How tax impacts taxpayer behaviour

As we move closer to the general election, we will undoubtedly see the manifestos of major political parties proposing new tax rules to encourage changes in behaviour. Perhaps businesses could be encouraged to make long term investment in infrastructure, or individuals encouraged to provide for their retirement. To what extent can tax rules be successful in changing behaviour, and are the changes always those that were intended?

THE CHANGE IN TAX RATES

It is generally accepted that there is not a linear relationship between tax rates and tax revenues. The Laffer curve, beloved of US Republicans, represents how both a 0% and a 100% tax rate generate zero tax revenues, and that increasing the tax rate does not always increase tax revenues. The difficult question is identifying at what point increasing the tax rate will actually reduce tax revenues, because the higher tax rate engenders a change of behaviour that results in a reduction in the profits to which the tax rate is applied.

Similar questions arise about changes in behaviour when a person's income means a loss of benefits or a move into a higher tax bracket. Ronald Reagan apparently claimed that, in the 1940s, he could make only four films before moving into the top 90% US income tax bracket, so he made his four films and then went off to the country for the rest of the year.

It is clear that a 100% tax rate provides little incentive to get up in the morning, but does, say, a 5% or 10% increase or decrease in tax rates also have an effect on behaviour? The UK has recent experience of this, with the imposition of the 50% additional rate of income tax rate in 2010 and the reduction in that rate to 45% in 2013. Do we believe that high earners are working harder in 2014 than in 2012, but not as hard as in 2009?

Taxpayers do react to announced future changes in tax rates. For example, it appears that some bonuses were paid earlier than normal in 2010 before the additional rate of income tax was applied, while others were delayed in 2013 until after the additional rate fell. Is this unacceptable tax avoidance, or a perfectly natural and foreseeable reaction to an announced future change? Surely, if the government had wanted to prevent this, it would have included appropriate anti-forestalling rules?

The most likely answer is that, whilst announcing a change in the tax rate will affect behaviour around the time of the change, smaller tax rate changes do not have that great an effect on ongoing behaviour.
FILM FINANCING

It is clear that governments need to think very carefully about the likely consequences of new tax reliefs, as sometimes they may give rise to behaviour that is not quite what was intended. The film financing regime is a good example of this. These rules were introduced in the 1990s to give support to the British film industry, by encouraging investment in low budget films. The regime was initially considered a success, and was extended. The transactions became more complicated, but at the same time were marketed to less sophisticated investors who were perhaps too quick to sign up to ‘too good to be true’ deals. Many investors are probably now regretting that decision, but should the way that these transactions developed have been foreseen by those who initially proposed the tax relief? Is there a clear line between choosing to invest in the British film industry, encouraged by the tax treatment of the investment, and seeking tax reliefs for their own sake?

SHORT-TERM INVESTMENT

A report published by Sir George Cox last year looked at how the UK might encourage sustained growth by overcoming short-termism within British business. As might be expected, many of the proposals related to tax.

The main proposal is not a new idea. It is the suggestion that tax can be used to encourage shareholders to be long-term investors by tapering the capital gains tax charge on the disposal of shares by reference to their length of ownership. Of course, we had a CGT taper relief for individuals until it was abolished by Alistair Darling in the 2008 Budget. There is therefore a certain irony in the fact that Labour’s latest policy document, Delivering long-term prosperity: reform of business taxation, states that Labour would explore the reintroduction of the relief in order to make long-term investment attractive.

DEBT OR EQUITY FUNDING

Another point made in the Sir George Cox report is that the existing tax rules encourage businesses to be over-reliant on debt funding, because interest is deductible but dividends are not. One can see the importance of this issue by looking at the efforts that are taken (with the support of HMRC) to ensure that interest on regulatory capital is deductible for tax purposes.

The problem, however, is one of the certainty and stability of the tax regime. The tax deductibility of debt has been examined closely by successive governments and each has concluded that it should remain. It is perhaps unlikely that any new tax deduction for equity funding would be acceptable unless it were revenue neutral, and so the cost would presumably be a reduction in the value of tax deductions for debt funding. Businesses are unlikely to welcome a tax change that requires a radical rethink of existing financing strategies.

TAX TREATMENT OF FOREIGN PROFITS

It is generally accepted that it is in a country’s interest to encourage foreign expansion. Multinationals need to be able to compete on a level playing field in other jurisdictions.
The UK tax regime initially struggled with the difficult balance between this important policy and maintaining an appropriate corporation tax base, as was seen by the number of corporate migrations from the UK in 2008. We have now landed on a territorial regime whereby foreign profits should generally only be taxable where they arise; the controlled foreign company rules apply only where there is a diversion of profits from the UK and dividends paid by a foreign subsidiary to its UK tax parent are exempt from UK corporation tax. Similar regimes are in place in a number of other European countries, and these changes have made the UK attractive as a holding company location.

The US tax treatment of profits earned by US corporations outside the US is different, but in some ways is equally attractive. Put simply, the US regime does not tax the profits as they accrue, but rather taxes these profits only as and when they are remitted back to the US.

How does this regime affect taxpayer behaviour? US owned businesses are naturally inclined to retain their foreign profits offshore, rather than to pay the additional tax on remitting the cash to the US. There was a tax amnesty in 2004, under which foreign profits could be returned to the US with a much reduced tax charge, but since then there has been little incentive to return the profits to the US. This has caused US groups to be particularly enthusiastic purchasers of non-US businesses, using these surplus cash resources.

In the absence of suitable investments, however, the surplus cash becomes a problem. Shareholders do not want to see groups with large piles of cash earning low rates of interest and therefore diluting equity values. This has resulted in behaviour that is more controversial, such as taking on significant new (and presumably tax deductible) debt in the US to fund dividends, whilst leaving cash resources offshore. Many of the recent and controversial US inversion transactions are driven by a desire to find a way to return this cash to shareholders without paying significant amounts of US tax.

These US tax rules were presumably intended to represent a fair balance between encouraging a US group to expand overseas, whilst maintaining an appropriate US tax charge on the profits once they were returned to the mother ship. The rules do to some extent seem to have achieved their desired result, enabling US groups to expand overseas on a competitive basis. But should the designers have envisaged that the regime could eventually have more far reaching consequences, including creating an unlevel playing field as between wholly domestic US businesses and US owned multinationals and causing US groups to want to leave the US?

TO WHAT EXTENT CAN TAX RULES BE SUCCESSFUL IN CHANGING BEHAVIOUR?

TAX SIMPLIFICATION

Politicians are fond of introducing relatively small tax reliefs to encourage ‘good behaviour’. These reliefs make for good headlines on Budget day, but what harm do they do to the already overcomplicated tax regime? Whilst most would not argue with the proposition that employers should be encouraged to offer cyclists a free breakfast, did we really need a specific income tax relief clogging up the tax rules to ensure that employees were not taxed on the benefit in kind? Once the fanfare has died away, these reliefs are often left to wither away (15p a day luncheon vouchers, for example) or to become more complicated as various anti-avoidance rules are added. The Office of Tax Simplification has done a great job in getting some of these reliefs repealed, but one fears that the reliefs may simply have been replaced with new ones. Surely it would be better to ask at the start whether using a tax relief is really desirable.
CONCLUSION

There is no question that tax rules can affect taxpayer behaviour. It is only natural for taxpayers to take advantage of reliefs or incentives made available to them. There is obviously a distinction between acceptable tax planning and unacceptable tax avoidance (although exactly where this line is drawn is not always entirely clear). Taxpayers, though, should not be criticised for arranging their affairs in a way to minimise their tax burden, and governments should not be discouraged from considering tax measures designed to change taxpayer behaviour.

There are, however, dangers. First, governments should ask whether the potential behavioural benefits justify the increased complexity of the tax code. Secondly, and more importantly, consideration should be given to the extent of the behavioural changes which might occur, and whether they are all desirable. As can be seen from the examples of film financing and the US inversions, the ultimate consequences of changes to tax regimes are not always what were originally intended.

SARA LUDER
T +44 (0)20 7090 5358
E sara.luder@slaughterandmay.com

This article was first published in the 12th September 2014 edition of Tax Journal