there are other factors involved, such as agglomeration factors, and that tax competition is not going to simply erode tax rates and tax bases away. In fact the economic geographers feel that there is room to state that tax rates in 'lumpy'[21] areas of countries are to in fact increase. The downward pressure on capital tax rates due to tax competition often has been argued to be counterbalanced by agglomeration factors, such as decisions for investment, due to the level of education, the skills possessed by the workforce, the infrastructure and access to the desired market.

The economic geographers are using their models to state that even though capital is becoming increasingly mobile this does not necessarily mean that a race to the bottom is occurring. Theorists such as Kind et al (2000), Andersson and Forslid (1999), Baldwin and Krugman (2000) and Hansson and Olofsdotter (2003) acknowledge the presence of agglomeration factors which put in place different economic rents across countries. These theorists have found that when economic activity is agglomerated or clustered in an area of a country, there is a positive taxation of capital without giving an incentive for the capital to flow out of the country. This can lead into the theory of 'location of investment' with such economists as Dunning and Marksuen or Mudambi and Navarro who stress that local policies, such as corporate income taxes, are one of many factors which come into play when deciding on the location of a firm. As Mudambi and Navarro state[22] "these influences on the location of investment emanates from locational and infrastructural factors" whilst also taking into account "local political tradition".

[21] Wilson, John, Wildasin, David, 2001, P.5
[22] Mudambi, Ram, Navarra, Pietro, "Political Tradition, Political Risk and Foreign Direct Investment in Italy", Management International review, volume 43(3), pp.247-265, 2003

3.3.1 Agglomeration Forces

Kind et al[23] stated that "due to the presence of agglomeration forces, previous tax recommendations need rethinking". Their analysis showed that if industrial agglomeration is concentrated in one single country, a government may, through a positive tax, be able to exploit the locational rents[24] created by agglomeration forces and there by increase national welfare.

Andersson and Forslid (1999) analysed the relationship between trade integration and industrial location. They attempted to show how economic integration may lead to increased concentration of industrial production. One of there key findings was that when one type of production is agglomerated in a region it tends to be stuck there due to its demand and supply linkages. Andersson and Forslid (1999) showed that by analysing tax competition in an economic geography framework it allows the possibility to unveil the focus which was absent in traditional tax competition literature. They stated that the scope for taxation depended crucially on whether industry was agglomerated or dispersed, which in turn justifies the argument that taxes do not have to be minimal when the mobile factor, capital, is concentrated.

Andersson and Forslid (1999) found that higher trade costs tend to make it less attractive to serve markets via exports, which tends to disperse production. A higher tax rate on low skilled workers makes a location more attractive for the mobile skilled worker since it implies a higher provision of public goods, which in itself makes the area attractive for businesses as it is full of highly skilled workers. Andersson and Forslid (1999) summarise to say that the emerging conclusions are that where the notion that immobile factors such as unskilled labour, are to be taxed very heavily due to competition for mobile factors is supported, the notion that this leads to very low taxes for mobile factors is not.

The agglomeration perspective gives rise to the second question within this paper:

[23] Extract from Krogstrup Signe, 2003, P.16 , 2000

[24] 'Locational Rents' are *"differences in profit measured relative to the normal level of economic profit. Essentially, these rents are merely the extra value of some factor of production"*, www.http://www.nera.com/Publication.asp?p_ID=1995

Question 2: *"Does the UK possess agglomeration forces which may influence the foreign direct investment link between the UK and Ireland?"*

3.3.2 Effective Corporate Taxes

Average effective corporate tax rates are different to normal (statutory) corporate tax rates as they include depreciation rules, inventory evaluation and loss offset provision. Though more comprehensive than the statutory rate they are harder to measure accurately. Hansson and Olofsdotter (2003) confirm theorist's[25] beliefs that statutory corporate tax rates have decreased dramatically over the last decade. However they also continue to say that *effective* corporate tax rates and *statutory* tax rates have not declined in the same manner due to the broadening of the tax bases.

Hanson and Olofsdotter believe that this absence of evidence to support a decline in effective corporate tax rates may indicate an increase in forces restraining a race to the bottom. Whilst statutory corporate tax rates have declined from the early 1970's to early 2000's, average effective corporate tax rates have been constantly rising and decreasing, but have increased on a whole from since 1965. Hansson and Olofsdotter conclude in there findings that tax competition does play a role in lowering corporate tax rates, but this is only a negative effect of EC membership, as the increased integration lowers trade costs. Yet as these trade costs are further reduced the importance of agglomeration forces increases and in turn creates a positive rent to be taxed.

3.4 Indirect Factors

3.4.1 Market Size

The market size and the geographical location are factors which are considered in this paper, setting out the traditional view of the Peripheral country, Ireland, and the core

[25] Bond and Chennells, 2000, Devereux, Griffith and Klemm, 2002.extract from Hansson, Åsa, Olofsdotter, Karin, "The effects of tax competition and new economic geography in OECD countries", 2003, P.7

country, the UK. Increasing returns to scale turn out to be essential for explaining the uneven geographical distribution of economic activity. Models of trade with increasing returns and imperfect competition explain why countries without significant advantages, with respect to each other, can develop different production structures on the basis of their different access to markets. The implications of these models for location, and the effects that economic integration has on it, are formalised by Krugman and Venables[26] (1990, 2000). They start by assuming that the world is divided into two regions: a large 'core' country and a small 'peripheral' country. "The core country has larger factor endowments than the peripheral country. This difference in endowments is meant to reflect better access to markets from the core region than from the peripheral region rather than differences in actual size. This distinction is particularly important when trying to assess the empirical relevance of market access effects. Davis and Weinstein (1998) find no evidence of market access effects for OECD countries on the basis of each country's own size, but find evidence of strong market access effects on the basis of each country's access to markets"[27].

"If there are some trade or transport costs for industrial goods, more firms set up production in the country with the larger market, In this case the UK, to avoid trade costs in a larger fraction of their sales. What Krugman and Venables (1990) show is that the tendency to locate in the larger market is stronger for values of trade costs that are neither too high nor too low. Economic integration, which is an important factor within this paper, increases the share of sales that each firm makes in the other country, thereby weakening the effect of more local firms on competition. Yet increasing returns imply that the larger sales of firms producing in the core give them higher profits. As more firms enter in response to those profits, the size of industry in the core rises above its share of world endowments"[28].

3.4.2 Transfer Pricing

Transfer pricing is another factor which will be mentioned within this paper due to the

[26] As cited from Ottaviano, Gianmarco, Puga, Diego, "Agglomeration in the global economy: A survey of the 'new economic geography'" Centre for Economic Performance, Discussion Paper No. 356, 1997, P.4
[27] Ottaviano, Gianmarco, Puga, Diego, 1997, P.4
[28] Ibidem, P.6

classical argument[29] of shifting profits from a high tax country to a low tax country. The theory of transfer shifting stems around the setting up and expansion of Multi National Enterprises (MNE's). "The strategies and structure of MNE's have changed over time. The establishment of stand-alone affiliates based on a specific territory, operating autonomously and duplicating activities represent old strategies"[30].

"The theory concerning MNEs suggests that they have access to propriety assets and that there projects will, on average, be more profitable"[31]. "At present, an increasing number of MNEs are becoming integrated Europe-wide organisations. They build, and operate through production and subcontracting networks that span the whole of Europe. The progress in information and communication technologies has made access to networks easier for all firms. Nevertheless, it remains true that larger firms have more possibilities to build and participate in such networks throughout Europe. The creation of these integrated enterprise networks have far-reaching effects on European restructuring and integration"[32]. The fourth question within this paper is:

Question 3: *"Do the indirect factors, which influence a firm's choice of location, have an effect on the tax competition between the UK and Ireland?"*

3.5 The Legal Aspect

The economic literature has defined the hypotheses that exist as to how and why tax competition exists, but whether the tax competition is deemed harmful or not can only truly be analysed from a legal perspective. Within this part of the literature review, the methods of analysing the economic hypotheses through a legal perspective are explained.

[29] Cnossen, Sijbren, "Taxing capital income in the European union", 2002, P.236
[30] Devereux, Michael P, Griffith Rachel, Klemm, Alexander "Corporate income tax reforms and international tax competition" Economic Policy, 35. 2002
[31] Devereux, Michael P, Griffith Rachel, Klemm, Alexander "Corporate income tax reforms and international tax competition" Economic Policy, 35. 2002
[32] "The Competitiveness of European Industry - 1999 Report´", Submitted by Österreichisches Institut für Wirtschaftsforschung (WIFO), Austria, 2000, P.18

3.5.1 Code of Conduct, the Treaty and the ECJ

Now that the economic side of the arguments has been set out it is also necessary to view the legal aspects. The 'Code of Conduct' was designed to '*curb those business tax measures which affect, or may affect, in a significant way the location of business activity within the community'*. The problem in question is the UK's tax system and its special tax regimes that it has set up to entice foreign investment into the country. These special regimes will be more competitive every time as the competition increases and each member state finds new ways of attracting the most capital and finds new ways of offering better deals. It is the task of this thesis to review these special tax regimes and make a judgment about whether they are viable and within the restrictions of the EU code of conduct guidelines or whether the UK is likely to run into problems with the commission[33].

The code of conduct is not a legally binding instrument. It represents a political commitment by member states to refrain from harmful tax competition, and includes evaluation and review procedures. The 'Code' deals with tax relief systems that may have a significant effect on business location within the EU, those systems that may potentially result in a lower effective level of taxation than is usual in the member state concerned are considered to be harmful and gives a definition of what constitutes 'harmful' competition. A high-level group comprising representatives of the Member States and the Commission was set up in March 1998, to discuss and review tax measures which might fall within the scope of the code[34]. These guidelines shall be applied to the special tax regimes as well as Article 86 EC of the treaty, saying that "member states shall not…in terms of special exclusive rights…enact or maintain in force any measure contrary to the rules contained in the treaty". The legal section shall be summed up with the fourth question of the thesis:

Question 4: "*What are the relevant tax incentives used by the UK and are they harmful to tax competition within the EU?"*

[33] How the code of conduct defines harmful tax competition can be found in the Appendices
[34] European Commission, "Tax Policies in the European Union", 2000, P31

4 UK Corporate Tax Reform

As cited by Krugman (2000)[35], "Sherlock Holmes frequently noted that it is a capital mistake to theorize before examining the facts since this insensibly leads one to twist facts to fit theories rather than theories to fit facts". The following sections displays and comments on factual data concerning tax rates, taking into account many different factors, with a theory then summarised in the Economic analysis.

4.1 Tax Policy from 1980 onwards

The literature review has set out the background to the arguments from which this thesis topic has stemmed from. The tax competition argument needed to be laid out so that one can understand why the UK would, if at all, be affected by the tax policy used by Ireland.

To assess the state of the UK, this paper will briefly discuss the history of the tax policy taken, highlighting the major changes and then focusing on the past twenty years to ascertain what tax policies the UK government has adopted in the past, what the policies were and the repercussions they have had on the tax revenue generated within the UK. Below is a time line dating back to 1980 highlighting these important changes in the tax system as researched by Devereaux, Griffith and Klemm (2004):

FIGURE B - SIGNIFICANT UK CORPORATE TAX REFORMS SINCE 1980

Year	Comment
1980	Corporate tax was 52% and the small companies' rate at 40%
1983	Small companies' rate cut from 40% to 38% from 1982/83.
1984	Corporate tax rates being gradually reduced from 52% in 1982/83 to 35% in 1986/87. Small company's rate cut in one step to 30% from 1983/84.
1986	Small companies' rate cut from 30% to 29%.
1987	Small companies' rate cut from 29% to 27%.
1988	Small companies' rate cut from 27% to 25%.

[35] Baldwin, Richard, Krugman, Paul, 2000, P5.

1991	Corporate tax rate cut from 35% to 34% in 1990/91 and to 33% from 1991/92..
1992	Temporary enhanced capital allowances between November 1992 and October
1993	First-year allowance of 40% on plant and machinery and initial allowance of 20% on industrial buildings.
1995	Small companies' rate cut from 25% to 24%.
1996	Small companies' rate cut from 24% to 23%.
1997	Corporate tax cut from 33% to 31%. Small companies' rate cut from 23% to 21%.
1998	Corporate tax rate cut from 31% to 30%, small companies' rate cut from 21% to 20% from 1999/00. ACT abolished from 1999/00. System of quarterly instalment tax payments phased in from 1999/00.
1999	New starting rate for small companies introduced at 10% from 2000/01.
2002	Small companies' rate cut from 20% to 19%. Starting rate cut from 10% to 0%.
2003	100 per cent first-year capital allowances for information and communication technology, reduction of the minimum expenditure threshold to £10,000 to R&D Tax Credit
2004	Company profits paid out as distributions to non-company shareholders subject to a corporation tax of 19%.

Data source: Devereux, Michael P, Griffith, Rachel, Klemm, Alexander, 2004 [36]

It is obvious at first glance that the major change in policy came in 1982/83 when the government decided to lower the tax rate from 52% to 35% over a four year period. Although further rate cuts occurred during the nineties, no changes of this magnitude were repeated. However, there are two other time periods within the table that seem to be rather drastic (See figure D, P.34). There were two successive tax cuts in the first period which was between 1989 and 1991, where the main corporation tax was reduced from 35% to 33%. Then there were another two tax cuts, the first was in 1996-1997 when the tax was reduced from 33% to 31% and then the second reduction was in 1998 - 1999 when it was reduced to 30%. The second reduction brought the

[36] All information up to 2002, is cited from Devereux, Michael P, Griffith, Rachel, Klemm, Alexander, “Why has the UK corporation tax raised so much revenue?”, Institute for fiscal studies, 2004, P.7

UK corporation tax below the EU average at the time, and coincidentally, this was the same period for which Ireland broke the UK threshold and brought there tax rate down to 28%.

Simple explanations exist that need to be stated for the reasoning behind the initial tax cuts at the beginning of the 1980's. The reasoning was due to economic integration within the European economy. As countries became closer on economic levels, restrictions and barriers were being effectively removed by the European Commission allowing an ever closer union to develop.

The traditional framework in the UK began to break up in the late 1970's and early 1980's as several interrelated developments occurred. The first major rate cutting, base broadening, corporation tax reform was in 1984. The rationale for the reform was to reduce distortions within the investment and financial policy for UK firms, by "reducing the dispersion in effective marginal tax rates across different forms of investment and sources of finance"[37].

"First, information technology and communications improvements hugely increased the data processing capacity of financial firms and extended the geographical range of their operations. Second, these technological advances encouraged the firms to look for new products and new international markets. Third, the growing internationalisation of banks widened the scope of their activities made regulatory control less effective. Furthermore, an international bank could escape at least some domestic restrictions by switching funds to a less regulated country. Thus competition between regulatory regimes to keep financial operations and jobs tended to encourage deregulation. Fourth, once the process of domestic deregulation had begun, it inevitably spread across sectors. For example, as the UK banks diversified in the 1980s, they became major lenders in the mortgage market, which previously had been the prerogative of the building societies"[38].

[37] Devereux, Michael P, Griffith Rachel, Klemm, Alexander "Corporate income tax reforms and international tax competition" Economic Policy, 35. 2002, P.480
[38] Thompson, Steve, Ingham, Hilary, "Structural Deregulation and Market Entry: The Case of Financial services, 1993, P.4

Through financial deregulation at the beginning of the 1980's the section of the tax system being directly affected was the statutory tax rate In contrast to this, almost 20 years later, according to a source[39] "the UK, like many countries in 1997 and 1998, were continuing to focus on improving the effectiveness of their taxing mechanisms through refinements to underlying tax bases rather than by direct changes to their corporate tax rates. In the hunt for additional tax revenues in their own jurisdictions, the UK and other tax authorities world-wide were targeting multinational companies far more aggressively showing that direct corporate income tax rates are only part of the story". A change to the statutory tax rate is fairly obvious in itself and does not need a great deal of explaining, but refinements to a tax system can come in many forms and are not always so apparent. These refinements will now be highlighted and analysed to see if they are a counter measure or merely coincidental policy changes.

A focused analysis of the UK tax system from 1998 to 2004 is shown below. When analysing the information it is clear to see that from what was once a fairly simple tax system has now become a lot more complicated and intricate. The changes in each tax year are highlighted so it can be assumed that the previous year's situation is the same for the following year's situation unless otherwise stated.

The main corporate tax rate changes have been highlighted already, in particular the period in 1998 – 1999 when the UK lowered its corporate tax rate below the EU average whist in the same period Ireland broke the UK threshold. From this point onwards it seemed that the tax rate itself was left alone but that the structure of the small company tax rate was altered a number of times as well as the distribution of profits tax rate being changed in 2004. Below, the tax system changes within the six year period are identified:

1998 – 31% (Main Corporate Tax Rate)

- A lower rate of 21% applies to companies with profits up to £ 300,000.
- Marginal relief applies on profits up to £ 1,500,000.

CHANGE:

  - It is proposed to reduce the main rate to 30% from April 1999

[39] KPMG, "Corporate Tax Surveys 1998", 1998 – 2004, P.1

1999 – 31% [Main Corporate Tax Rate (Ireland break UK threshold)]

CHANGE:

- April 1999, the general corporate rate will be reduced to 30%
- Small companies' rate will be reduced to 20%.

2000 – 30% (Main Corporate Tax Rate)

CHANGE:

- From April 2000 a 10% rate will apply to companies with taxable profits up to £ 10,000 with marginal relief up to £ 50,000.
- Companies with profits between £ 50,000 and £ 300,000 will continue to pay tax at the small companies rate, which will not necessarily remain at 20%

2001 – 30% (Main Corporate Tax Rate)

- No Changes

2002 – 30% (Main Corporate Tax Rate)

- No Changes

2003 – 30% (Main Corporate Tax Rate)

CHANGE:

- A nil rate (10% at 1 January 2002) applies to companies with taxable profits up to £ 10,000, with marginal relief up to £ 50,000.
- 100 per cent first-year capital allowances for information and communication technology, reduction of the minimum expenditure threshold to £10,000 to R&D Tax Credit
- Companies with profits between £ 50,000 and £ 300,000 pay tax at a 19% rate.

2004 – 30% (Main Corporate Tax Rate).

CHANGE:

- From April 2004, profits distributed to non-corporate shareholders will be charged at a minimum rate of 19% even where they would otherwise be taxed at a lower rate

When viewing the information above there appears to be no alterations to the tax system in years 2001 and 2002, so the tax system setup in the year 2000 remained unchanged for three years. It should be worth noting that it was within this period that the Irish corporate tax system moved to 10% points lower than the UK corporate tax rate, and the revenue of taxes as part of the whole GDP was on the decline.

The next section is going to analyse these refinements within the tax system which appeared to have a major affect on the manufacturing and financial sectors within the UK.

4.1.1 2001 – Tax Refinements

Below are the refinements to the UK tax system produced by the government in the 2001 budget, these are not viewed as major changes in the tax system but as refinements to the system.

1. Enhanced Capital Allowances (ECA's) enable a business to claim 100% first year allowances on their spending on qualifying plant and machinery. There are three schemes for ECA's which are for energy-saving plant and machinery, low carbon dioxide omission cars and natural gas and hydrogen refuelling infrastructure, and water conservation and plant and machinery. Businesses can write off the whole of the capital cost of their investment in these technologies against their taxable profits of the period during which they make the investment. This can deliver a cash flow boost and a shortened payback period[40].
2. Abolition of Withholding Tax on international bonds and foreign dividends. The measure will mirror for these firms the exemption, currently enjoyed by banks, from the requirement to deduct tax at source from annual interest payments made in the ordinary course of their business.
3. The repayment of the Climate Change Levy via reduced Employer National Insurance Contributions (NIC's) begins reducing the rate by 0.3%.

The first refinement allows the companies, mainly those in the manufacturing sector to invest in plant and machinery and not get taxed on the initial investment. This was the first piece of legislation in many years which actually was directed towards the

[40] http://www.eca.gov.uk/

manufacturing industry. At this time there was also talk of a special Research and Development scheme being setup by the government aimed at the larger companies within the manufacturing sector in the following year. The second relief refinement quote above, proved very popular within the financial sector by allowing the withholding tax to be abolished. This refinement is designed to increase the desire and the attractiveness to relocate and invest into the UK.

Finally, the third refinement is there to highlight what a true refinement is, such as decreasing the national insurance contribution paid by the employer within the UK. It benefits all industries and even though this change may seem minor and inconsequential it did in fact cost the UK Government £1,050 million.

4.1.2 2002 – Tax Refinements

This section is going to set out the tax alterations in 2002 which were deemed very popular and once again spoke mainly to the manufacturing sector, and this was the production of a Research and Development tax credit for large companies.

- "Company's spending money on research and development including those who subcontract work, to an exhaustive list[41], are allowed to use the R&D tax credit system set up by the UK government in the annual budget of 2002.
- It is a refinement to the R&D tax credit which was issued to small and medium sized companies in 2000 which will now allow large companies to use the tax credit.
- Large Companies will be entitled to an additional deduction from their taxable income of 25% of their current spending on qualifying R&D, in addition to the normal 100% deduction. For example, if a company spends £100,000 on qualifying R&D, it will be able to deduct £100,000 from its taxable income under ordinary tax rules and an additional £25,000 under the R&D tax credit. For a company paying the main rate of corporation tax at 30% this gives a reduction of £7,500".[42]

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[41] non-taxpayer such as a university or a charity body http://www.inlandrevenue.gov.uk/budget2002 /revce1.htm,

[42] http://www.inlandrevenue.gov.uk/budget2002 /revce1.htm,

As an example of how important the R&D section of the manufacturing sector is, researchers, Becker and Hall (2003), found that “an increase of 1% in the share of business R&D funded by the government will increase the volume of foreign R&D investment by 1.6%”.[43] The R&D tax refinement is an area which can be developed and built upon, perhaps analysing the level of manufacturing FDI inflows and outflows over the coming years and what affect the R&D refinement has had on them.

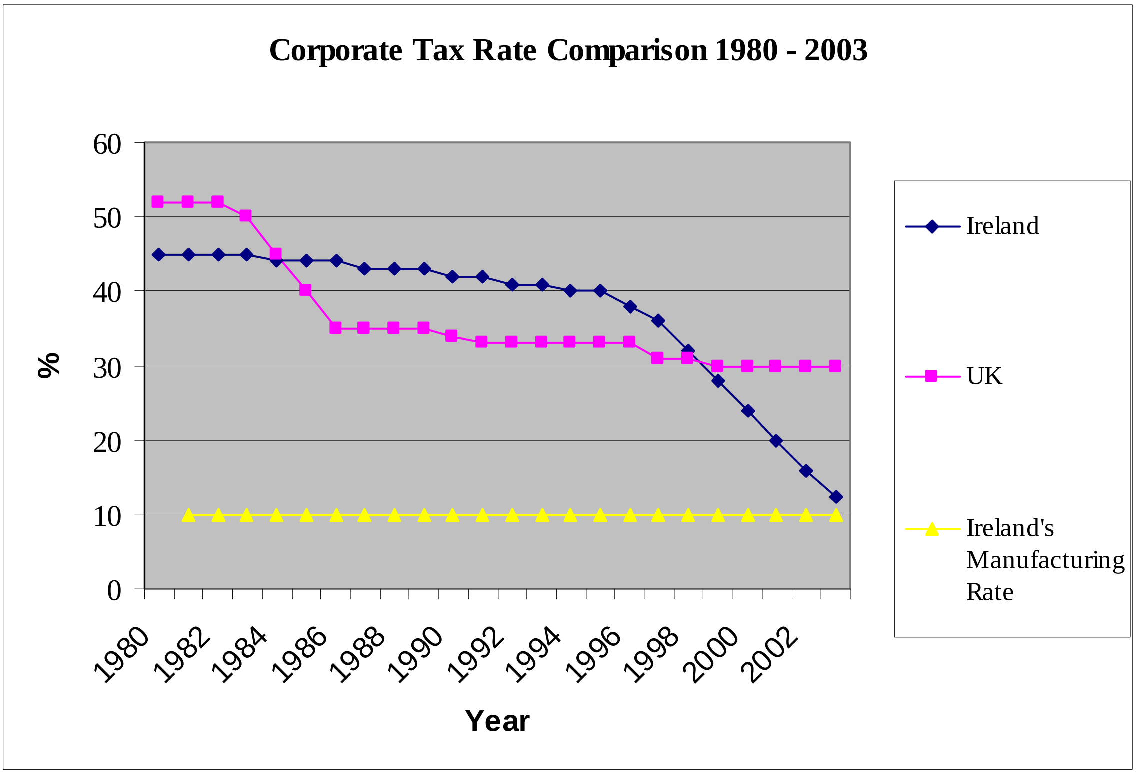
Now the tax reforms from 1980 have been stipulated and an in-depth analysis of the tax system over the last six years has been laid out, the next section is going to analyse the rates mentioned in the tax reforms ad compare them with that of Irelands statutory rate and its manufacturing rate. The previous section has been a one sided view from within the UK concerning its fiscal policy changes, the next section is going to build on this by comparing the situation with another EU country, namely that of Ireland.

[43] Hall, Stephen, Becker, Bettina, “FDI in industrial R&D and exchange rate uncertainty in the UK”, 2003, P.13

5 Corporate Tax Rates and Revenue

Within the literature review the comment was made that the statutory tax rates of Ireland and the UK would need to be compared and the relationship between them defined. This section displays the statutory tax rates for both countries, allowing a visual comparison over the last 20 years, and also discusses the revenue effects of the UK tax rate.

FIGURE C - UK & IRELAND CORPORATE TAX RATES



Source: "Corporate income tax reforms and international tax competition"[44]

Ireland's manufacturing tax rate of 10%, which is a main focus of this paper, was introduced in 1981 and even though some data is missing, the next biggest cut started from 1997 when the statutory tax rate was reduced every year leading up to 2003 with a 4% percentage point difference in each subsequent year. The biggest changes for the UK occurred when the three successive tax cuts between 1983 and 1986 caused a percentage dropped of 5% points in each year, can be seen on Figure C, above. This

[44] Data collected from: Devereux, M.P., R. Griffith and A. Klemm (2002) "Corporate income tax reforms and international tax competition" *Economic Policy*, 35, P.451-495.

was the only time that the UK had a lower statutory tax, with exception to the manufacturing and IFSC tax rate, than Ireland. It is clear to see that after the last tax reduction to 35% in 1986 the UK has managed to hold a fairly stable corporate tax rate, only dropping 5% points over the next 18 years.

This leads to the first question of the thesis:

1. *"Have the statutory income rates for the UK and Ireland been continuously declining, and what is the relationship between them?"*

It is this question that will spurn the argument on concerning the harmful tax competition within the EU, and whether there really is need to worry or whether it is just a passing fashion. Of course by purely comparing statutory tax rates one tends to have a naïve picture of what is really going on. The trend of declining corporate tax rates was evident in 1997 and the comparison of direct corporate income tax rates is only part of the approach in analysing the underlying costs-to-businesses. "Companies can be affected by direct and indirect forms of taxation, the tax base on which taxes are levied, the degree of sophistication of tax legislation and compliance monitoring by authorities, and the various forms of incentives offered by countries to attract certain type of business activity"[45].

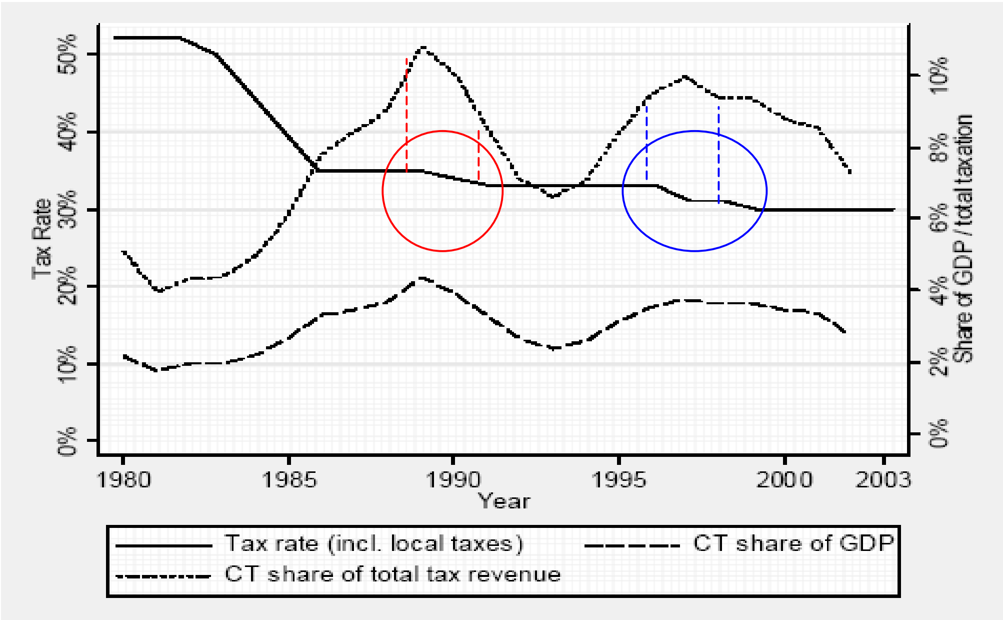
One of the ways to identify how the UK could have been affected by Ireland's tax cuts is to analyse the revenue generated by the corporate tax rate. The graph below demonstrates one of the puzzles[46] that will hopefully be unwrapped in this thesis, and this concerns that fact that even though the present corporate tax rate is almost half of what it was in 1980, 20 years on, the government has earned more revenue from a lower corporation tax than it had done previously.

Chote et al[47] state that the "tax revenue from the corporate tax rate is volatile and also admits that it could stem from stiffer competition between governments and action taken by the European court of justice in response to company complaints or new

[45] KPMG, "Corporate Tax Survey 1998-2003", 1998 – 2003, P.1
[46] Devereux, Michael P, Griffith, Rachel, Klemm, Alexander, "Why has the UK corporation tax raised so much revenue?", Institute for fiscal studies, 2004, P.3
[47] Chote, Robert, Emerson, Carl, Simpson, Helen, "The IFS Green Budget", 2003, P.25

European directives"[48]. The graph below definitely fits in with the UK governments description when it stated that it is volatile, and they also contributed the fact that, from previous research on the statutory tax system, it would be a fair assumption to state that it works on a cyclical basis and that the revenue from the corporate tax rate should be improving over the next few years.

FIGURE D - REVENUE FROM CORPORATE TAX RATES



Data Source: Devereux, Michael P, Griffith, Rachel, Klemm, Alexander, 2004

The graph above indicates the two time periods where their have been important tax cuts. The first was in the form of two successive tax cuts, 1989 – 1991, highlighted by the red circle. The red circle shows that the tax cuts were followed by declining revenue, though this was just after the opening of the single market. When looking at the tax cuts occurring in 1996 and 1998, highlighted by the blue circle, there was also another immediate reduction in tax revenue.

In comparison with world events, the first period, 1989-1991, coincided with the opening of the single market whist the second period, 1996-1999, coincided with the Asian Financial crisis, 1997, and the adoption of the Euro occurred during the 1998-1999 tax reduction.

[48] Chote, Robert, Emerson, Carl, Simpson, Helen, "The IFS Green Budget", 2003, P.25

Also, one can see from Figure D that although there has been a slight fluctuation in the corporate tax/GDP performance, overall the corporate tax has become an increasingly larger part of the UK's GDP, so it appears that as the tax rate has decreased over the twenty year period the tax revenue has increased. By analysing the 1985 point on the graph, as the statutory corporate tax rate was being reduced from 40% to 35%, the revenue soared in the opposite direction, as well as the GDP percentage increasing to what would become an all time high.

It should be noted that "revenues also received a temporary boost in the four years from 1999–2000 to 2002–2003 from the introduction of a payment system in quarterly instalments (see Figure D, P.34). This had the effect of bringing tax payments forward and thus led to companies paying more than one year's tax per year during the transition to the new system"[49].

Obviously, this is a simple picture and it isn't an entirely accurate description, but when taking the majority of actions that have occurred on the graph, it is a fair assumption to say that these tax cuts over a long period of time are promoting more revenue than previously, although the correlation does seem to have exponential effects. The Institute for Fiscal Studies (IFS[50]) Green Budget report 2003 stated that "each downward revision of the forecast for the near future has been accompanied by an upward revision of the growth rate of revenues for later years". This implies that almost the entire revenue decline is attributed to cyclical or other temporary factors that will soon reverse[51].

Now that we have seen that the revenue is higher than it was in 1980, even though the corporate tax rate at the time was at an all time high, we can see how profits in the main sectors of the economy were essentially made up.

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[49] Chote, et al, 2003 , P. 29

[50] IFS is an independent research organisation, Which provides economic analysis of public policy, www.ifs.org

[51] Chote, et al, 2003 , P. 29

FIGURE E – SHARE OF TOTAL CORPORATE PROFITS IN UK

Sector / Year	**1982-85**	**1986-90**	**1991-95**	**1996-00**	**2001**
Agriculture	0,7%	0,5%	0,5%	0,4%	0,4%
Manufacturing	**46,8%**	**40,5%**	**40,0%**[52]	**32,1%**[53]	**31,1%**
Construction	2,7%	4,1%	2,6%	2,5%	2,7%
Overseas	5,8%	3,3%	5,6%	5,0%	5,0%
Services	44,1%	51,1%	51,3%	60,0%	60,8%
Of which:					
Banking,Finance, Insurance	**16,3%**	**16,8%**	**19,3%**	**27,7%**	**32,8%**
Other services	27,8%	34,8%	32,0%	32,3%	28,0%

Data source: Inland Revenue Statistics[54]

On a general level the profits levels in Figure E show which industries are more successful. The success or demise of an industry sector in a certain country will undoubtedly affect the location decision of investors when choosing to invest in another country. It is an indicator of the economic situation within the UK and how some sectors decrease in profitability and others increase.

When analysing the above table we should focus primarily on two areas, the manufacturing and the financial sectors. The first area is the manufacturing sector, as it is a central pulling point for the Irish tax system. From the table above we can see that the biggest difference in profits came from two points. The first point was from 1986-1990 where the profit dropped by 5,1% points, and then again in between 1996-2000 where the profit dropped again but this time it was bigger at 7,9% points. The second sector to look at is the financial sector, for which the UK is famous for, which was growing at a rapid rate while the manufacturing sector was steadily declining. The financial sector seems to be steady between 1982 and 1990 with a slight increase but then over the next 5 years the sector increased by 3 percent and then in the following 5 years the whole sectors profits essentially doubled.

[52] Red marker highlights two successive corporate tax cuts as shown in the "UK revenue analysis" chapter, P.20

[53] Blue marker highlights two successive corporate tax cuts as shown in the "UK revenue analysis" chapter, P.20

[54] Devereux, Michael P, Griffith, Rachel, Klemm, Alexander, "Why has the UK corporation tax raised so much revenue?", Institute for fiscal studies, 2004, P.24

The statutory tax rate and sector profitability are major concerns for those companies wishing to invest in an industry in another country. These investments decisions are fuelling the competition between the EU member states. In the next section the integration between the UK and Ireland are going to be shown by highlighting the amount of investments that have occurred between the two as well as the main outflow destinations. This next section is going to be used as a general indicator that the two economies have economic links and are both embroiled in the same want for investment as other EU member states.

6 Foreign Direct Investment Analysis

This section is going to present data regarding FDI flows focusing on the UK and Ireland as well as the integration with the other European countries on a whole. First of all, due to data limitations it is not possible to obtain information regarding sector and country location, but county and sector information can be gathered individually. This means that the FDI data collected is only going to be used as an indicator as it should be able show the level of integration between the UK and Ireland and the UK and a selection of other European countries.

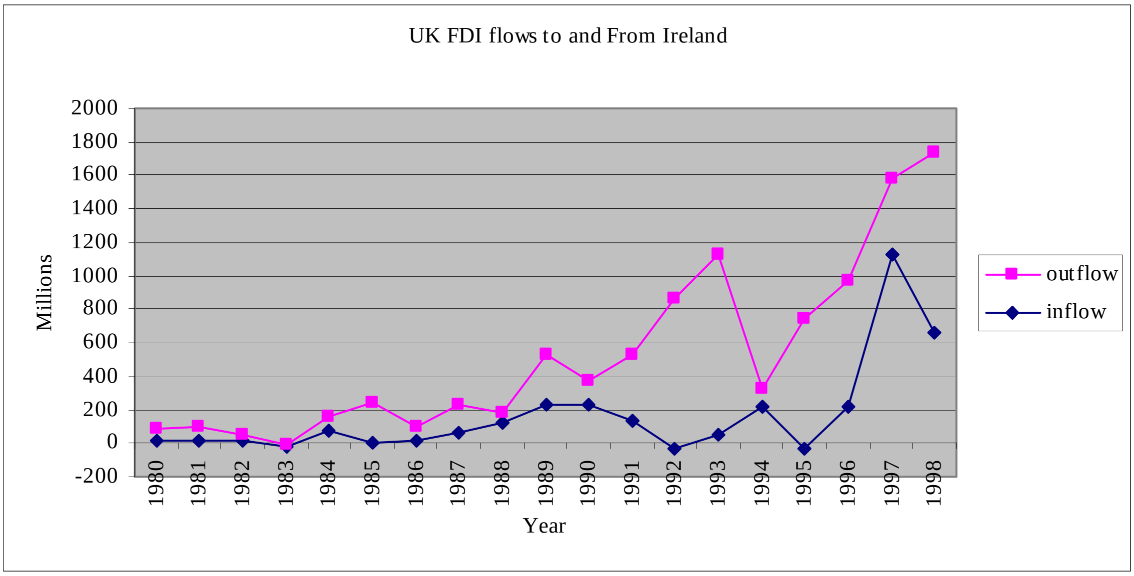
Since the UK joined the EU in 1973, London has arguably been seen as the financial capital of Europe battling against Frankfurt of Germany and Paris of France. The increase of financial revenue at the beginning of the 1980's is due to the reign of Margaret Thatcher as the UK's prime minister as she greatly strengthened the commitment to monetarism. The financial deregulation that she introduced in 1979 allowed many businesses within the financial sector to enter new markets and compete against each other on new levels and in new ways. The Manufacturing industry was badly affected due to the Conservatives party's victorious win over the industry's strikes whilst at the same time the financial sector was strengthened[55].

The first group of data to be presented are the total UK FDI flows to and from Ireland. This graph will be used as an indicator to illustrate the level of integration between the two countries and will be seen as sign of transactions between the two countries, displaying the level of cross border movement.

The graph below, Figure G (P. 39), covers all sections of industry and shows that outflows from the UK to Ireland have been of a higher value than those coming from the opposite direction. However, the two sets of data on the graph do tend to follow the same trend with exception to the period during the opening of the single market, when outflows were boosted from the UK and relocated to Ireland, and the inflows from 'Ireland to the UK' slumped.

[55] http://www.ex.ac.uk/~RDavies/arian/amser/chrono18.html

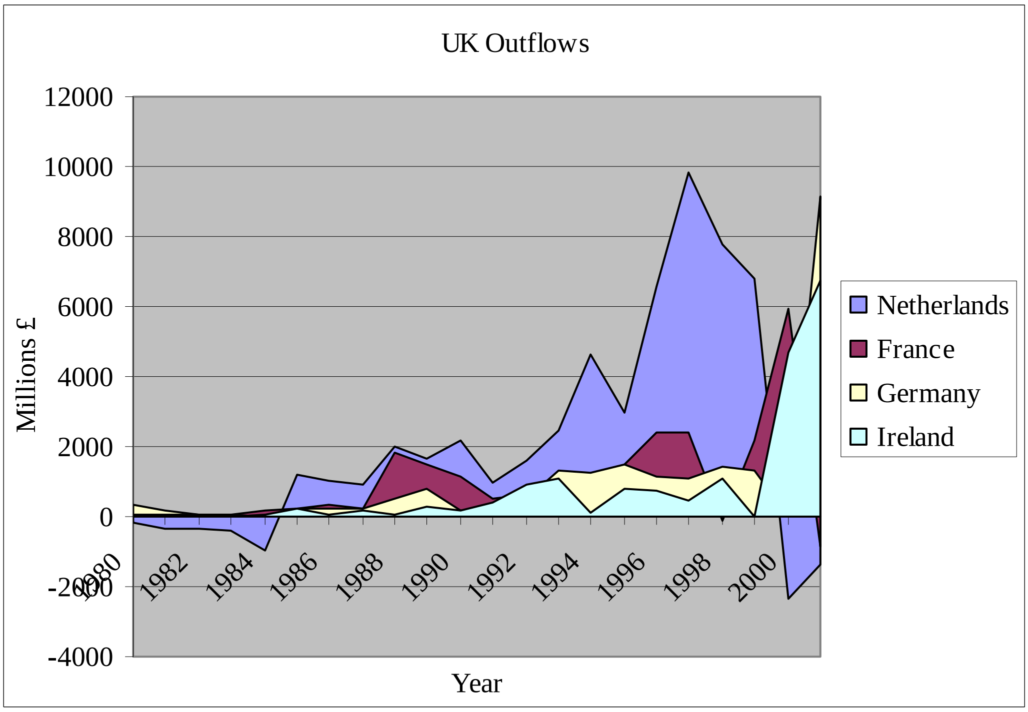
FIGURE F – FDI FLOWS WITH IRELAND



Source: OECD Database

It should be noted that the years from 2000 to 2001 have been omitted from the graph above due to the fact that the FDI outflows were at 4672 and 6756 million pounds respectively. This would mean that the graph would not be as readable as it is now. This obviously must be taken into consideration when analysing the above data.

FIGURE G – UK OUTFLOWS TO SELECTED COUNTRIES

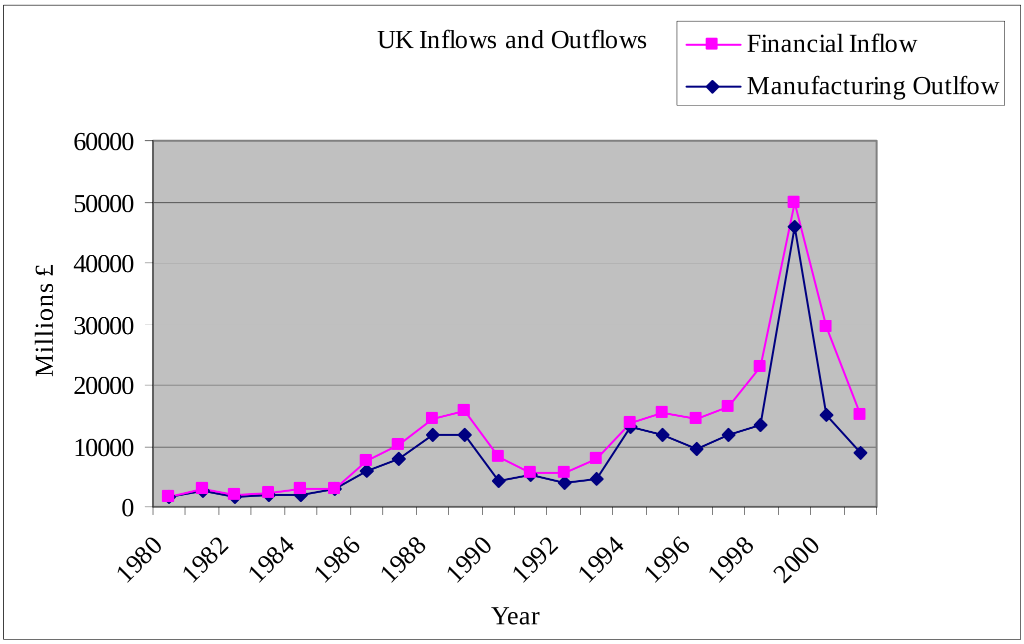


Source: OECD Database

The next piece of data, Figure H above, involved all of the UK's FDI outflows with focus on a select group of countries. Two core countries, that of France and Germany were chosen, and two peripheral countries such as Ireland and the Netherlands were chosen. The Netherlands will be counted as peripheral as its core status comes with being integrated with Belgium and Luxembourg. The core countries are those which are meant to hold the agglomeration factors, the concentrations of production which provide economic of scope and scale for industry so should be a magnet for FDI outflows. The Netherlands has extremely attractive tax measures and can be seen as the biggest outflow region for FDI from the UK. One of the reasons for the FDI from the UK to the Netherlands being so high is due to the tax system offered by the Dutch government in which it allows "brass-plate" [56] companies to register the head office, and the tax measures instilled by the Dutch government have often caught the attention of the EU commission. Figure H shows that Ireland, even though a peripheral country, is affecting the location of investment flowing out of the UK. The FDI flows from the UK to Ireland has in periods out valued that of the 'UK to France' and has not been far from being on the same value as the FDI from the 'UK to Germany'. Figure I, below, shows data containing the manufacturing out flows from the UK and the financial inflows.

FIGURE H – FDI SECTOR INFLOWS AND OUTFLOWS

Source: OECD Database



[56] 'Brass Plate' companies are defined as "Companies were set up tax laws that have helped businesses from other countries avoid paying taxes on royalty income. Documents and regulatory filings show that most companies had no employees, sold no goods and had headquarters consisting of post office boxes", http://www.iht.com/articles/125147.html

At the beginning of the 1990s, the UK government cut both its small business tax and it reduced its normal corporation tax with two successive cuts, from 33% down to 30%. This appeared to have little effect on the inflow of the finance industry or the outflow of the manufacturing industry. Though there is an increase of both out flows and inflows when the next two tax rates cuts were made in the late nineties, it seems clear from the graph that the FDI flows work on a cyclical basis, when the economy seems favourable for investment the companies carry it out.

Due to the availability of the data it is not possible to identify the location of the manufacturing outflows, or the type of FDI outflows that are making there way to Ireland but they do provide a good indicator that FDI location does exist between the two countries.

The foreign direct investments themselves rely on more than just the statuary tax rates, but also include the infrastructure, in particular transport links, market access, market size, agglomeration factors, effective tax rates, tax incentives, tax relief as well as cross border tax agreements. The next section is going to highlight some of these factors within this list, namely, the agglomeration factors, effective tax rates, market size and access as well as tax incentives in the form of the possibility of transfer pricing. By highlighting these other factors a more informed perspective can be created over the reasons why an investment choice is made and why the two countries are competing for this investment.

7 UK Agglomeration Analysis

The agglomeration analysis of the UK[57] will involve highlighting the industries that are perceived to be agglomerated, which includes a brief analysis of the market, the area where the industry clusters exist and why the UK is so favourable for this industry. The question in the literature review was:

Question 2: *"Does the UK possess agglomeration forces which may influence the foreign direct investment links between the UK and Ireland?"*

The UK contains four main areas of agglomeration, which is extremely important in terms of investment as these areas within the UK may not be advantaged with favourable tax incentives but the fact that the industry is agglomerated creates an incentive in itself. Below, are the four areas defined and explained with relation to the industry, its location, and in some cases, why the UK has economic advantages within this area.

7.1 Biotechnology Industry

"The UK is the European leader in biotechnology through its accomplishment as a centre of excellence for science. With favourable economic and political conditions, a clear and fair regulatory regime and one of Europe's largest venture capital markets, the UK provides the ideal conditions for biotechnology development. Forty-five percent of Europe's public biotechnology companies are located in the UK. The UK country has approximately 480 dedicated biotechnology companies which utilise the cluster development around key universities, research and regulatory institutes"[58].

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[57] All information regarding agglomeration in the UK has been cited from www.invest.uk.com.
[58] http://www.invest.uk.com/investing/info_sheets.cfm?action=sheet&sheetID=48

7.1.1 Clusters

"The UK's biotechnology community is clustered in regions with a strong scientific base that is supported by the provision of high quality infrastructure. A number of industry-led networks have been established to link the activities of biotechnology companies with local universities, research institutes and development organisations. The areas are Oxfordshire, Cambridge, York and London".[59]

7.2 Electronics Sector

"The UK is one of the leading locations within Europe for electronics and related industries. Its research and development expertise and strong support structures for manufacturing have enabled it to attract many large global electronics companies."[60]

7.2.1 Clusters

"The electronics industry represents approximately 10 per cent of Scotland's economy and provides between 70,000 and 90,000 direct jobs. Wales has a strong electronics industry led by overseas investment, with approximately 300 companies"[61].

7.2.2 Economic strengths

"The UK's greatest strength is its leading-edge research and development, aided by close links with academia, which has attracted some of the world's largest manufacturers, such as Sony, Motorola and HP/Compaq. These are low-volume, high-value market sectors, requiring a highly skilled engineering base and a well-educated workforce. The UK is Europe's strongest market for independent semiconductor

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[59] http://www.invest.uk.com/investing/info_sheets.cfm?action=sheet&sheetID=48
[60] http://www.invest.uk.com/investing/info_sheets.cfm?action=sheet&sheetID=41
[61] Ibidem

design, with 40 per cent of Europe's revenues and 40 per cent of the design houses.[62]"

7.3 Software Sector

"The UK is one of the most successful locations in Europe for attracting software companies with expanding e-business and telecommunication markets having created many investment opportunities. The UK's software sector is one of the fastest growing areas in the economy, characterised by extremely rapid technological change".[63]

7.3.1 Clusters

"The UK is known as one of the most innovative and advanced locations within the software sector. Major clusters for software and computer service companies exist, for example, in the central belt of Scotland, Cambridgeshire, Thames Valley/M4 Corridor, Greater Manchester and the Midlands".[64]

7.3.2 Economic strengths

"There are more than 95,000 software and computer services companies based in the UK, from small, dynamic innovators to global corporations, within the software sector. Major UK strengths are technical and high-level management skills, a good business infrastructure, flexible employment, high levels of internet penetration and access to European markets."[65]

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[62] http://www.invest.uk.com/investing/info_sheets.cfm?action=sheet&sheetID=41
[63] http://www.invest.uk.com/investing/info_sheets.cfm?action=sheet&sheetID=49
[64] Ibidem
[65] Ibidem

7.4 Financial Services

"The UK is one of the world's leading centres for international banking and financial services. London is the largest international banking centre in Europe, with an estimated 50 per cent share of European investment banking activity. It is the world's top city for institutional equity holding and the most important over-the-counter derivatives trading market, with 36 per cent of the global turnover. London is also the leading international centre for Foreign Exchange trading, with 31 per cent of global turnover. London accounts for 56 per cent of the world's foreign equity trading, over two-thirds of which is in euro area stocks. London's leading role in the international financial services industry arises from a long history of openness, with relatively easy access to markets and a tradition of welcoming foreign firms, supporting a trading culture which dates back over a century to the time when the UK was the dominant world trading country"[66].

7.4.1 Clusters

"While London is both an international centre and also central to the UK financial services industry, other cities, particularly Edinburgh, but also Glasgow, Manchester, Birmingham, Bristol and Leeds are important domestic financial centres. Scotland is the second-largest financial centre in the UK and one of the ten largest European centres for banking, life and pensions and investment management. There are more corporate headquarters located in London than in any other European city. One-third of the Fortune Global 500 companies have their European headquarters there, compared with Paris (9 per cent) and Frankfurt (3 per cent). Investment banking is encouraged since over 65 per cent of the Fortune Global 500 companies are represented in London, more than in any other European city"[67].

[66] http://www.invest.uk.com/investing/info_sheets.cfm?action=sheet&sheetID=40
[67] Ibidem

7.4.2 The UK's Financial Services Strengths

"Factors underpinning London's status as an international financial centre include a history of openness, combining relatively easy access to markets and tradition of welcoming foreign firms. As well as a trading culture sustained since the UK was the dominant world trading country over a century ago and a concentration of firms in one location contributing to economies of scale".[68]

The analysis of the agglomeration clusters in the UK indicates that the 'race to the bottom' is not a simple economic effect and that the UK does have measures to halt or at least slow down its descent. These clusters within the UK mean that when a firm is considering a location it will want to consider more than merely statutory tax rates but the infrastructure, market size, market access, knowledge 'spillover[69]' effects and economic openness.

According to a source[70], Ireland too has agglomeration forces in the form of the electronics industry and the pharmaceutical industry. The Irish government targeted these industries with investment and growth due to "weightlessness" of the industry as they contain a high value to weight ratio. According to the same source, these industries are more commonly found in peripheral countries due to the reason just stated, but the UK, as a core country also contain a clustered Electronics sector.

The next section will be presenting the theory of effective tax rates and why this factor is important for the location of investment. The agglomeration factors in themselves are only a small part of the overall investment picture, so by combining this with the effective tax rates analysis the influences of the investment choice between the UK and Ireland will be shown.

[68] http://www.invest.uk.com/investing/info_sheets.cfm?action=sheet&sheetID=40
[69] Spillover effects: "any direct effect of public expenditure, or a special type of beneficial externality. *A spillover effect occurs when an investment increase the productivity of other people, or business. Some types of spillover also increase the rate of return to investment*". www.agtrade.org/defs.cfm
[70] Turley, Gavin, "Is Irelands corporate tax system creating tax induced distortions on the location of investment?", 2002, P.15.

8 Effective Tax Rates and Indirect Factors

This section is going to first look at effective tax rates across the UK, Ireland and a third EU country, namely that of Italy, in order to assess the attractiveness of the location for investment. Then, the other indirect factors which are relevant to the UK and Ireland case are going to be examined. Due to the complexity of assessing effective tax rates, a previous study is going to be used to portray the attractiveness of all three locations.

8.1 Effective Tax rate

There are many factors which affect the location of a firm when investing in a country. At the end of the previous section some of these factors were listed. The factors from this list which are deemed relevant are going to be the market access and market size as well as the subject of transfer pricing. The reason why the last factor has been included is due to the fact that the UK has a relatively low tax rate compared to the rest of Europe and allows "brass-plate" companies to exist allowing corporation's profits to be taxed within the UK corporate tax rate and also gives firms the incentive to move profits between high and low tax jurisdictions in order to avoid high taxation.

Both the tax rate and the tax base are relevant in determining incentives for investment. The standard way to summarise an investment choice is to look at the impact of tax on a hypothetical investment project that just earns the minimum required rate of return. In this section a study[71] conducted by Devereux, Griffith and Klemm (2002) will be represented as an example of how effective tax measures are calculated and used in the analysis of location investment. This section will attempt to highlight the fact that location investment is influenced by more than just the statutory corporation tax.

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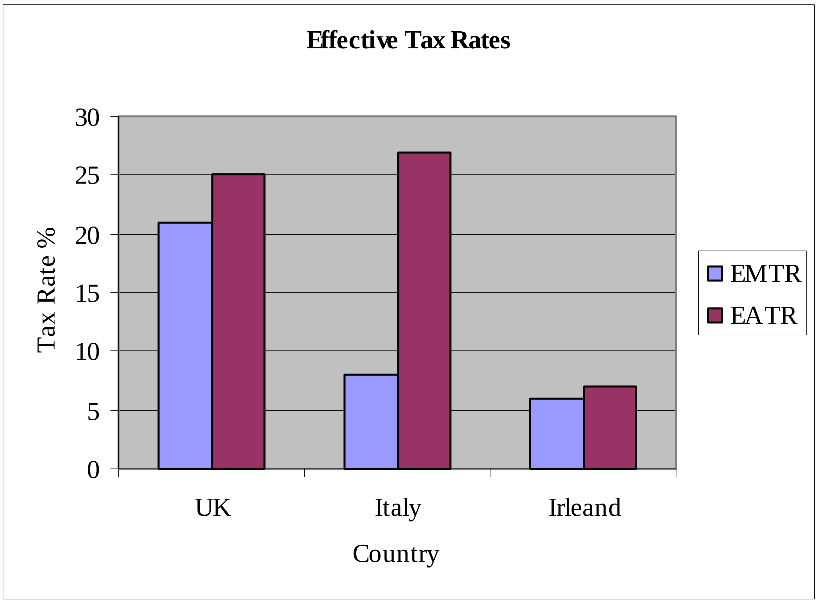
[71] Devereux, M, Griffith, R, and Klemm A, "Corporate income tax reforms and international tax competition", 2002, *Economic Policy*, 35, P.451-495.

The study took the approach of assessing the "proportional difference between the pre-tax and post tax required rate of return" (EMTR)[72] and the proportion of total profit taken in tax (EATR)[73]. "The higher the EMTR figure, the greater the required pre tax rate of return is, and so the incentive to invest in this location is lowered. If there are two investments one of which has a higher pre tax profit, but a higher EATR, then the one with the lower pre tax profit will be taken due to the fact that the proportion of profit which is taxed is lower, meaning that the corporation get to keep more of the money that it makes"[74].

FIGURE I – EFFECTIVE TAX RATES COMPARISON



Source: OCED Database

To explain the EMTR and EATR system, the graph above contains data for the UK, Italy and Ireland. When comparing just the UK and Italy, Italy has a lower EMTR, which would normally mean that is more attractive for investment as the required pre-tax rate of return is lower, but when contrasted against Italy's EATR, the investment choice changes as the UK has a lower EATR, which means that a smaller proportion of its profits gets taxed, and this is deemed more favourable as a location for investment according to Deveraux, Griffith and Klemm (2000)..

72 Effective Marginal Tax Rate
73 Effective Average Tax Rate
74 Devereux, M, Griffith, R, and Klemm A, "Corporate income tax reforms and international tax competition", 2002, Economic Policy, 35, P.461

Ireland on the other hand has a lower EMTR and a lower EATR which according to the study would make it a more favourable choice for investment than the other two countries represented in the graph. As stated previously, Ireland has a lower statutory tax rate, at 12.5%, plus its effective tax rates are lower as well.

Yet there are still other factors to be taken in to consideration in the form of market size/access and transfer pricing.

8.2 Market Size/Access

Though as shown above the effective tax rate may be more favourable in Ireland than the UK but the market size and the access to this and other markets is a very important factor when a company is deciding on investing in another country. The UK is dubbed as one of Krugman's "Core countries". It enjoys the advantages of having a big market, easier access to other member state markets and having the title of a core country which statistically are more successful due to agglomeration forces, market sizes and overall wealth. Ireland is within the peripheral definition and does not experience that market access or the market size that the UK does. Though the economy is growing, Ireland is not represented on a financial scale like the UK or on a manufacturing level like Germany[75].

8.3 Transfer Pricing

Transfer pricing concerns the terms that connected parties use when they conduct business with each other. The issue is of most importance for multinational groups that conduct business across international boundaries. The transfer pricing policy of such groups will often have a significant effect on the amount of profit or loss that is recognised in each of the countries in which they do business. For this reason, the issue of transfer pricing is of great importance both for multinational groups and for tax authorities around the world.

[75] Ottaviano, Gianmarco, Puga, Diego, "Agglomeration in the global economy: A survey of the 'new economic geography'" Centre for Economic Performance, Discussion Paper No. 356, 1997, P.5

In common with most other industrialised countries, the UK has legislation that requires cross border trading and financial transactions between affiliated entities to be conducted according to the arm's length standard. "This means that the terms and pricing of such transactions undertaken in the course of conducting business and in the provision of finance should be the same as if the transactions had been between completely independent parties".

At the moment the UK allow profit shifting for corporate groups, called "group relief", within the UK and to overseas branches without any charge. However, companies which have subsidiaries outside of the UK will encounter a tax on the payment paid to and from the parent company. This means that companies will not need to conduct transfer pricing within the UK but should be careful when conducting business between member states.

This section has analysed the indirect factors that are relevant to this case, and it is these factors that spurn the third question of the paper:

Question 3*: "Do the indirect factors, which influence a firm's choice of location, have an effect on the tax competition between the UK and Ireland?"*

The previous sections of this paper have outlined the economic indicators concerning Ireland and the UK and there respective tax rates. The tax rates themselves play an important role in attracting investment, as well as playing an important role in the form of retention. These sections are now going to be analysed, and theorized in the following summary.

9 Economic Analysis

This section will now attempt to theorize the economic relationship between the UK and Ireland. First, the questions which were stated in the literature review will be answered by using the data from the previous sections. Then, special consideration will be given to the UK's manufacturing and financial sectors to attempt to explain the industry activity and how the tax incentives used by Ireland may have affected them.

9.1 Question Analysis

Question 1: *"Have the statutory income rates for the UK and Ireland been continuously declining, and what is the relationship between them?"*

It is not a disputed fact, and the data within this paper strengthens that fact, that the statutory tax rates for both the UK and for Ireland have been decreasing over a 20 year period. The initial decrease at the beginning of the 1980's was due to the financial deregulation which swept through Europe. It often coincided with a broadening of the tax base so that the revenue which was once simply generated by one tax did not decline, but did in fact increase on average over this twenty year period.

This increase in revenue at the beginning of the 1980's can be attributed to the financial deregulation that occurred through Europe as the economies became more integrated, the UK itself lowered its statutory tax rate but broadened its tax base. In fact, after the tax base was broadened the revenue from the tax within the UK increased dramatically. The revenue results then appeared to work on a cyclical basis but each tax reduction did also coincide with a drop in tax revenue.

The relationship between the UK tax rate and the Irish tax rate is not a close one but both taxes share the same world economy and so both are open to the same economic shocks. The first change to both countries tax rates at the beginning of the 1980's has been due to the aforementioned deregulation. Then, after the single market had opened, the UK instilled two successive tax rate reductions but there was no evidence that this has any relationship to the tax system of Ireland. It would be a natural reaction by most countries to want to be more attractive as a place of investment. The relationship between the tax systems does appear to increase when entering the second half of the 1990's. Ireland has announced that it planned to decrease its tax rate by 4% each year until it reached 12.5%. The UK at the same time reduced its tax rate twice in 3 years, which placed the tax rate below the EU average. The tax system within the UK of the next 5 years was refined with lower tax rates for small and medium companies, introduction of plant and machinery credits for its declining manufacturing sector and the introduction of 100% tax credit for research and development expenditure.

The link with the statutory tax rate is weak, but it may exist. Though Ireland is deemed a peripheral country, it has the highest growth rate within Europe. Its infrastructure is arguably on par with the core countries and it is definitely competing within Europe for foreign direct investment. The UK as a core country, has certain securities, but is by no means untouchable. Though the UK may not have been as overt as Ireland, when digging deeper into the tax system, it appears that the UK has instilled measures to entice investment away from its Celtic neighbour.

Question 2: *"Does the UK possess agglomeration forces which may influence the foreign direct investment links between the UK and Ireland?"*

It was clear from this section on agglomeration factors that there are forces at play within the UK which as a core country is common. The UK has arguably Europe's and one of the world's most illustrious financial capitals which plays a great part in attracting investment and keeping the country competitive. Though Ireland has established a centre in Dublin with an attractively low tax rate, it has not affected the profitability of the UK financial industry. The software and electronics industries' are going to be given a big boost with the R&D tax credit that has just been introduced and is likely to strengthen the industry and increase the incentive to invest in this area.

The profits of the manufacturing industry have been declining over the past twenty years but have now slowed up presumably due to the government stepping in and designing tax policies specifically for that industry.

Figure H, within the FDI section (P.39), shows that the amount of FDI flowing from the UK to Ireland greatly outweighs the amount of FDI coming from the opposite direction. The outflows from the UK to Ireland have been growing at a faster rate over the last 20 years, and have been growing exponentially compared to the inflows from Ireland after the single market had opened.

Around the time when the Irish corporate tax system fell below the UK's corporate tax rates in 1998/1999, the FDI outflows to Ireland soared, as well as the manufacturing sector outflows hitting its highest value in over fifteen years, which coincided with the manufacturing sector having its biggest decrease in profitability. Though at the same time the financial industry inflows achieved an all time high as well as the financial industry profits achieving its best result in almost twenty years.

The outflow to Ireland reached almost 7000 million in 2002, which almost equalled that of the FDI to Germany and 'leaped-frogged' the UK's other main destinations which were the Netherlands and France. This shows that Ireland has become increasingly popular to move to over the last twenty years. It has become so popular in fact that the country which once relied heavily on the UK's economy has now being seen as one of the major destinations of its FDI.

Question 3: ***"Do the indirect factors, which influence a firm's choice of location, have an effect on the tax competition between the UK and Ireland?"***

One of the reasons why Ireland may not have affected the UK as much as it could have may be mainly due to the indirect factors mentioned in this paper. The UK has a bigger market than Ireland, and is regarded as a major player within Europe. As a core country it is seen as having invaluable market links allowing easy market access to every EU country. The effective tax rate of Ireland seems a lot more attractive than the UK, although the UK does not possess extremely high effective tax rates, as the comparison to Italy showed. However, as the UK is a core country, the effective tax rates may not be the only factors at play, the more indirect factors must have an influence on investment decisions as well.

Transfer pricing is also extremely important in the choice of investment locations between the two countries. The UK allows groups to shift profits between subsidiaries and branches on UK soil but then charges a tax on those transfers that leave its borders or are conducted through subsidiaries overseas, so companies will have to conduct transfer pricing at arms length prices, in order to avoid this tax.

In summary, these are the main points of conclusion from the Economics section:

Tax rate

- Manufacturing industry losing profitability may affect investment decisions into this area.

However

- No direct reaction was found to Irelands tax policy, although weak links exist surrounding the UK's tax reduction at the end of the 1990's.
- Tax Revenue works on a cyclical basis

FDI and Location Influences

- The UK does possess strong manufacturing and financial agglomeration forces

However

- Manufacturing outflows from the UK have been increasing almost on the same rate as the inflows of financial FDI have been increasing.
- Ireland has become one of the major destinations of FDI outflows from the UK competing with France, Germany and the Netherlands.
- FDI outflows from the UK to Ireland have been continuously increasing over the last 20 years and have grown a lot faster since the opening of the single market.

It appeared that the reaction by the government to the manufacturing decline at the beginning of the millennium was to focus on more high value investments such as R&D. In the UK, foreign investment in R&D accounts for a significant amount of total R&D, over a third in manufacturing in the later 1990s was made up of this[76]. The government in the 2000 budget offered tax credits from 100% to 150%[77] on R&D expenditure which manufacturing companies would then be able to exempt this payment from there annual corporation tax for which Ireland did not offer anything, but eventually could only offer up to 20%[78].

Over the last four years it appears that Ireland tax system has grown into a threat to the UK government, and although subtle changes to the UK tax system have been made before to compete with the rest of Europe it appears that due to a lack of regulation within the EU countries, that Ireland has become one of the leading destinations for UK foreign direct investments. Its tax system has acted as a lure to many manufacturing industries in the past, and now that the statutory and effective tax rates are one of the lowest in Europe, Ireland appear to be outgrowing there peripheral shell.

If the tax polices were regulated, and the optimal common base taxation method was used then Ireland would not be affected, but would in fact find that many companies are choosing their tax rate to be taxed on. However if a European Corporate Income Tax was set then it would inevitably be above that of Irelands statutory tax rate and then this would certainly devastate the Irish economy and have little effect on the UK.

[76] Hall, Stephen, Becker, Bettina, "FDI in industrial R&D and exchange rate uncertainty in the UK", 2003, P.11
[77] www.dti.gov.uk
[78] This is proposed in Irelands 2004 Budget, http://www.finance.gov.ie/viewdoc.asp?DocID=1923

10 The Legal Perspective – UK Analysis

The legal section of this paper is not entirely directed at tax competition but more towards the corporate tax system in the UK, the tax incentives it offers and the parts of the tax system which has attracted attention from the UK high courts and the EU Commission. Within the economic section of this paper, we have examined the relationship between the UK and Ireland, and explored the effects in the absence of regulation. The fact that tax incentives are needed proves that there is competition within Europe for this type of investment which is why the European Union has been very focused on the subject of harmful tax measures and the effects they are having, or might have on a country's welfare.

10.1 A 'Three-Layered' Approach

The 'three-layered' approach refers to the method that is to be used to analyse whether the UK have created harmful tax measures or not. The first method of analysis will be consulting the rulings of the European Court of Justice (ECJ) in past and relevant court cases.

The second approach is then going to be the Code of Conduct, as mentioned in the literature review, with tax systems that are relevant to the subject matter of the UK being analysed within the non-binding tax package, to see why the commission abolished or phased out certain tax incentives and to see if any of these tax incentives are being used by the UK. Though the analysis may seem crude, it is vital in identifying to what extent the Government's of Europe will go to in using tax incentives to fund their welfare states and if any danger exists for the UK in their quest to do so.

The third and final approach comes in the form of the actual tax incentives used by the UK as analysed by the 'Code of Conduct', to see if the UK are in breach of EU regulations involving state aid and tax provisions. This section will be built upon with reference to newly amended Parent-subsidiary directive 90/435EEC and the role it plays in the analysis of the UK tax system.

The main legislation used when assessing the harmfulness, if any, of a tax regime is the EC treaty. Within the treaty it is stated that "regulative or administrative action"[79] by a member state which is seen as "distorting the conditions of competition in the common market"[80] will be consulted by the European Commission, which results in the elimination of the harmful tax regime and the imposing of possible fines. Also relevant to the legal section of this paper is the Parent-Subsidiary directive 90/435/EEC. The directive requires member states to refrain from imposing withholding taxes on distributions of profits made by subsidiary companies to other parent companies. The parent company's subsidiaries were defined as parent companies which hold a 25% equity holding or share of the voting rights in another company. The amendments to the directive, for which member states must comply with by December 2004, involve reducing this 25% to 10%, widening the definition of subsidiary in the eyes of the directive, as well as making any tax paid in 'the chain'[81] to be deductible at the parent company level.

[79] Article 96 EC
[80] Article 96 EC
[81] 'The Chain' refers to the path of the profits from subsidiaries and branches leading up to the parent company.

11 European Court of Justice (ECJ) Rulings

In this section the rulings by the ECJ which have been fundamental in shaping the stance on direct taxation will be highlighted and the reason why the court ruling plays such an essential part shall be explained in relation to Tax Law and the European Unions fight against harmful tax regimes.

11.1 Commission V France 'Avoir Fiscal' [82]

In Commission of the European Communities v. French Republic (Avoir Fiscal case) the ECJ ruled that France violated the principle of freedom of establishment within the European Union when denying a shareholder's tax credit (Avoir Fiscal) to French branches of insurance companies registered abroad, for dividends received from French companies. The Avoir Fiscal case illustrates how a tax law can restrict the freedom of a company to choose its form of establishment by making a particular form unattractive (for example, the branch form), thereby breaching Article 43 EC. It is a breach of EU law because France made it more costly in tax terms to establish a subsidiary in another EU jurisdiction when compared to setting up in its own country.

The ECJ rejected the French government's argument that a foreign insurance company could benefit from the dividend tax credit by setting up a French subsidiary instead of a branch. It held that the freedom of establishment *". . . expressly leaves traders free to choose the appropriate form in which to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions"*. Despite the lack of harmonization in the field of corporation tax, the EC Treaty "prohibits Member States from laying down in their laws conditions for the pursuit of activities by persons exercising their right of establishment which differ from those laid down for its own nationals"[83].

The Avoir fiscal case was chosen due to the fact that the UK does impose restrictions

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[82] http://curia.eu.int. (C-270/83), ECJ
[83] Mbwa Mbwa, Marcellin, 'The Push Toward Pan-European Tax Consolidation: A French perspective on Marks & Spencer Case', 2003, P.460

on company type, e.g. branch or subsidiary, and which of these company types are allowed to have tax credits. The Avoir fiscal judgement stated that *"By treating the two forms of establishment in the same way for the purpose of taxing their profits, the legislature of that member state has in fact admitted that there is no objective difference between their positions in regard to the detailed rules and conditions relating to that taxation which could justify different treatment".* The UK taxes all companies the same, thereby admitting that there is no objective difference yet allows one type of company tax credits and the other is not.

However though all companies are taxed the same, when transferring profits from a subsidiary to a parent company, involving a subsidiaries that are not on UK soil, the profits are exposed to being taxed. However, if the company was a branch of a UK firm and both firms were located on UK soil, then the transfer of payments would be untaxed.

11.2 Campagnie de St Gobain SA, zweiniederlassung Deutschland V Finanzamt Aachen-Innenstadt[84]

The Saint-Gobain case is an ECJ decisions involving a French company that deals with direct corporate taxation. Compagnie de Saint-Gobain SA (Saint-Gobain SA), a French resident parent company, owned a branch in Germany (Saint-Gobain ZN) which is a company incorporated under French law whose seat and business management are located in France. In Germany, Saint-Gobain SA was subject to limited tax liability because neither its seat nor its business management are located in that State. Saint-Gobain ZN was the head company of a tax consolidated group formed with two German subsidiaries of Saint-Gobain SA. The profits of those consolidated companies, which were reported on the consolidated tax return, included dividends distributed by foreign subsidiaries established in non-EU member states namely the USA and Switzerland. The German tax administration (Finanzamt) denied the tax exemption for the dividends on the grounds that it only applied to dividends received by companies subject to unlimited tax liability in Germany. For the same

[84] http://curia.eu.int, (C-307/97), ECJ

reason, the German tax administration rejected Saint-Gobain's claim for the indirect tax credit and the capital gain tax treatment of gain from assets held by the German branch.

The Finance Court of Koln referred the issue to the ECJ for a preliminary ruling on the compatibility with the Freedom of Establishment. It asked whether the exclusion of a permanent establishment in Germany of a company resident in another member state from the enjoyment of the dividend tax exemption, the indirect tax credit, and the capital tax treatment, on the same conditions as those applicable to company's resident in Germany, was compatible. The ECJ ruled in favour of Saint-Gobain SA and stated that the refusal by the German tax administration to grant the three tax benefits was in violation of the freedom of establishment[85].

This case adds further weight to the case of the UK and its definition of a company's form and these entitlements within its tax system. The UK does seem to be in violation of the freedom of establishment, but due to the fact that each case's judgement is specific to each case, it is not certain that the UK will be haled as in breach of the EU rules.

11.3 Lankhorst – Hohorst GmbH V Finanzamt Steinfurt[86]

Lankhorst-Hohorst was a German corporation selling boating equipment and other related goods. It was a subsidiary of a Dutch corporation, which itself was fully owned by another Dutch corporation. The latter had granted a loan of DEM 3,000,000 repayable over 10 years in annual instalments, with a variable interest rate payable at the end of each year. The loan, which was intended as a substitute for capital, was accompanied by a letter of support under which the grandparent corporation waived repayment if third party creditors made claims against Lankhorst. The dispute concerned the tax treatment of interest paid to the grandparent corporation. The German Tax Administration concluded that such interest was to be subject to a tax of

[85] Mbwa Mbwa, Marcellin, 'The Push Toward Pan-European Tax Consolidation: A French Perspective on Marks & Spencer Case', 2003, P.462
[86] http://curia.eu.int, (C-234/00), ECJ

30%, thereby implementing the ‘Law on Corporation Tax’. The corporation law stated that there was no entitlement to corporation tax credits for non-resident shareholders.

The Court concluded that difference in treatment between resident subsidiary companies according to the seat of their parent company constitutes an obstacle to the freedom of establishment which is, in principle, prohibited by Article 43 EC. The ECJ made it plain that measures purely designed to protect the tax base of one Member State cannot be justified on the grounds of prevention of tax avoidance.

EU Member States applying thin capitalisation rules, which included the United Kingdom, were forced to review there tax systems in the light of the ECJ ruling in order to avoid risks of being prosecuted by the Commission and face damages. The ECJ stated in the Lankhorst case that “*It should be remembered that, according to settled case-law, although direct taxation falls within their competence, Member States must none the less exercise that competence consistently with Community law and, in particular, avoid any discrimination on grounds of nationality*” (such as below, “Joined Cases C-397/98 and C-410/98 Metallgesellschaft and Others”,2001).

The ECJ landmark ruling in the Lankhorst-Hohorst case demonstrates the extent to which the freedom of establishment principle trumps direct tax rules enacted by member states. This case highlights the problems member states have had with thin capitalisation rules, and the UK appears also to be in breach of these, though it will take a few years before the judgement is given. This case is especially pertinent to the case of the UK at hand.

11.4 Metallgesellschaft Ltd / Hoechst AG v Inland Revenue Commissioners[87]

“Parent companies resident in the United Kingdom with subsidiaries also resident were entitled under the ‘Income and Corporation Taxes Act 1988’ to make a group income election and consequently not pay advance corporation tax on dividends distributed to them by the subsidiary. Non-resident parents with resident subsidiaries

[87] http://curia.eu.int, (Cases C-397 and 410/98), ECJ

were not entitled and so had to pay the tax. In consequence, a non-resident parent did not have the cash flow advantage that the resident company had when it came to paying the advanced corporation tax and the main corporation tax and so the resident subsidiary enjoyed a cash flow advantage compared with the non-resident"[88].

"In proceedings in which German parent companies, claimed that they were discriminated against, the ECJ was asked to rule on, whether there was an infringement of Article 43 EC. The ECJ said that there was a large difference of treatment between resident and non-resident parents, clearly resulting in a cash flow disadvantage for the latter, and since the United Kingdom had not established that the consequent discrimination on grounds of nationality could be justified for the reasons advanced by it, that the situations of the two groups of companies were not comparable and that the differential treatment was necessary for the cohesion of the corporation tax system, the relevant legislation was contrary to Article 43 EC"[89]. Moreover, discrimination in the tax laws of a Member State against enterprises purely on the grounds of country of residence has been held to be objectionable in EC law on the grounds that it would "deprive Article 52 EC of all meaning"[90].

This case touches on one of the problems that the UK has encountered with its "Group Relief" advantages that it offers. In this case it dealt with the advanced corporation tax handicap that foreign companies dealt with when having subsidiaries in the UK. Though this advanced corporation tax has been abolished the "Group Relief" incentives still seem to be in breach of EU law. All of the above ECJ rulings are important to the history of the EU tax law, as it is only the uncoordinated rulings that are bound as legislation and force the member states to abide by what was said. These ECJ cases were an example of how the tax law is made up, and what kind of problems a company within Europe faces and how the ECJ deals with these problems. The next section builds on this section, and shows examples of tax schemes set up by other member states that have been deemed in breach of the Code of Conduct and have been effectively outlawed by the EU Commission.

[88] http://www.lawreports.co.uk/ecjmar0.4.htm
[89] Ibidem
[90] http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/1C9AD219-D5DA-4B47-B3E6-92022DAC5CFB.cfm

12 The Code of Conduct – Applied

The Code of Conduct is designed for the specific tax measures created by member states that offer taxation 'below what is deemed as the general level' within the member state. Through the EU initiative, those tax measures which discriminate against foreign companies, labelled non-residents, or conduct 'ring-fencing'[91] or those companies where no actual economic activity takes place are scrutinized by the Primarilo group and deemed harmful tax incentives.

The main concern of the Code of Conduct is the shifting of profits between member states, most often in multinationals, which creates a distortion of economic activity. This section explains the court rulings that are specific to the subject of this paper concerning actions that possibly affect the UK, and highlight actions taken by member states that have been reprimanded by the European Commission which may or may not exist in the UK currently.

12.1 Coordination Centres, Belgium[92]

The Belgian coordination centres are "*an undertaking belonging to a multinational group providing services to the members of the group*"[93]. During a ten year licence agreement granted by the tax authorities, "the taxable revenues of a coordination centre are determined according to the 'cost plus'[94] method. This method is normally aimed at avoiding double taxation and limiting tax avoidance. In the cost plus method, the taxable profit is calculated as a percentage of the aggregated operating costs. With respect to the Belgian scheme, the commission has concluded that the Belgian authorities apply the 'cost plus' method in a way that gives rise to state aid.

[91] A regime may explicitly or implicitly exclude resident taxpayers from taking advantage of its benefits, or enterprises which benefit from the regime may be explicitly or implicitly prohibited from operating in the domestic market., OECD, "Harmful tax competition – an emerging global issue", 1998, P26

[92] Belgium Coordination Centres V The Commission (2003/531/EC)

[93] http://www.mbo.com.mt/mbo.nsf/perspectives/Final+negative+State+aid+decisions+on+special+tax+schemes+in+Belgium,+the+Netherlands+and+Ireland

[94] "The cost plus method starts by computing the cost of providing the goods or services and adds an appropriate mark up", www.inlandrevenue.gov.uk

Firstly, Belgium systematically used a default mark up rate of 8% without verifying if this rate was a fair reflection of an economic reality and the service provided by the coordination centres. Secondly, the way in which the expenditure of the centre is calculated excludes significant operating costs of the centre. Thirdly, the Belgium coordination centres enjoyed the additional tax advantage such as withholding exemption on income distributions and a real estate property tax exemption. These benefits reduce the amount of taxable profits and thus grant an advantage not justified under the EU state aid rules. The commission discontinued the scheme, and it is planned to be faded out by 2010”.[95]

12.2 International Financing Activities, Netherlands

“The Dutch international financing activities regime date back to 1996. Under this tax scheme multinational companies active in more than four countries or two continents may place up to 80% of there foreign source financial profits in a tax free reserve for a period of 10 years. Under the scheme the beneficiaries can further release the reserve formed without incurring taxation or at a reduced tax rate if the reserve funds are used for certain objectives encouraged by the scheme. The beneficiaries can also decide voluntarily to put an end to their reserve by releasing the funds over five years at a reduced tax rate of 10% instead of the applicable corporate taxation rate of 34%.”[96]

“The commission decided that these tax advantages were not justified under the EU state aid rules and had also been instituted without the mandatory prior notification, and so these systems were phased out ending in the year 2010.”[97]

These two incentive schemes were highlighted as possibilities that the UK may have created within there economy. Both of the schemes dealt with multinational companies which is what the UK is trying to attract into its country.

Within this paper, Ireland has been possibly identified as a culprit in affecting the

[95] http://www.mbo.com.mt/mbo.nsf/perspectives/Final+negative+State+aid
[96] Ibidem
[97] Ibidem

UK's economy by offering investment incentives which seemed to lure companies from the UK to Ireland and affect the industries profitability. The two harmful tax measures below are the main reasons why the possibility of Ireland being able to affect the UK's economy existed.

12.3 The International Financial Services Centre (IFSC), Ireland

"Incentives are granted to companies locating and carrying on 'relevant trading operations' in the International Financial Services Centre (IFSC) in Dublin. IFSC approved projects must be engaged in financial services activities which have substance and which contribute to the development of the IFSC and all projects approved for the 'Centre' must commit to creating a minimum number of new jobs. There is a range of ownership and funding structures in the IFSC, arising from a variety of different requirements, although 'Brass plate' companies were not approved within the regime. The following is a breakdown of the financial services benefits established in the IFSC"[98]:

1. 10% rate of corporate income tax.
2. Exemption from rates (local property taxes) for ten years,
3. Double deduction of rent expenses in the centre for lessees for ten years,
4. 100% write-off in first year of new building costs in the centre for owner occupiers,
5. 54% write-off in first year of new building costs in the centre for lessees and write off of the balance at 4% per annum thereafter,
6. 100% write-off in the first year of expenditure on new equipment.

The IFSC was deemed to break the EU's Code of Conduct and was given a phasing out phase up to the year 2010. Companies who were approved within the centre before the Code of Conduct ruled that it was illegal are allowed to use the system until the given end date.

[98] Primarolo Group, 'Code of Conduct (Business Taxation)', 1999, P.35

12.4 10% Manufacturing Rate, Ireland

This measure applies to companies' income from manufacturing activities undertaken in Ireland. It applies to both resident and non-resident companies and covers transactions with both residents and non-residents.

"Income is subject to corporation tax at 10% instead of the standard rate and it was proposed to phase out the 10% manufacturing rate by end-2002. Though, through negotiation the Commission recognised that certain companies have legitimate expectations in relation to the 10% rate so increased the year to 2010. Existing companies which have legitimate expectations of the continuation of the 10% rate until 2010 will be entitled to retain that rate until then. This includes projects approved on or before 31 May 1998. At the end of 2002, these projects will be subject to the standard rate then applying"[99].

[99] Primarolo Group, 'Code of Conduct (Business Taxation)', 1999, P.63

13 Illegal UK Tax Schemes

This section is aimed at specific systems designed by the UK that have been found to be in breach of EU legislation and in the next section the UK's other tax measures which have been investigated using the Code of Conduct and have been deemed as 'not' being harmful. There is still the possibility that alterations to these tax measures will be attracting the attention of the Commission in the not-too-distant future. This section covers the fourth question of this paper:

Question 4: "What are the tax incentives used by the UK and are they harmful to tax competition within the EU?"

13.1 Advanced Corporation Tax

Tax claims based on a misunderstanding of UK law, saw EU legislation reverse one aspect of the July 2003 High Court decision in Deutsche Morgan Grenfell[100] v IRC. That case concerned the group litigation arising out of the 2001 decision of the European Court of Justice in Hoechst/Metallgesellschaft[101]. "It was held in that case, that the UK's Advance Corporation Tax system (ACT) was in breach of EU law by denying UK companies, with overseas parent companies, the opportunity to avoid the requirement to account for ACT on payment of dividends by entering into a group income election with their parent company. Deutsche Morgan Grenfell decided that ACT had been paid by the claimant in that case under a mistake of law because it had failed to appreciate (as had the Revenue and all other taxpayers) that it could have made a group income election"[102].

"This finding was crucial because the limitation period, during which claims based on

[100] Deutsche Bank AG, a German company and the parent company, direct or indirect of DBI and DMG

[101] The combined cases in the CJEC of Metallgesellschaft Ltd and others v. Commissioners of Inland Revenue and the Attorney General (Case C-397/98) and (1) Hoechst AG (2) Hoechst United Kingdom Ltd v. Commissioners of Inland Revenue and the Attorney General (Case C-410/98). The judgment of the CJEC was delivered on 8 March 2001 and is reported at [2001] STC 452

[102] Herbert Smith, Tax Dispute Briefing, 2003, P.1

mistake of law must be filed before they are time-barred, is generally six years from the discovery of the mistake. This is the effect of the rule within the Limitation Act 1980 in relation to claims based on mistakes. The High Court held that Deutsche Morgan Grenfell did not discover its mistake, i.e. the payment of ACT, until the ECJ issued its decision in 2001. This meant that, provided a claim was made within six years of the ECJ decision, a claimant was able to claim compensation for ACT wrongly paid as far back, potentially, as the introduction of ACT in 1973"[103].

13.2 The Group Litigation Orders (GLO's)

There are two relevant GLO's[104] against the UK Inland revenue, within the UK high courts, which may soon be moved to the ECJ, and these are

1. **UK Group Relief,** "whereby it is possible for a member of a UK Group of Companies to surrender losses for corporation tax purposes to fellow members of the same group. The complaint being made by the Claimants is that the rules which prevent UK companies claiming relief for the losses of their fellow non-UK group members unfairly discriminate against the establishment of companies in the EU outside the UK"[105].

2. **Controlled Foreign Company (CFC) legislation**, "forces certain subsidiaries of UK companies either to repatriate their profits, or in default of actual repatriation, taxes the parent company on a deemed dividend of those profits. Again, the claim is that these rules discriminate against subsidiaries set up in the EU outside the UK, and is thus incompatible with EC law"[106].

[103] Herbert Smith, Tax Dispute Briefing, 2003, P.1
[104] GLO mandatorily groups together similar claims, and enables the selection of a test case or cases with common issues of fact or law, and provides for a proportion of the legal costs to be shared amongst all the claimants.
[105] http://newsweaver.ie/ernst/e_article000181968.cfm
[106] Ibidem

13.2.1 UK Group Relief[107] - Defined

Currently, the UK's loss relief rules allow a UK company with a loss-making overseas 'branch' to surrender the branch losses against UK taxable profits elsewhere in the UK group. However, if the overseas activity is carried on through a local 'subsidiary', the losses of that subsidiary cannot be used in the UK and it is claimed that this breaches EU law.

13.2.2 CFC Legislation – Defined

"Dividends from overseas subsidiaries and CFC legislation Dividends received by a UK company from another UK company are tax-free under section 208 Taxes Act 1988, whereas dividends received by a UK company from overseas subsidiaries are taxable. The remittance of profits from low-tax overseas subsidiaries is encouraged by the UK's CFC rules. Briefly, these require a UK company to pay corporation tax on the profits of any UK controlled, non-UK based company in which the UK company has an interest of at least 25% unless the non UK company pays local tax equal to at least three quarters of the tax it would pay if it were a UK resident".[108]

"It is arguable therefore that the UK's rules for taxing dividends from overseas subsidiaries and the CFC rules, either alone or in combination, breach EU law because they can make it more costly in tax terms to establish a subsidiary in another EU jurisdiction as opposed to in the UK"[109].

"UK CFC rules charge UK companies to tax in respect of certain over seas CFC's. With effect from 11 October 2002, Irish controlled foreign companies were removed from the UK's excluded Countries list. With the exception of the 10% manufacturing companies and those located in the IFSC, this list previously provided Irish subsidiaries with automatic exemption from the UK CFC rules"[110]. The reason for this was due to the fact that *"The Government has decided that changes to the rate of*

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[107] Group relief information has been cited from www.herbertsmith.com in reference to a tax briefing paper.
[108] http://newsweaver.ie/ernst/e_article000181968.cfm
[109] Ibidem
[110] Ibidem

Corporation Tax in Ireland (being reduced to less than 75% of the UK Corporate tax) means that it is no longer appropriate for companies operating there to enjoy automatic exemption from the UK's CFC rules."[111]

13.2.3 "Excluded Countries List" (ECL) [112]

"The ECL consists of countries that have a tax system roughly comparable to that in the UK or countries where multinational corporations are unlikely to set up subsidiaries to reduce their UK tax. The benefit of being on the ECL is that even though the corporate tax rate in an ECL country may be less than three-quarters of the UK corporate tax rate, the CFC rules don't apply. The ECL is divided into two parts. Part one lists those countries were all CFC's are automatically exempted from the UK's CFC rules, and Part two lists countries whose CFC's could avail of the exemption, provided the CFC is not benefiting from any particular tax exemptions or reductions in that jurisdiction; Ireland is currently on Part two of the ECL."[113]

"Legal actions have recently been initiated in the UK concerning the unfavourable treatment of distributions received from companies resident in other European Economic Area (EEA) member states as compared to UK recipients of UK distributions. As dividends received from companies resident in other EEA Member States are fully chargeable, the UK claimants are contending that the treatment of foreign dividends is in breach of the EC Treaty and/or the non-discrimination article of various Double Taxation Agreements. If the claims are successful in the UK courts or the European Court of Justice (ECJ) the decision will have significant implications for the Irish tax system"[114].

"At present UK companies are liable to UK corporation tax on dividends received from Irish resident companies where distributions from UK companies are exempt. If the litigation is successful UK parents of Irish subsidiaries could be entitled to full

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[111] www.williamfry.ie
[112] A list of the excluded countries from August 2003 can be found in the appendix
[113] http://www.williamfry.ie/article.asp?categoryID=31&articleID=478
[114] Cited fromhttp://newsweaver.ie/ernst/e_article000181968.cfm

refunds of any corporation tax imposed on dividends from there Irish subsidiaries."[115]

13.3 Incentive Schemes deemed Harmless[116]

The following are a brief description of UK incentives which have been analysed by the OECD and by the European Union and have been deemed as being harmless tax measures although, the 'International Headquarters Companies' incentive, which was within the original investigation by the Primarolo group was abolished in 1999.

- Enterprise Zones
- Small and Medium Sized Enterprise Schemes
- Cost Plus Rulings
- Independent Investment managers
- Special Scheme for accelerated depreciation
- Scientific research allowances

The incentives have many tax benefits, and are designed just like the other aforementioned incentives, to attract investment to certain areas, or into certain industries, though there appears to be a fine line between what is deemed harmful and what is deemed harmless, and now the legal perspective summary shall be presented followed by the papers overall conclusion.

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[115] http://newsweaver.ie/ernst/e_article000181968.cfm
[116] All of the information for the tax measures in this section has been taken from Primarolo Group, 'Code of Conduct (Business Taxation)', 1999, P1 - 168

14 UK Legal Summary

The legal section of this paper has detailed the tax measures that were subject to investigation by the Code of Conduct, the tax measures that were abolished by the 'Code' and also a brief outline of what the European Union is against in the European Court of Justice and how it perceives these different member state incentives.

The last direct question to be answered is:

Question 4: *"What are the relevant tax incentives used by the UK and are they harmful to tax competition within the EU?"*

The relevant tax incentives have been laid out in the previous section with the three regimes that have been deemed harmful and the other six which have not. The UK has been found in breach of EU rules concerning its Advanced Corporation Tax, and is being investigated by the UK high courts concerning its Group relief and CFC rules, which are very likely to be referred to the ECJ.

The UK it appears has been fortunate not to be picked up on more if its tax measures and it is very likely that if any of these tax measures are altered to a more attractive level, that the OCED[117] and the EU action groups will condemn them and have them abolished. The Advanced Corporation Tax (ACT) system, which was court by the commission, was abolished and it was instead replaced with a quarterly payment system.

Ireland on the other hand, has been reprimanded for two of its tax measures which were identified in this paper as having a possible effect on the UK economy. The IFSC and the 10% manufacturing rate was highlighted in this paper as having the power to attract investment away from the UK. The manufacturing sector in Britain has been on a downward decline since the early 1980's and it is no surprise that this decline may have been caused by the Irish tax measure.

[117] Organisation for Economic Cooperation Development

The fact that Ireland has been removed from the Exclusions list, apparently due to the fact that the tax rate was too low and no longer fulfilled the 75% tax rate requirement is extremely suspicious, considering that the Slovak republic are on ‘Part one’ of the list offering a statutory tax rate of 19%, still below the 75% threshold stated by the UK. Ireland’s position as a suitable location for centralised group services has been put at risk by this move, which could have a knock-on effect on inward investment by UK firms into Ireland. In addition, the change will increase the compliance burden, and therefore costs, of Irish operations with UK parents. In effect the UK are sending a signal to other tax authorities that in its opinion the use of the 12.5% rate of corporate tax is questionable, even though Ireland has obtained approval from the EU for this rate. This move by the UK Inland Revenue means that Ireland is the only EU country to be removed from the ECL. Thus the Inland Revenue seems to be singling Ireland out as the “tax haven” of the EU.

Overall, the UK seem to have forgotten the line between ‘harmful’ and ‘harmless’, by having one of its tax incentives deemed illegal by the Code of Conduct and another two possibly on there way to the ECJ. A very important piece of information regarding the tax policy under investigation is the deletion of Ireland from the “excluded” list which refers to which company gets taxed by the UK when concerning the repatriation of profits. This is most definitely a move against Ireland, but whether this piece of national legislation will stay in place will be up to the UK national and perhaps European courts to decide.

This knowledge may benefit Ireland, as they will no doubt endeavour to produce more tax incentives to promote its growth and its attractiveness as a location for foreign investment.

15 Conclusion

This paper has attempted to ascertain what impact Irelands corporate tax system has on the UK, and on the UK's corporate tax system. By analysing the economic factors involved and by conducting a legal dissection of the UK tax system, this paper has attempted to produce an overall perspective on the relationship between the UK economy and Ireland.

The UK analysis shows us that when Ireland created its now 'illegal' manufacturing tax incentive of 10% in 1981, that the UK's manufacturing sector FDI outflow wasn't affected a great deal, although the profitability of the sector did decrease substantially. Although the UK corporate tax rate was almost halved during the same period, this has been concluded as being due to international deregulation and cyclical effects.

The signing of the single market was a success for Ireland, in terms of attracting UK companies to invest across the water. The UK's financial sector increased in FDI inflow just before the documents was signed and then boomed straight after. Irelands IFSC certainly did not have an effect on the stability of the UK financial sector as it continued to increase at a perpetual rate over a twenty year period. The financial agglomeration force of the UK seemed to outweigh any possible moves from the peripheral country in attempting to make Dublin a more attractive location.

The direct investments from the UK to Ireland have definitely grown since the opening of the single market and have now become one of the top four UK FDI outflow destinations in Europe. This piece of evidence in itself would suggest that Ireland's growth should not be taken likely and that due to unregulated tax competition, Ireland now threaten to be seen as a main destination and steal foreign direct investments away from the UK.

Everything previous to 1995, has been attributed to world events and economic shocks, but it is believed that from 1995 onwards, as the Irish tax rate was being lowered by 4% every year to 12.5%, that the UK government refined its tax policy to maintain its attractiveness and then coupled with the deletion of Ireland from its "excluded" list, cut off any economic benefits it may have given the now fastest growing economy within the peripheral states.

In summary, over the fifteen years from 1980 onwards, it is believed that the UK has been far from touchable as a core country. It seems that under closer inspection the decline of the profitability of the UK manufacturing sector led the government into seeking a stop gap policy in the form of the R&D tax credit. It then moved to refine its tax system without making major changes and cut the friendly economic ties to Ireland, making the movement from the UK to Ireland very unattractive due to the taxation of repatriated profits.

The conclusion of this paper is that the UK was never concerned with the tax policies of Ireland, until the mid-90's when Ireland's economic growth boomed and suddenly became a major player in the FDI environment. When the tax policy fell below the 75% CFC threshold, Ireland were severed from the UK economy, although Slovakia, with a 19% corporate tax rate are still on the list which is also less than 75% of the UK rate. This move by the UK was motivated by the need to secure its retention of industry and make the prospect of relocation to its Celtic neighbour very unattractive and in doing so has attracted the attention of the UK and European courts.

An interesting follow up to this paper would be to carry on the investigation into the relationship between the two countries following the High court decision of the two tax incentives used by the UK, and how the relationship develops in the future.

16 Appendices

16.1 Code of Conduct

A. Without prejudice to the respective spheres of competence of the Member States and the Community, this code of conduct, which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community. Business activity in this respect also includes all activities carried out within a group of companies. The tax measures covered by the code include both laws or regulations and administrative practices.

B. Within the scope specified in Paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code. Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor. When assessing whether such measures are harmful, account should be taken of, inter alia:

1. Whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or
2. Whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or
3. Whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or
4. Whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or
5. Whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way[118].

[118] European Code of conduct.

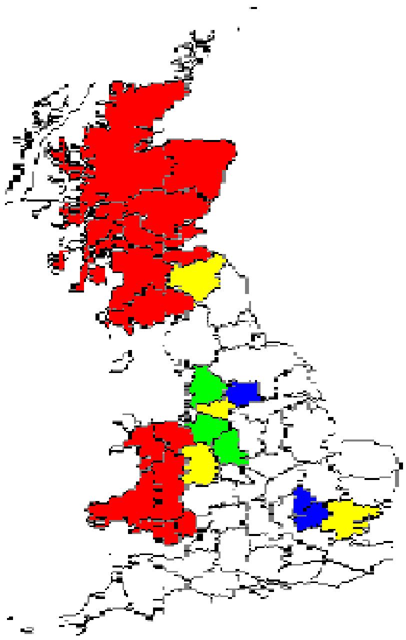
16.2 Tax Rates

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Ireland	45	10[119]	10	10	10	10	10	10	10	10	10	10
UK	52	52	52	**50**	**45**	**40**	**35**	35	35	**35**	**34**	**33**
	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Ireland	10	10	40 (10)	40 (10)	38 (10)	36 (10)	32 (10)	28 (10)	24 (10)	20 (10)	16 (10)	12,5 (10)
UK	33	33	33	33	**33**	**31**	**31**	**30**	30	30	30	30

16.3 Clusters of Agglomeration in the UK

Red = Electronics Yellow = Financial Sectors Green = Software

Blue = Bio Technology



[119] Data for the Statutory tax rate, other than that used for IFSC and the Manufacturing sector was unobtainable from 1981 to 1993.

16.4 Harmless Tax Incentives - defined

16.4.1 Enterprise Zones

With a view to stimulating regeneration in areas suffering from physical or economic decay, the UK Government designated geographical areas within the country and labelled them called 'Enterprise Zones'. The 'Enterprise Zone' status confers the following range of benefits, which run for a 10-year period from the date on which each zone is designated:

16.4.1.1 Tax Benefits

1. 100% capital allowances for corporation and income tax purposes for capital expenditure on industrial and commercial buildings. Outside a zone that expenditure would either get allowances of 4% per annum for an industrial building or nothing at all. For 20 years after the zone is first designated, 100% allowances are also available for expenditure after the expiry of the zone, if it is incurred under a contract entered into during the zone's life.
2. Exemption from local taxes on industrial and commercial property;
3. Employers are exempt from industrial training levies and from the requirement to supply information to Industrial Training Boards.
4. A greatly simplified planning regime: developments that conform to the published scheme for each zone do not need individual planning permission.
5. Applications from firms in Enterprise zones for certain Customs facilities are processed as a matter of priority and certain criteria relaxed.
6. Government requests for statistical information are reduced.

16.4.2 Small and medium sized Enterprise schemes

On 12 May 1998 the Chancellor of the Exchequer announced his intention to introduce 100% first year capital allowances for spending by small and medium sized businesses on machinery and plant for use in Northern Ireland. The scheme allows spending on such assets during the period from 12/05/98 to 11/05/2002. It was part of a targeted package of measures to help modernise Northern Ireland’s economy by generating investment and fostering enterprise. Small and Medium sized enterprises are those that meet two of the three following tests:

- have an annual turnover of not more than £11.2 million ;
- assets not more than £ 5.6 million ;
- No more than 250 employees. If the company is a member of a group, the group must be small or medium-sized.

The measure will also be available to businesses carried on by individuals and partnerships made up of individuals, provided the business would qualify if it were carried on by a company.

16.4.2.1 Tax Benefits

The normal rate of capital allowance for expenditure on machinery and plant is 25% per year on the reducing balance basis.

16.4.3 Cost plus rulings

The OECD Transfer Pricing Guidelines have statutory effect in the UK and the ‘cost plus’ method[120] is used in those circumstances in which it is approved by the Guidelines. The overriding principle in the Guidelines is that the ‘cost plus’ method should only be used in those situations where it gives a reliable measure of arm’s length[121] profits. In this situation, a company can ask for a ruling on the arm’s length mark up to be used in the particular case. The Guidelines explains that the ‘cost plus’ method is "most useful where semi-finished goods are sold between related parties,

[120] See Coordination Centres, P.44
“*Where financial arrangements made between associated firms in different contracting states have the result that profits accrued to a firm other than the one to which they would have accrued has the firms been independent, the sums concerned may be included in the profits of the firm to which they would normally have accrued, and taxed in its hands*”, Farmer, Paul, Lyal, Richard, “EC Tax Law”, 1994, P.303

where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services". These are also referred to as preparatory and auxiliary activities.

16.4.3.1 Tax Benefits

Any agreement as to the applicable arm's length mark-up is determined on the facts and circumstances of the case. All relevant costs must be taken into account. There are no fixed percentages or ranges and regular reviews are carried out on the continuing appropriateness of individual rulings. The UK moved to a system of self-assessment for all companies in July 1999. Prior to self-assessment, the Inland Revenue was responsible for making the appropriate tax assessment for a company each year following an examination of the company's annual tax return. The continuing appropriateness of any cost plus ruling was subject to that annual examination. Under self-assessment, companies are required to submit a return of their profits each year and self-assess the tax due.

16.4.4 Independent Investment Managers

This provision applies to non-residents who, through an agent, carry on trade in the UK of dealing in investments. The independent agent must be carrying on the business of providing investment management services and the transactions performed on behalf of the non-resident must be carried out in the ordinary course of that business; the agent must be acting in an independent capacity; and the non-resident must have paid for the agent's services at arm's length prices.

16.4.4.1 Tax benefits

The profits of such a trade are outside the UK charge to tax, if the agent is independent of the non-resident. The provision reflects the distinction in article 5 of the OECD Model Tax Treaty, which states taxing rights where a trade is carried on through a dependent agent but not where it is carried on through an independent agent.

16.4.5 Special Scheme for Accelerated Depreciation

This was a temporary one-year measure, for the accounting year 1998.1999. It was available to Small and Medium sized Enterprises (SME's) which invest in plant and machinery other than those in connection with leasing of cars, ships, railway assets or long-life assets.

16.4.5.1 Tax Benefits

Investment in qualifying plant and machinery entitles the SME to an increased first year allowance at a rate of 40% instead of the normal allowable depreciation at a rate of 25%, declining balance method.

16.4.6 Scientific Research Allowances

The Capital Allowances Act provides allowances for capital expenditure for scientific research. This measure applies where a person carrying on (or about to commence) a trade incurs capital expenditure on scientific research related to that trade. The research may be undertaken directly by that person or on his behalf. "Scientific research" is defined as "any activities in the fields of natural or applied science for the extension of knowledge"[122]. No allowances are available in respect of expenditure on the acquisition of land.

16.4.6.1 Tax benefits

100% tax relief is granted in respect of capital expenditure on scientific research.The harmless tax measures above, when compared to the Code of Conduct section, can be seen as a fine line between what is deemed harmful and harmless by the Primarolo group.

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[122] www.inlandrevenue.gov.uk

16.5 The excluded countries list

PART I SPECIFIED TERRITORIES

Australia

Austria

Bangladesh

Bolivia

Botswana

Brazil

Bulgaria

Canada

Colombia

Czech Republic

Denmark

Dominican Republic

Falkland Islands

Fiji

Finland

France

Gambia

Germany

Ghana

Honduras

Iceland

India

Indonesia

Ivory Coast

Japan

Korea, Republic of

Lesotho

Malawi

Mexico

New Zealand

Nigeria

Norway

Papua New Guinea

Poland

Romania

Senegal

Sierra Leone

Slovak Republic

Solomon Islands

South Africa

Swaziland

Sweden

Trinidad and Tobago

Turkey

Zambia

Zimbabwe

PART II SPECIFIED TERRITORIES WITH QUALIFICATIONS

Argentina	Companies obtaining exemption from tax on income from transactions, activities or operations carried on in, or from goods located in, tax free areas in accordance with Law 19640 of 16th May 1972.
Belgium	1. Companies which are regarded as Foreign Sales Corporations in section 922(a) of the United States Internal Revenue Code 1954 and which accordingly qualify for reduced Belgian taxation. 2. Companies approved under Royal Decree No. 187 of 30th December 1982 as Co-ordination Centres.
Brunei	Companies qualifying as "pioneer companies" under the Investment Incentives Enactment 1975.
Chile	Companies obtaining exemption from tax under Law 16,441 of 1st March 1966 on income from property located in the Department of Isla da Pascua or from activities developed in that Department.

China	1. Companies deriving income in or from the Hong Kong Special Administrative Region and submitting tax returns to the authorities of that Region. 2. From 20th December 1999, companies deriving income in or from the Macao Special Administrative Region and submitting tax returns to the authorities of that Region.
Egypt	Companies which do not fall within the scope of Article 111, Book 2 of Law 157 of 1981 because they do not operate in Egypt.
Faroe Islands	Companies deriving interest from Faroese financial institutions from which tax is deducted at source under Law 4 of 26th March 1953.
Greece	1. Companies whose profits are exempt from tax under Article 6(2)(c) of Law 3843/1958 (profits from the operation of ships under the Greek flag). 2. Companies having profits exempt from company income tax by virtue of Article 25 of Law 25/1975 or by virtue of Law 89/1967 (profits from shipping and associated activities).
Hungary	Companies benefiting from the reduced rate of tax for extra-territorial companies under section 19(2) of Act LXXXI of 1996 on Corporate Tax and Dividend Tax.
Ireland	See below
Italy	Companies benefiting from paragraphs 12 to 14 of Article 11 of Law 413 of 30th December 1991 (Trieste Free Zone Financial and Insurance Centre).
Kenya	Companies having income exempted from tax under paragraph 11 of Schedule 1 to the Income Tax Act 1973.
Luxembourg	1. Companies obtaining any special tax benefit under the Law of 31st July 1929, the decree of 17th December 1938 or the Grand Ducal Regulation of 29th July 1977 (holding companies). 2. Any reinsurance company established in Luxembourg requiring authorisation under Article 92 of the Law of 6th December 1991.

Malaysia	1. Companies exempt from tax in accordance with section 54A of the Income Tax Act 1967 (shipping). 2. Companies subject to tax at 5 per cent. in accordance with sections 60A and 60B of the Income Tax Act 1967 (inward reinsurance and offshore insurance). 3. Companies deriving dividends from a company or companies deriving income from one or more of the activities referred to in paragraphs 1 and 2 above. 4. Companies obtaining a tax benefit under the Offshore Companies Act (Island of Labuan) 1990.
Malta	1. Companies entitled to exemption or relief from tax at the discretion of the Minister responsible for finance under section 12(2) of the Income Tax Act 1948. 2. Companies obtaining exemption from tax under section 86 of the Merchant Shipping Act 1973. 3. Companies obtaining exemption or relief from tax under section 30 of the Malta International Business Activities Act 1988 or section 30 of the Malta Financial Services Centre Act 1988. 4. Companies obtaining exemption or relief from tax under section 18 of the Malta Freeports Act 1989.
Morocco	Companies receiving a tax benefit under Law 58-90 of 1992 (offshore financial centres).

Netherlands	1. Companies which are regarded as Foreign Sales Corporations under section 922(a) of the United States Internal Revenue Code 1954. 2. A company ("the first company") receiving interest, rents or royalties in an accounting period directly or indirectly from a Dutch company ("the second company") which is connected with the first company within the meaning of section 839 of the Taxes Act, in circumstances where- (a) the second company does not satisfy the income and gains requirement in regulation 5 as respects its accounting period in which the interest, rents or royalties were paid, and (b) the aggregate of the non-local source income of the first company in its accounting period in question and the interest, rents and royalties received by it from the second company in that period exceeds whichever is the greater of- (i) £50,000 or, where that period is less than twelve months in duration, that amount proportionately reduced, and (ii) an amount equal to ten per cent. of its commercially quantified income arising in that period.
Pakistan	Companies deriving royalties, commissions or fees which are exempt from tax under paragraph 139 in Part I of the second Schedule to the Income Tax Ordinance 1979.
Philippines	1. Companies authorised under Presidential Decree 1034 of 30th September 1976, or under Presidential Decree 1035 of 30th September 1976, to operate an offshore Banking Unit or a Foreign Currency Deposit Unit as defined in those Decrees. 2. Companies receiving interest on deposits with a Foreign Currency Deposit Unit, or other interest subject to the reduced rates of tax under section 27(D) of the National Internal Revenue Code 1997.
Portugal	Companies obtaining tax benefits under Decree Law 502/85 of 30th December 1985, Articles 41 and 51(g) of the Tax Benefits statute (EBF) approved by Decree Law 215/90 of 31st August 1989 (free zone in Madeira), or Decree Law 501/85 of 28th December 1985 as implemented by Decree Law 63/87 of 5th February 1987 (free zone in the Azores).

Puerto Rico	1. Companies obtaining a tax benefit under section 2(o) of the Industrial Incentive Act 1978 (designated service industries). 2. Companies obtaining a tax benefit under section 25 of the International Banking Centre Regulatory Act 1989 (International Banking Entities).
Singapore	1. Any company obtaining tax concessions under Ministry of Finance Regulations pursuant to section 43A, and sections 43C to 43K, of the Income Tax Act. 2. Companies obtaining exemption from tax on the income of a shipping enterprise in accordance with section 13A of the Income Tax Act. 3. Companies obtaining relief from tax in accordance with sections 45 to 55 (international trade incentives), and sections 75 to 84 (warehouse and service incentives), of the Economic Expansion Incentives (Relief from Income Tax) Act. 4. Companies deriving dividends from a company or companies deriving income from one or more of the activities falling within paragraphs 1 to 3 above.
Spain	1. Companies which are registered in the official register of the Canary Islands Special Zone (Zona Especial Canaria) established under Law 19/1994 and which benefit from the special low tax rate applied to such companies. 2. Companies benefiting from the alternative taxation regime for co-ordination centres established by the provincial governments of the Basque Country under laws pursuant to Norma Foral 3/1996 of 26th June 1996, Norma Foral 7/1996 of 4th July 1996, and Norma Foral 24/1996 of 5th July 1996.
Sri Lanka	Companies obtaining relief or exemption from income tax under any of the following provisions of the Inland Revenue Act 1979- (a) section 8(c)(iv) (foreign currency banking units); (b) sections 10(d) and 15(b) (income derived from approved bank accounts); (c) section 10(e) (interest of newly resident companies); (d) section 15(cc) (services rendered outside Sri Lanka); (e) section 15(p) (re-export of approved products).
Tanzania	Companies relieved or exempted from income tax under section 15(1) or (1A) of the Income Tax Act 1973.

Thailand	Companies obtaining a tax benefit under Royal Decree 280 of 22nd September 1992 (offshore banking units).
Tunisia	Companies obtaining exemption from, or reduction of, tax under Law 76-63 of 12th July 1976 (financial and banking institutions dealing with non-residents).
United States	Domestic International Sales Corporations as defined in section 992(a) of the Internal Revenue Code 1954.
Ireland	Companies in Ireland are no longer able to claim under the Excluded Countries Regulations. For accounts periods beginning before 11 October 2002 companies other than those listed below were eligible. 1. Companies obtaining relief or exemption from tax under Chapters 1 and 2 of Part 14 of the Taxes Consolidation Act 1997. 2. Holding companies having income exempted from tax under section 44 in Chapter 3 of Part 3 of the Taxes Consolidation Act 1997.

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