



# UK Tax Competitiveness Survey 2008: Riding the Storm

TAX

# Introduction



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As corporations become ever more mobile and operate on an increasingly global scale, countries are competing more and more to attract businesses to locate in their territories.

And many are using their tax systems to do this.

There are several factors driving a business's location decision: access to new customers, the workforce, the country's infrastructure and the geographic location, to name a few, but tax is a key element in the mix.

And arguably, unlike elements such as access to new customers which are often a result of demographic and social trends such as rapid population growth, tax is something that is under a country's direct control.

In 2008 a rubicon was crossed when a number of UK listed companies announced they were leaving Britain, citing the tax system as their reason for going. Prior to this, the complaints had been growing louder but noises about business becoming so dissatisfied with the system that they would leave were often dismissed as mere sabre-rattling. The few companies that had thus far left our shores were limited to specific sectors (such as insurance) or the move was associated with a corporate restructuring. The 2008 departures were different and the debate about Britain's tax competitiveness moved to a new level.

As the recession bites, business is even more focussed on the bottom line than in more normal circumstances and, for those still making profits, tax is a major cost. The departures of 2008 suggest that it is possible to move headquarters and thus, whilst still subject to UK tax on profits earned in Britain, escape the clutches of the UK's much disliked system of taxing foreign profits earned overseas.

The UK system of taxing foreign profits is the subject of a reform process, initiated in 2007 and is still ongoing. In the 2008 pre-budget report, a tax exemption for foreign earned dividends was announced, a development likely to be welcomed by business and which may result in funds flowing back to the UK according to our survey. But the "price" for losing the ability to tax dividends coming into the UK is the introduction of a worldwide debt cap, restricting the amount of interest that can be offset against UK tax.



Whilst intended to be broadly neutral in tax revenue terms, the draft legislation on how the debt cap will operate (which was released in December 2008) suggests there will be clear winners and losers resulting from this move depending on an individual company's intragroup financial arrangements. The overall impact is yet to be assessed but it seems there will be a number of inward investors to the UK who will see a significant increase in their tax burdens.

Furthermore, although the system of taxing foreign dividends has been addressed, the thorny issue of the UK's controlled foreign companies ('CFC') regime is separate and is the subject of a continuing, detailed consultation process. It's important to get the reforms 'right', but there is a tension between needing to allow sufficient time to consult and running the risk of businesses losing patience and leaving or losing faith that reform will be possible before an election at which point all bets could be off.

The tax authorities are in a particularly unenviable position: facing the prospect of reforming a difficult area of corporate tax in a way that does not create unacceptable fiscal risk at a time when business has shown it's willing to up sticks and leave and also when public finances are under enormous pressure. The good news is that so far the consultation process on this has worked well with both sides listening to each other and with all appreciating the urgency on this matter.

At a time when both the state and business are having to work closely in an unprecedented way to help us through the credit crunch, perhaps the feeling that we are all in this together will lead to increased mutual understanding and a better working relationship in the future.

#### **Sue Bonney**

Head of Tax and People Services  
KPMG Europe LLP

The UK corporate and personal tax regimes, and the manner of their implementation, are impacting detrimentally on the competitiveness of the UK financial services sector and beginning to affect business location decisions.

*Michael Snyder, Policy and Resources Chairman for the City of London Corporation (February 2008)*

#### **The research**

For the third year running, KPMG commissioned business advisers Lighthouse Global to conduct an independent research study into the competitiveness of the UK tax regime.

As in previous years, the survey respondents comprised 50 senior finance or tax professionals drawn more or less evenly from FTSE 100 companies, FTSE 250 companies and large foreign-owned subsidiaries:

#### **The survey sample:**

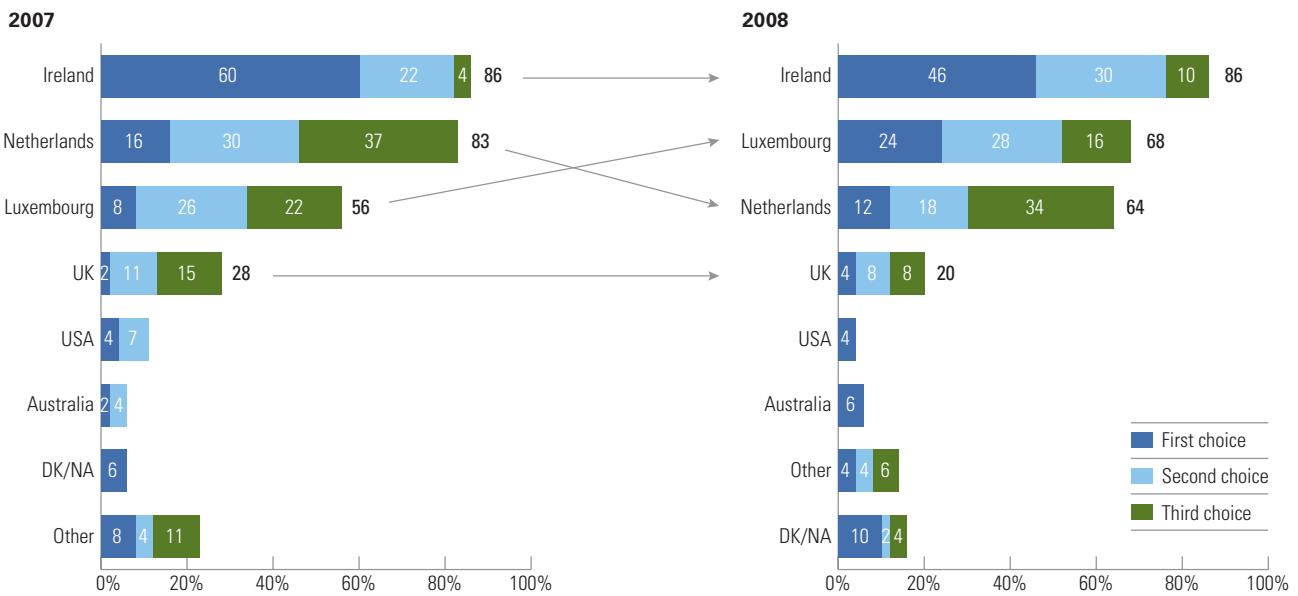
- 70% of respondents were from companies with turnover of £1bn +
- 32% - FTSE 100
- 38% - FTSE 250
- 30% - Foreign subsidiaries

# UK Tax Competitiveness – where are we now?

## How does the UK rank?

**Steady at fourth position – still behind Ireland and the Netherlands but ahead of other competitors**

Ireland retained its position as most competitive  
UK still lags



### Ireland, Netherlands and Luxembourg in top three for all audiences

Q7 Which of the following countries do you think has the most competitive tax regime?  
Base: all respondents (50)

Q7 Which of the following countries do you think has the third most competitive tax regime?  
Base: all respondents (50) (Re – based to 50 for each choice)

The UK has maintained its position as the fourth most competitive tax regime, behind Ireland, the Netherlands and Luxembourg – all of whom actively use their tax systems to attract investment. It is gratifying however, that the UK remains ahead of such key global competitors as France, Germany and the US, although the UK’s aggregate score declined from 28 percent in 2007 to 20 percent in 2008.

Ireland’s aggregate score remained steady at 86 percent, keeping it in first place, and Luxembourg edged ahead of the Netherlands.

## How important is tax on location decisions?

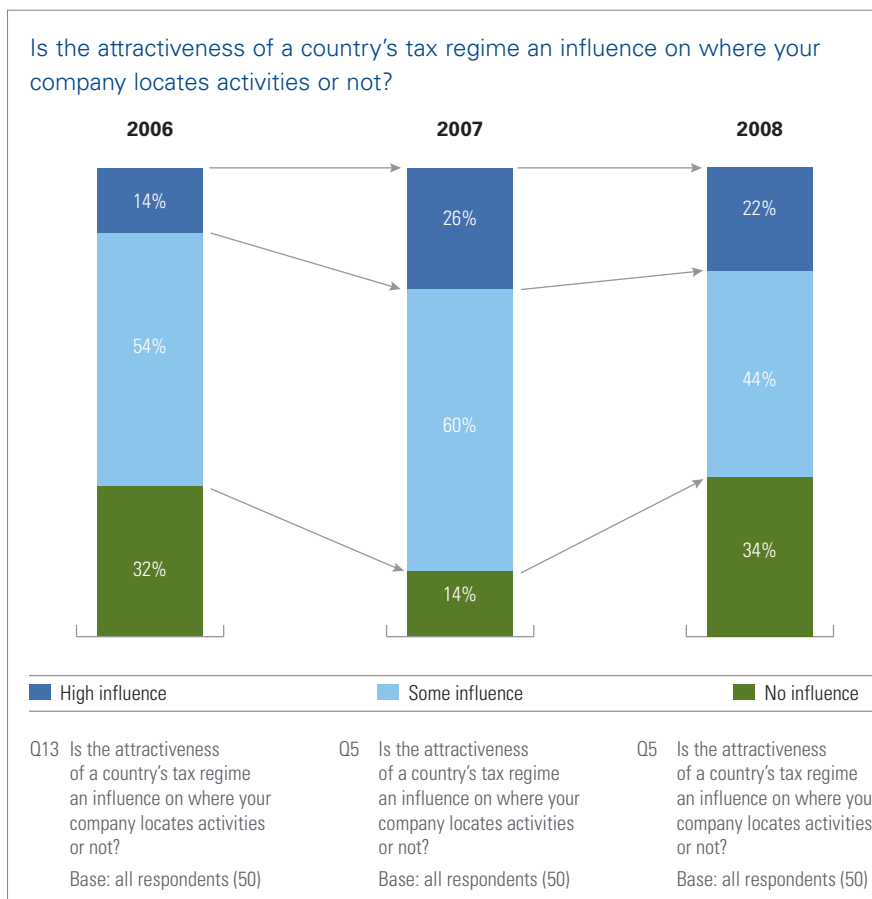
### Still a significant influence on business location decisions

The influence of tax on business location decisions appears to have declined since 2007, returning to levels closer to 2006; a surprising finding given the sentiment expressed above, the high profile corporate departures from the UK this year (Shire, UBM, WPP among others) and the government's stated commitment to improving Britain's competitiveness from a tax perspective.

This may be because many respondents felt that they have other business priorities such as simply weathering the storm in the current economic climate. Closely associated with that, it may be that setting up a new location for business activities is not likely at the moment.

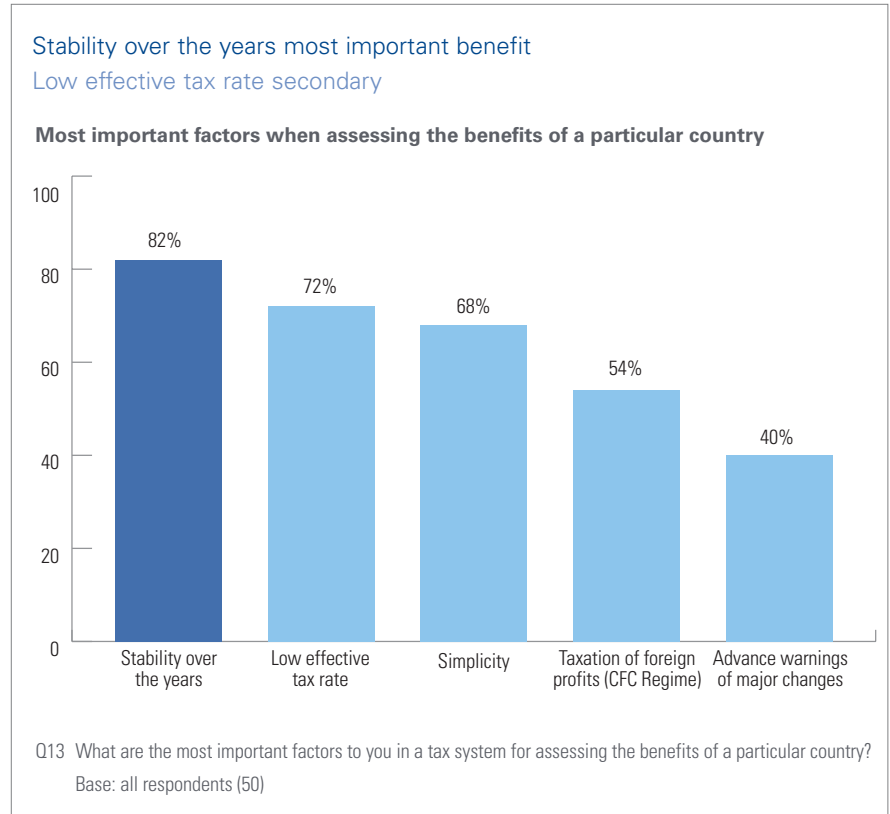
The proportion indicating that the attractiveness of a country's tax regime influenced where their company locates activities declined 20 percentage points from 86 percent in 2007 to 66 percent this year. However, the proportion for whom tax had a high influence on these decisions only declined four percentage points from 26 percent in 2007 to 22 percent in 2008, perhaps suggesting that where tax is an important factor, it has tended to remain so.

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## And what is business looking for?

Stability ranks more important than the rate

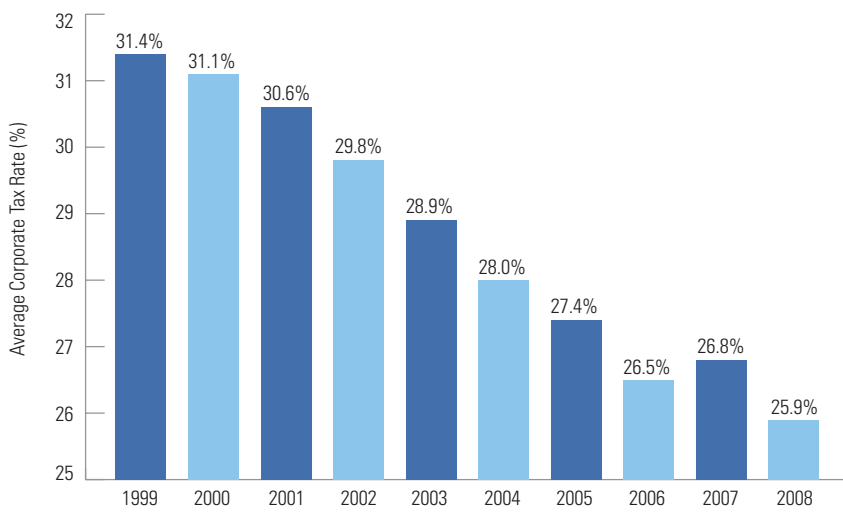


Despite the economic downturn, it seems that our respondents overall are more concerned about stability than a low effective tax rate. In a question where the respondents could select more than one option, more than eight out of ten said stability was the most important factor. However, when the FTSE 250 respondents in the sample were analysed separately they ranked the effective rate equally important to stability.

This is in line with previous years when areas such as clarity of interpretation and consistency have ranked ahead of the headline rate, but at a time when businesses are looking to save costs, it is perhaps a little counter-intuitive. That said, the headline corporate tax rate was reduced from 30 percent to 28 percent in April this year, and the respondents may be less concerned about the rate as a result of this change.

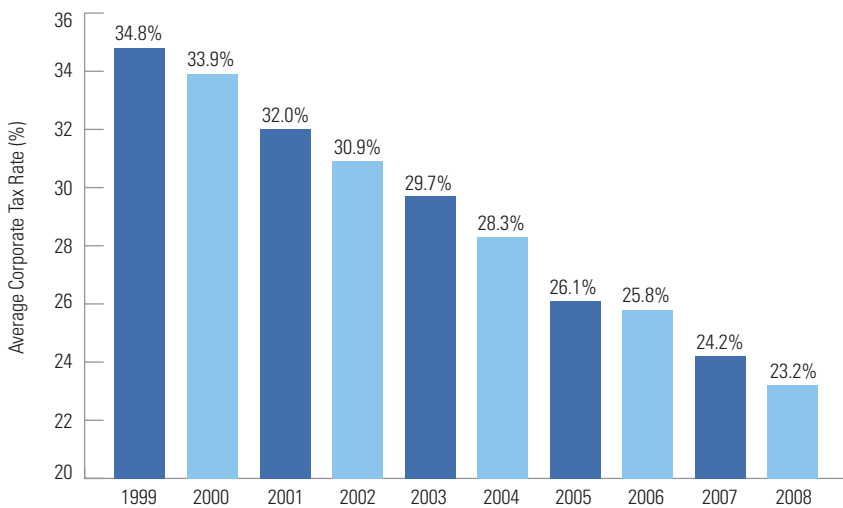
Indeed corporate tax rates around the world are falling, illustrated in the charts below from the KPMG global corporate tax rate survey. The UK remains above the average when compared both worldwide and within the EU but it is lower than key competitors such as the US, Germany and France.

Corporate tax rates etc – all countries in KPMG survey 1999–2008



The UK remains above the average when compared both worldwide and within the EU but it is lower than key competitors such as the US, Germany and France.

Average EU Corporate tax rates 1999–2008



Another factor explaining why the rate itself may be secondary to stability is that if the respondents are envisaging a very harsh downturn, the tax rate may be irrelevant; taxes are only paid on economic profits so if a business makes a loss, there is no tax due.

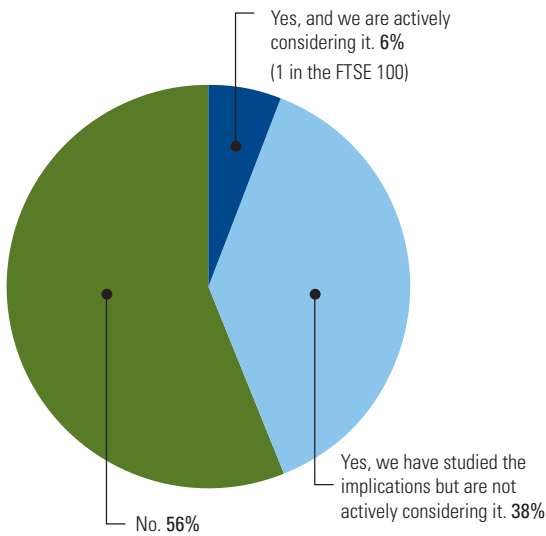
Additionally, these results underline the importance of the taxation of foreign profits, with over half of the respondents saying that this area of tax is an important factor when assessing the benefits of a particular country.

# More businesses set to leave?

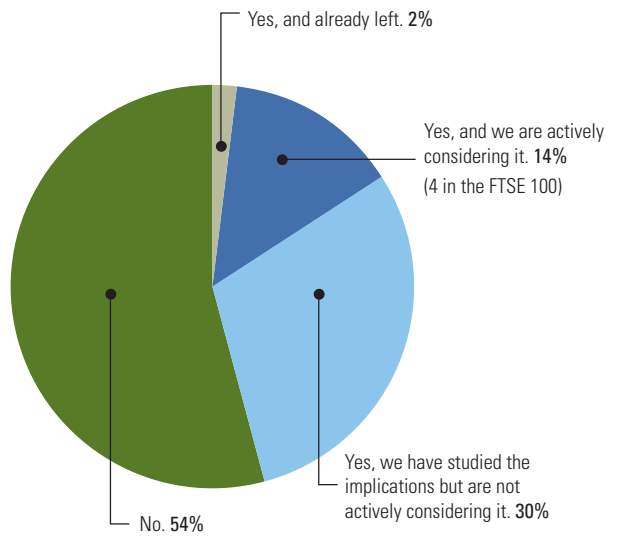
Alarming, our survey says yes

## More actively considering moving tax residence

2007



2008



**75% of companies actively considering moving have a turnover of over £1 billion**

Q12 Have you looked at moving your tax residence away from the UK?  
Base: all respondents (50)

Q10 Have you looked at moving your tax residence away from the UK?  
Base: all respondents (50)

Last year just 6 percent of our respondents said they were actively considering moving their tax residence out of the UK. This year this has jumped to 14 percent – half of which were FTSE 100 respondents – saying they were actively thinking of leaving and one respondent saying that their company had already left.

Interestingly, the proportion saying they have no plans to leave has remained broadly flat. It seems that those who have looked at the implications of moving but dismissed it in the past are now actively considering it, leading us to think that this may be a result of their seeing other companies leave and thus some sort of precedent being set.

## Taxation of foreign profits behind this sentiment

The way in which the UK tax regime reaches out to tax profits earned overseas is at the heart of many businesses' dissatisfaction. These rules were explicitly named as the reason for some of the high profile departures this year and are the subject of an ongoing reform process.

There are two areas of foreign profits taxation under reform:

1. The "Controlled Foreign Companies" (CFC) regime, under which the profits of overseas subsidiaries of UK-resident parents can be subject to UK tax;
2. The way in which foreign earned dividends are taxed;

The UK authorities issued a "discussion document" on a proposed route for reform of the way in which foreign profits are taxed with specific proposals for changes to the CFC regime and the taxation of foreign earned dividends in the summer of 2007. Whilst the proposals relating to the treatment of these dividends were welcomed, business gave the proposals addressing the CFC regime a very negative response and the Treasury have abandoned these initial plans for the CFC regime – showing that they are prepared to listen to key stakeholders in this area of tax.

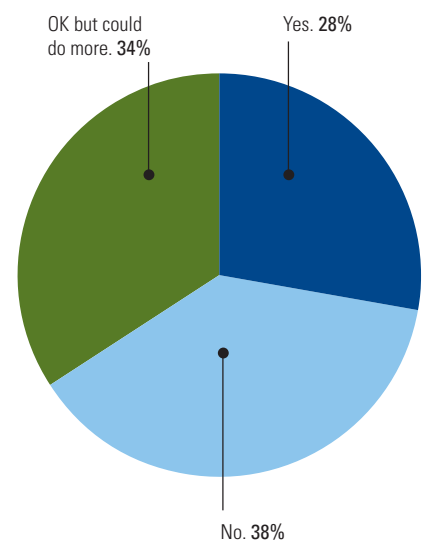
Our respondents recognised the extent to which the authorities have engaged with business. Less than four in ten said that they were not listening sufficiently. 28 percent felt that the authorities had listened sufficiently. Just over a third said that they were "OK, but could do more."

While the CFC reforms are, to some extent, back at the drawing board following the response to the initial proposals, reform of other areas of foreign profits tax are more advanced and have now been unveiled separately rather than waiting to introduce all reforms once the CFC regime has been worked out.

Our survey suggests that overall business would have preferred to have the reforms introduced as a package, but that our respondents did want to see a dividend exemption introduced.

28% feel that the authorities are listening sufficiently

34% feel that they are OK, but could do more



Q14 Do you feel that the authorities are listening sufficiently to business views?

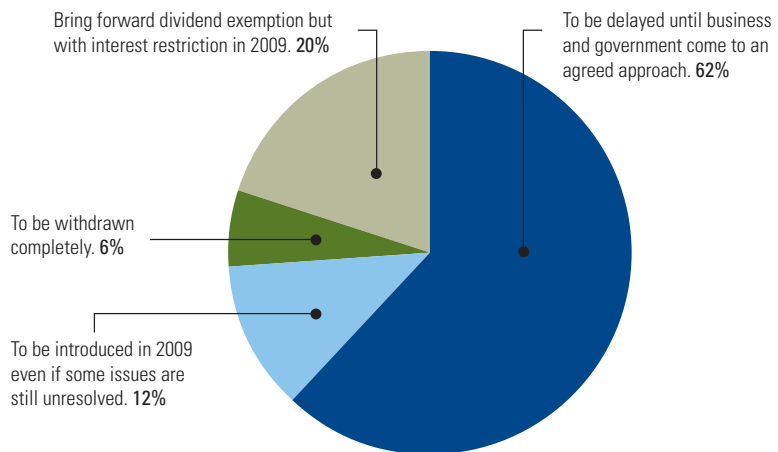
Base: all respondents (50)



## Respondents would prefer delay in reforms

In November 2008's pre-budget report, an exemption system for foreign-sourced dividends was duly unveiled and draft legislation on this and some other areas tax such as Treasury Consents was then released early in December that same year.

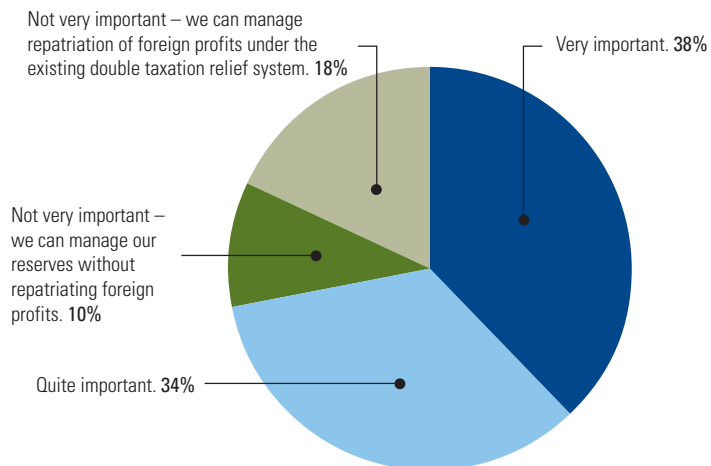
Only 6% think they should be withdrawn



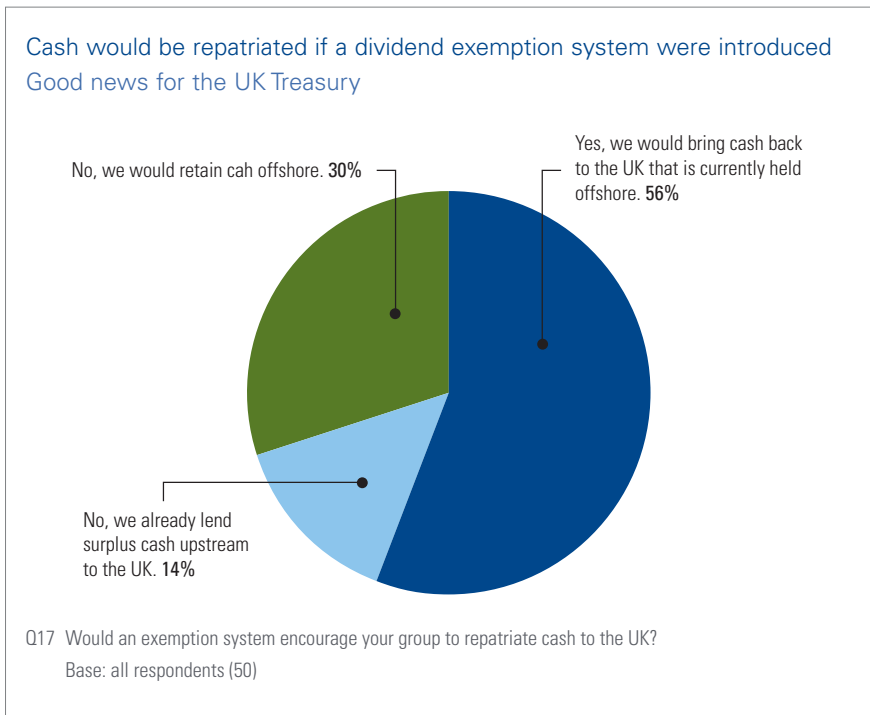
Q15 On the basis that the reforms are to be introduced as a package, would you prefer this?  
Base: all respondents (50)

According to our survey, business should welcome this development and hopefully it will result in repatriation of funds as 56 percent said they would bring funds back to the UK and a further 14 percent said they were already making upstream loans which presumably they can now unwind.

Exemption system for dividends is important for 72%  
The PBR delivered on this



Q16 How important do you think that it is for the UK to have an exemption system for both foreign and UK dividends?  
Base: all respondents (50)



This dividend exemption was coupled with a “debt-capping” system of restricting the level of interest that can be deducted in the UK. This debt-cap is likely to lead to companies unwinding upstream loans due to the increased tax that they will face on them. For groups with complex intra-group lending arrangements (particularly inward investors to the UK where an overseas parent is providing significant debt-funding) this may well lead to an increased UK tax bill.

In KPMG’s view the risk that the worldwide debt cap rules may penalise inbound groups may in turn disincentivise foreign companies from investing via the UK. So while many UK headquartered businesses will be winners as a result of the exemption for foreign earned dividends, there is concern about the impact this has on the attractiveness of the UK for inbound investment.

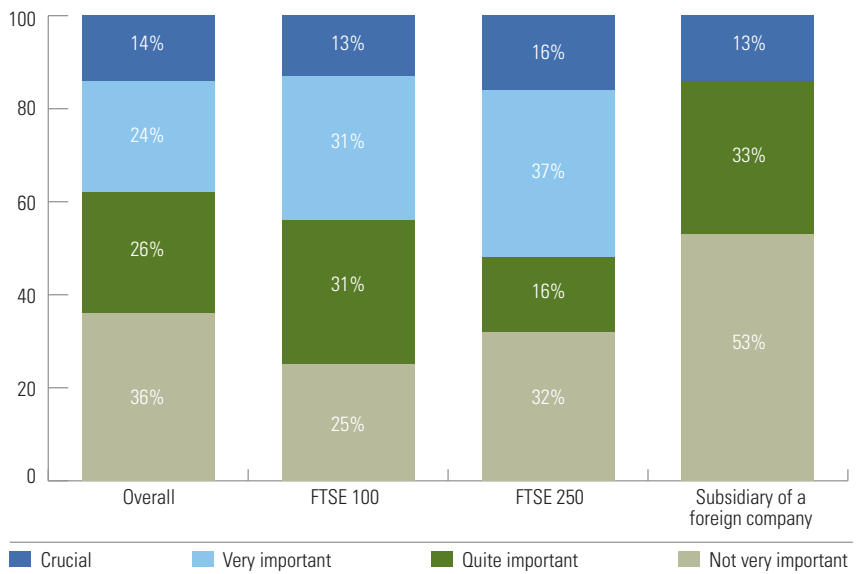
And given the current difficulty of raising funds externally, a UK subsidiary of a foreign parent may well borrow from its parent rather than from a bank. If the worldwide group was itself cash rich, the UK subsidiary may find it is denied a deduction for the finance cost even though it has borrowed on commercial, arm’s length terms. This is clearly inequitable.



## Reform of foreign profits is crucial for some areas

This PBR indicates a willingness to deal with this issue

For 6 out of the 8 companies actively considering moving their tax residence from the UK, reform of foreign profits is crucial or very important.



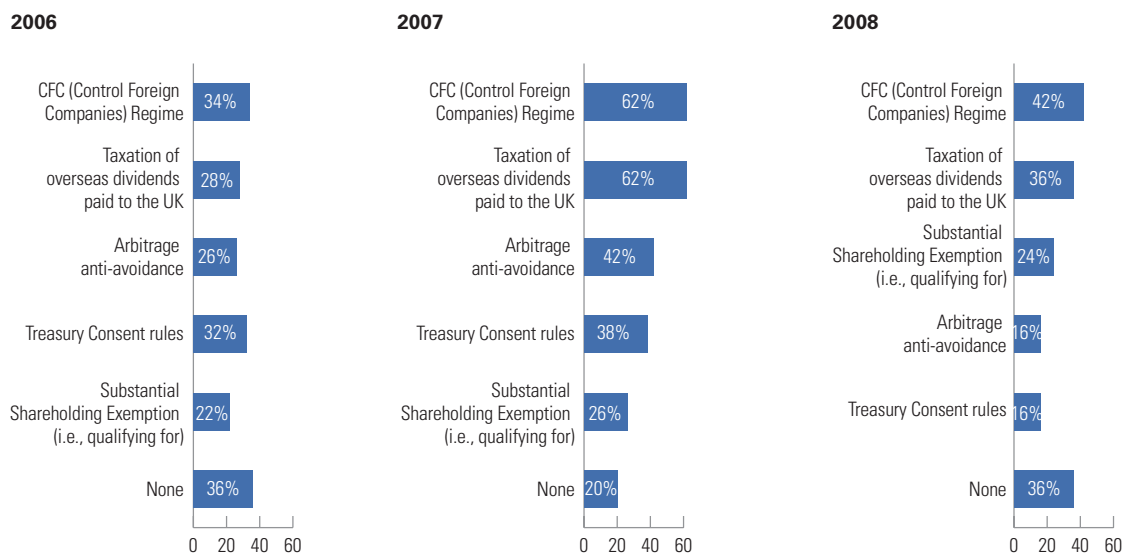
Q11 Notwithstanding the importance of general issues such as clarity and consistency in tax policy, how important is the taxation of foreign profits reform for your company in terms of making the UK an attractive place for you to do business?

Base: all respondents (50). FTSE 100 – 16; FTSE 250 – 19; Subsidiary of a foreign country – 15.



## The CFC regime keeps its top spot hindering outbound investment

CFC and taxation of overseas dividends hindering outbound investment

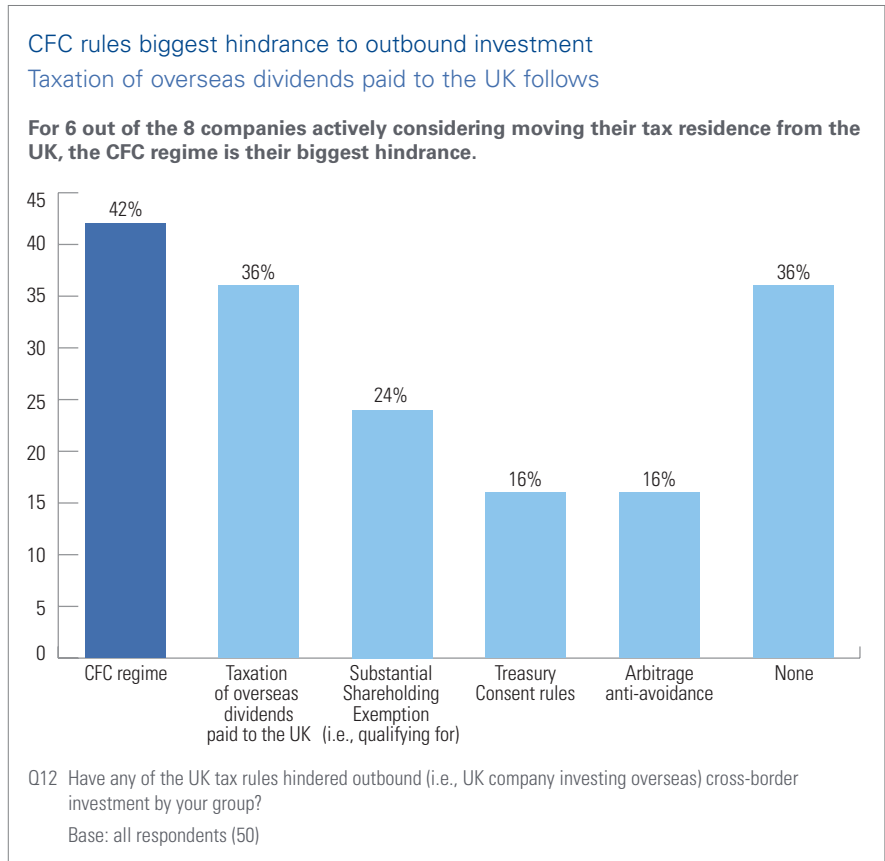


Q16 Have any of the following UK tax rules hindered outbound cross-border investment by your group?  
Base: all respondents (50)

Q13 Have any of the following UK tax rules hindered outbound cross-border investment by your group?  
Base: all respondents (50)

Q12 Have any of the following UK tax rules hindered outbound (i.e., UK company investing overseas) cross-border investment by your group?  
Base: all respondents (50)

Additionally, and perhaps more likely, cross-border outbound investment opportunities may have been less common in 2008 and therefore there were fewer to have suffered a hindrance.



The CFC regime and the taxation of overseas dividends kept their respective first and second places in the table of specific tax rules hindering outbound cross-border investment, however the percentages citing them dropped quite significantly compared to the previous year. This could suggest that the respondents were not so unhappy with them in 2008 than in 2007 or, that they took some comfort from the fact that the reform process was underway. Additionally, and perhaps more likely, cross-border outbound investment opportunities may have been less common in 2008 and therefore there were fewer to have suffered a hindrance.

## Did the pre-budget report change the minds of those planning to leave the country?

Given that the fieldwork was conducted just prior to the 2008 pre-budget report in which a tax exemption for foreign dividends was announced (a move predicted to be popular with business), Lighthouse returned to the respondents who had said they were thinking of leaving (or had already left) immediately after the PBR to ask if they had changed their minds.

One respondent could not be reached, but of the seven remaining, all except one said that their views remained the same. There was some appetite for seeing the detail with one saying that they would reserve judgement until that point and another saying that their mind remained made up for now but could change on seeing the detail. One commented that the changes to the personal income tax system unveiled in the pre-budget report could even make the situation worse.

## Did you change your mind about actively thinking of leaving the UK in light of the Pre-Budget Report? Yes/No and why.

### PBR has only had a small effect

6 out of 7 actively looking to move are still going

" Our advisors would look at that and make recommendations. If our advisors recommended moving our tax residence then we would. At the moment I am more concerned with making the 2.5% adjustments for VAT"

*Finance Director*

" We have already done it. We moved our tax residence away from the UK before the Pre-Budget Report was announced."

*Tax Director*

" It would make absolutely no difference. In some ways it could even make it worse. Where the personal income tax rates have increased, the additional costs for ex-patriots would be borne by our company. As a consequence, it makes remaining in the UK less competitive."

*Tax Manager*

" I have not changed my mind. It would still mean if you compared two scenarios the UK is still not better. It still has a higher tax rate. If it was equal to others, you would opt to stay in the UK. It is not equal so it's not an attractive proposition. The whole system is in disarray. Coming up with a new system now and another one later does not give certainty"

*Tax Director*

" It hasn't made me change my mind. Whilst there was a lot of spin on Monday, there was no detail. The Government has said the details will come out some time in December. There is not enough detail at present to make an informed decision. Depending on the detail, I may or may not change my mind."

*Tax Director*

" It has been put on hold. We were looking at moving our tax residence. There was no decision made, it was a consideration. There was not enough detail at the pre-budget report to know for certain at this point. It sounded good but until I receive the detail, I reserve judgement."

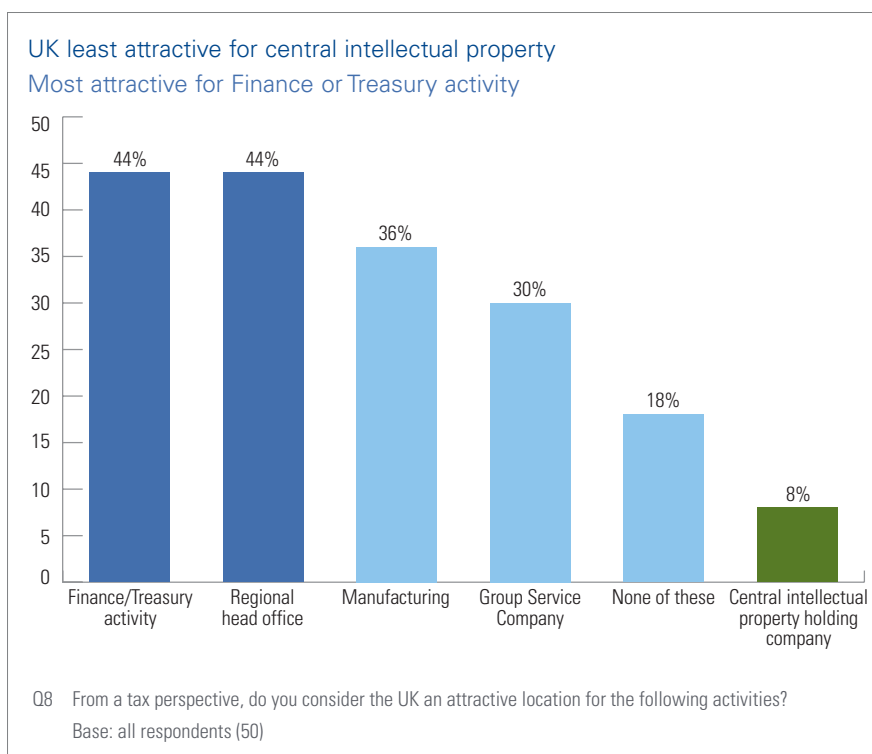
*Tax Director*

" We haven't changed our mind. The main reason we are looking at moving our tax residence away from the UK is because of how harsh the controlled foreign company rules are. A reduction in or relaxation of these CFC rules could have been added to change our mind."

*Tax Manager*

## How attractive is the UK for particular activities?

**Attractive for Finance / Treasury activity and regional head offices but not for intellectual property**

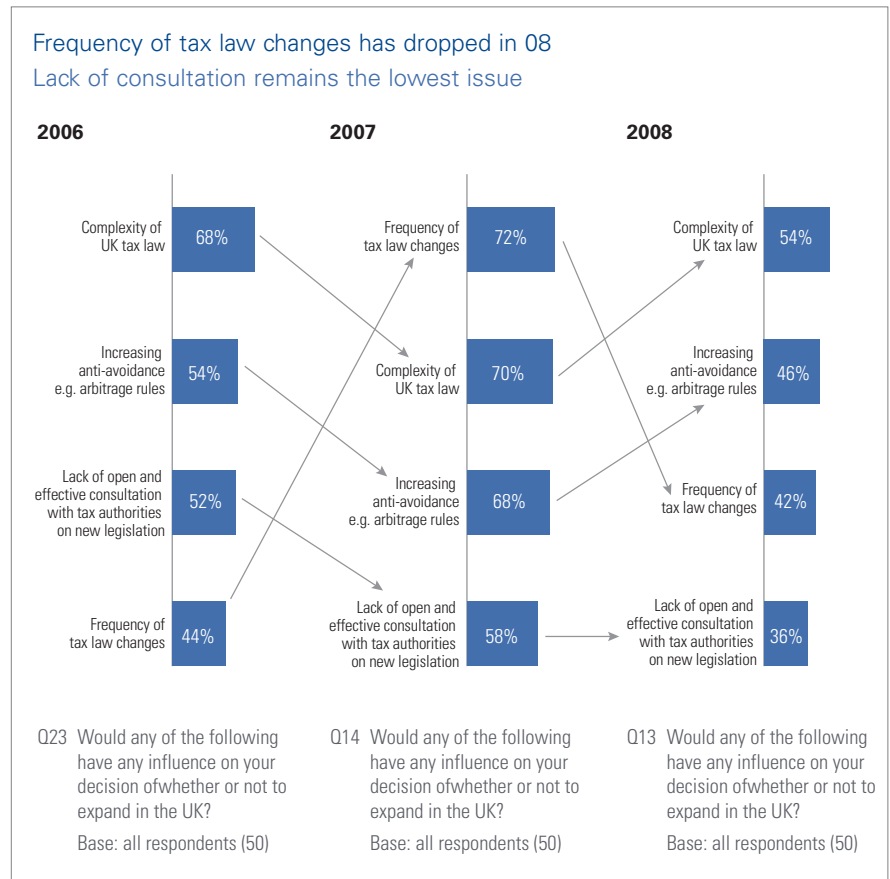


It is encouraging that the UK is seen as attractive for finance / treasury activities and for regional head offices. This perhaps reflects Britain's skills base and leading position in the financial sector and, in the case of the regional head office, it being an attractive place for internationally mobile executives to come to live.

Disappointingly however, given the UK's ambitions to build a knowledge economy, it is not seen as an attractive location for a central intellectual property holding company. It would be good to see the authorities considering introducing a tax regime to actively encourage business to locate intellectual property in the UK – a lower rate for example.

## What tax factors are putting business off expanding in the UK?

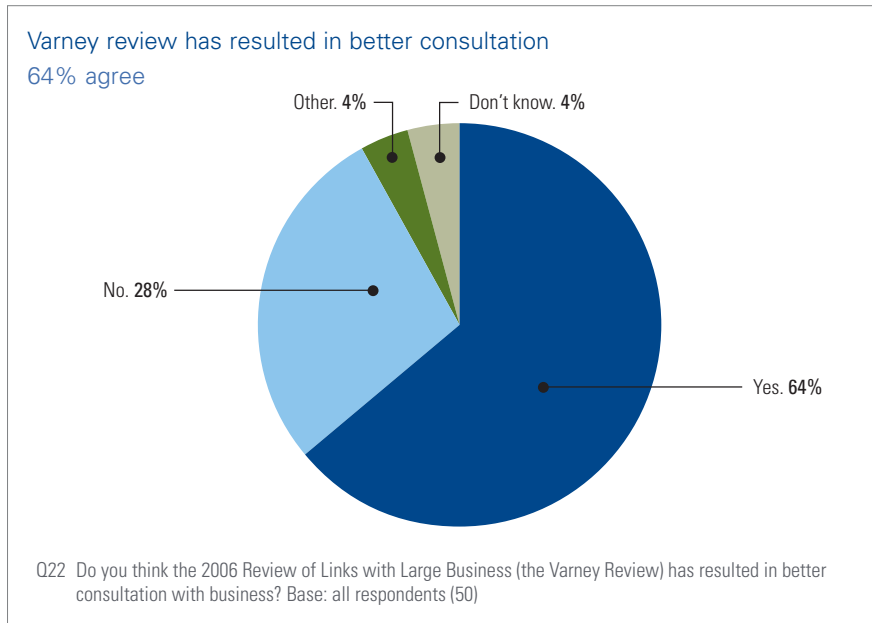
**Complexity back on top of the table but significant decline in complaints about consultation**



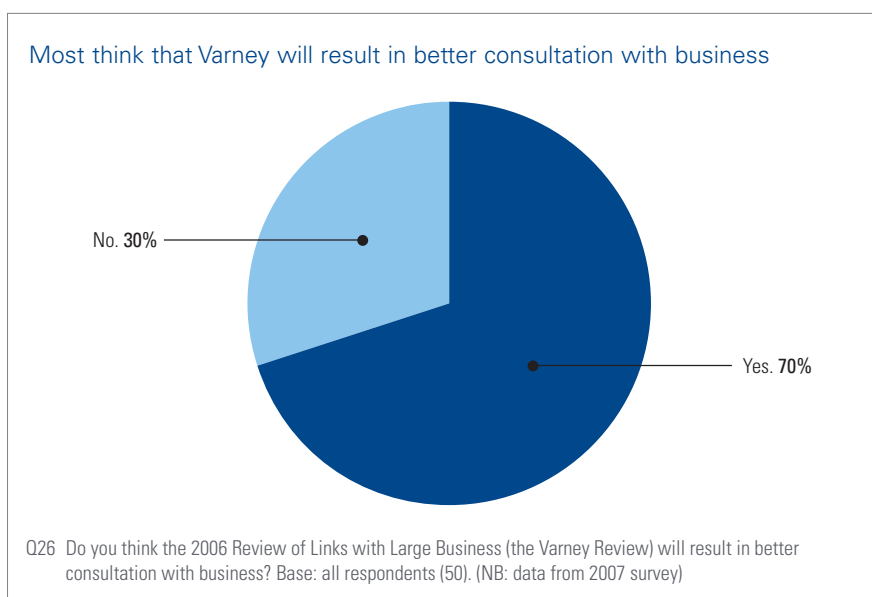
Complexity is back as the number one issue preventing expansion in the UK this year but with 54 percent of the respondents citing it, it is lower than the least common gripe last year (58 percent citing consultation), suggesting that perhaps the mood has softened on these issues a little.

## But progress is being made

The survey revealed some encouraging signs



Almost two thirds of the respondents agreed that the Varney review had resulted in better consultation – a view perhaps also reflected in the reduction in the percentages citing the lack of open and effective consultation as a reason not to expand in the UK (down from 58 percent last year to 36 percent in 2008). And encouragingly this is in line with the 70 percent of the respondents last year who expected that this would happen.



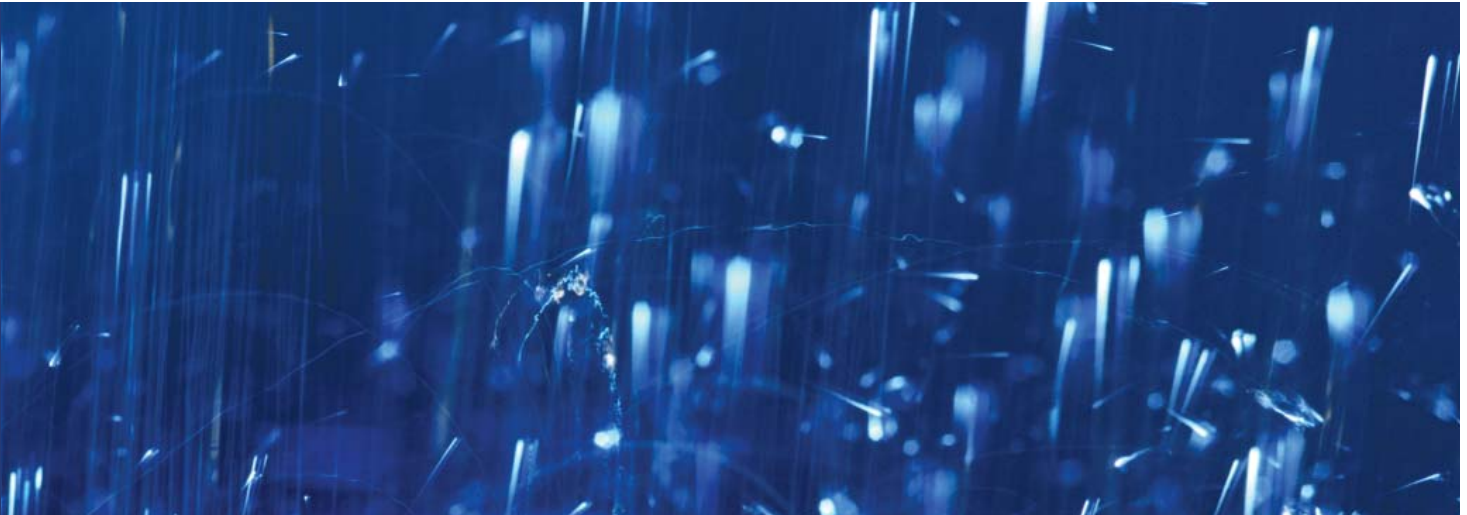
# So where do we go from here?

At first sight, our survey seems to suggest that the UK's tax competitiveness remains in decline. Indeed in terms of the proportion of our largest companies saying that they are thinking of leaving, the picture has worsened substantially.

However, the authorities have taken the first step in reversing this trend by introducing measures to address the UK's tax competitiveness by introducing a tax exemption for foreign earned dividends and announcing in the pre-budget report that the government intends to move towards a "territorial arrangement" for taxing foreign profits generally.

In general policy terms, this is good news for business as it suggests that the UK will not seek to tax profits made outside its boundaries. However, the increasingly jittery business community will be anxious to see real progress towards achieving this and it is important that the authorities make clear how they are going to apply the current CFC rules in the meantime – i.e., between now and when the rules are eventually changed.

While this clarity is urgently needed, it is good to see that, in the main, the issues that have been causing such deep concern to British businesses are being addressed and there are encouraging signs that the authorities are actively listening to business.



In last year's report, we said that the UK's tax competitiveness was reaching a tipping point saying "with the increasing mobility of staff and capital and the growing ability of smaller countries such as Ireland and Luxembourg to entice multinational corporations with appealing tax regimes, there is evidence to suggest that the UK is in danger of losing jobs and investment because of its tax laws."

As the 2008 report goes to press, we have seen corporations migrate from the UK, suggesting that we did indeed reach that tipping point where businesses were prepared to leave.

However, there is an opportunity to prevent what has so far been a trickle from becoming a flood. The key issues around our tax system that so vex UK-resident businesses are being addressed and the indications are that the consultation process is effective insofar as businesses' views are being listened to.

The very real challenge for the authorities is managing to devise a set of reforms which improve the tax regime from the business "user's" perspective, but which still preserves the tax-take at a time when public finances are under intense pressure. It's no easy task and the business and tax professional community need to continue to play their part in the reform process.

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