Office for
**Budget
Responsibility**

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Supplementary forecast information release

Corporation tax: increase the main rate to 25 per cent and introduce a small profits rate

1.1 The OBR is releasing this information following a request for further detail on the information presented in our March 2021 *Economic and fiscal outlook (EFO)* in respect of the '*Corporation Tax: 19% rate for profits up to £50,000, tapering to main rate of 25% for profits over £250,000, from April 2023*' measure. We will, as far as possible, meet any requests to release supplementary forecast information where this will improve the quality of public debate on the public finances. Our full release policy is available on our website.

1.2 The Government has announced that the headline rate of corporation tax (CT) is to increase from 19 to 25 per cent with effect from April 2023. It has also reintroduced a 'small profits rate' of CT that applies the existing 19 per cent rate for those with profits less than £50,000 and the new 25 per cent rate for those with profits greater than £250,000. For those in between there is a marginal relief, similar to the previous small profits rate policy, so that in effect the average tax rate is tapered on profits between £50,000 and £250,000. For example, a company with £100,000 of profits will therefore be subject to a roughly 23 per cent tax rate while one with £150,000 of profits will pay 24 per cent.

1.3 Table 1.1 shows that this measure is estimated to raise amounts rising to £17.2 billion a year in 2025-26. The tax base is the amount of pre-measure taxable profit that will be affected by the rate change. Our forecast assumes the tax base will rise by 40 per cent between 2020-21 and 2025-26. This partly reflects the 26 per cent growth in our gross company profits forecast, but also the fact that use of deductions – particularly loss relief – to reduce taxable profits is expected to be elevated in 2020-21 and to ease back as a share of gross profits over the medium term. Applying the change in rates, thresholds and reliefs to this pre-measure tax base gives what we call the 'static' costing. This provides the starting point for estimating how much the measure will actually raise once taxpayers have adjusted their behaviour in response it its introduction.

1.4 We assigned the costing a 'medium' uncertainty rating, with the main area of uncertainty relating to these behavioural responses, which we assigned a 'medium-high' rating and which are estimated to lower the yield by 10 per cent in 2025-26. Raising the headline rate increases the incentive for multinationals to shift profits to lower-taxed jurisdictions and for all profitable companies to find ways to reduce their taxable profits. The rate increase also makes working through a company rather than as an employee or self-employed trader relatively less attractive, boosting personal tax receipts via reduced tax-motivated incorporation. Finally, changes in the CT rate affect the take-up of R&D tax credits by altering the value of the tax credits that those schemes provide.

1.5 'Indirect' behavioural effects from a policy change differ from the four 'direct' behavioural responses identified above because they affect economy-wide variables. The main indirect effect from the increase in the corporation tax rate is to increase the post-tax cost of capital, lowering the desired capital stock and business investment in the medium term. We typically include the direct behavioural effects in the policy costing and the indirect effects, when identifiable and quantifiable, in our economy forecast, where they then impact the fiscal forecast as economic determinants.[1]

1.6 In the *EFO*, we noted that the yield from the measure was greater than one might have expected by looking back at how CT receipts had varied over the previous decade of headline rate cuts. As well as the recovery of gross profits after the financial crisis, several measures were introduced over that decade that broadened the tax base, meaning the rate increase raises significantly more than it would have done otherwise. These include restrictions on carried forward loss relief and the deduction of interest expenses, as well as less generous capital allowances. In addition, a surcharge was introduced on banking profits that raises the overall effective CT rate on profits in aggregate.

Profit shifting

1.7 'Profit shifting' describes the ways that multinational companies lower their global corporation tax liability by locating profits in different tax jurisdictions. There are various ways this can be done within existing tax rules, including changes in transfer pricing for goods and services moved between different parts of the company, the use of intra-group financing arrangements, and the location and pricing of intangible assets and services.

1.8 The degree of profit shifting assumed in the costing relies on internal HMRC research that uses administrative and financial data to investigate profit shifting behaviour between UK subsidiaries and their foreign-owned parent companies. Looking at data between 2006 and 2017, during which the UK CT rate peaked at 30 per cent before falling to its current 19 per cent, it finds that a 1 percentage point increase in the UK CT rate (holding non-UK rates fixed) reduces reported UK profits by 0.65 per cent.

1.9 In the costing this 0.65 'semi-elasticity' is applied directly to the profits of UK subsidiaries of foreign-owned companies. It is halved for the profits of UK subsidiaries of UK-owned companies, to reflect a lower assumed rate of profit shifting. Applying these assumptions across the population of larger companies that pay CT in quarterly instalments, each 1 percentage point increase in the CT rate reduces reported profits by 0.38 per cent. The costing does not assume any profit shifting by non-multinationals, but it does include an attrition assumption discussed below that allows for other forms of profit suppression.

1.10 Estimates of profit-shifting behaviour are inherently uncertain, and the true extent of future profit shifting may not reflect what can be discerned from past behaviour. While the statistical techniques used to estimate the semi-elasticity attempt to control for non-tax factors that might influence the profit location decision, there remain real world

[1] For more on direct and indirect effects see *Briefing paper No.6: Policy costings and our forecast*, which is available on our website.

considerations that are challenging to model. Furthermore, there is a six-year gap between the most recent data point for HMRC's analysis and the introduction of the 25 per cent rate. Any relevant developments within that time, such as the impact of the OECD's base erosion and profit shifting initiatives or structural changes in the economy, are not captured. And if other countries also choose to raise CT rates in response to the fiscal costs of the pandemic, the incentive to shift profits out of the UK would be smaller than assumed in the costing.

1.11 **Profit shifting reduces the yield from the measure by £1.1 billion (6 per cent) in 2025-26**, with a small proportion of that relating to lower bank surcharge receipts.

Other behavioural responses

1.12 Attrition is a catch-all term that includes a variety of behavioural responses that reduce the yield from a costing, ranging from legitimate tax planning through to outright tax evasion. For this measure, tax planning behaviours might include delaying the use of trading losses so that they can be used to offset against profits liable to the higher 25 per cent rate, but it is also possible that a higher headline rate will increase non-compliance. The tax gap for corporation tax is relatively low – around 7 per cent according to HMRC's latest estimates – suggesting the additional impact of attrition, on top of the profit shifting, should be relatively small. But even our modest top-down **5 per cent attrition assumption reduces the yield by a further £0.9 billion in 2025-26**.

1.13 Increasing the headline CT rate disincentivises tax-motivated incorporations. The costing includes an increase in income tax and NICs and a reduction in CT receipts to reflect fewer incorporations. But as we described in the *EFO*, the reintroduction of the small profits rate fully or partially reduces that disincentive for smaller businesses (most new incorporations are expected to fall below the £50,000 to £250,000 'taper' region). The costing assumes that the introduction of the small profits rate removes around three-quarters of the effect on overall tax receipts of fewer incorporations relative to the headline rate element of the costing. Overall, **the reduction in tax motivated incorporations increases the yield by just £0.2 billion (1.2 per cent) in 2025-26**.[2]

1.14 R&D tax credit schemes allow companies to deduct qualifying expenditure on R&D-related activities against their taxable income. The increase in the CT rate is expected to incentivise additional R&D expenditure in the small and medium-sized enterprises scheme. This scheme allows companies that carry out eligible R&D activity to claim an enhanced deduction that substantially reduces their CT liability (or makes them eligible for repayments). For tax-paying companies the higher CT rate increases the effective rate of the relief, so we expect qualifying R&D expenditure to increase as a result, lowering the costing yield. There is a partially offsetting effect from non-tax-paying companies that claim the R&D expenditure credit, which is now liable to a higher rate of CT. **Changes in R&D expenditure reduce the yield by £0.1 billion (0.5 per cent) in 2025-26**.

[2] The effect is uneven across years, largely due to the timing of self-assessment income tax receipts, which are paid with a long lag.

Tax devolution

1.15 Table 1.1 shows the breakdown of the costing by tax and spending component. Most categories relate to the behaviours described above in an intuitive way, but there are also lines for the Scottish and Welsh Government 'block grant adjustments' (BGAs) that affect our spending forecasts. This is because the measure affects income tax receipts via the incorporations behaviour and so has knock-on effects to the amounts the Scottish and Welsh Governments can expect to raise through income tax. These effects need to be compensated for via changes in BGAs under the terms of the Scottish and Welsh Governments' fiscal frameworks agreed with the UK Government.

Table 1.1: Costing breakdown: increase CT main rate to 25 per cent and introduce a small profits rate

	£ million					
	Forecast					
	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Tax base	241,486	251,475	295,618	312,468	323,686	337,507
Static costing	0	36	2,815	13,855	18,257	19,098
Behavioural adjustments	-6	-16	-426	-1,953	-2,008	-1,902
of which:						
Profit shifting	0	0	-235	-1,132	-1,094	-1,134
Attrition	0	-1	-150	-710	-868	-908
Tax motivated incorporations	-6	-14	-41	-102	13	235
of which:						
Personal taxes[1]	0	10	54	189	519	935
Corporation tax	-6	-24	-95	-291	-506	-700
R&D expenditure	0	0	0	-8	-59	-96
Final costing	**-6**	**20**	**2,389**	**11,902**	**16,250**	**17,201**
of which:						
Corporation tax	-6	10	2,341	11,760	15,831	16,435
Income tax	0	3	28	98	300	600
NICs	0	6	23	81	192	282
Company and other credits	0	0	0	-23	-72	-144
Bank surcharge	0	0	-6	-24	-29	-30
Scottish BGA (current AME)	0	0	2	8	25	52
Welsh BGA (PSCE in RDEL)	0	0	0	1	4	7

Note: This table uses the convention that a positive sign implies a gain to the Exchequer (and is therefore a decrease in PSNB). The costing of this measure captures the interactions with two other newly announced measures - the capital allowances 'super deduction' and the corporation tax 'loss carry back' extension. It is presented on a National Accounts basis. Totals may not sum due to rounding.

[1] Includes the consequential impact of UK Government income tax policy decisions on devolved administration expenditure.