Tax Representation

ICAEW TAX FACULTY

TAXREP 85/08

2008 Pre-Budget Report – Treasury Committee Inquiry

Paper submitted on 2 December 2008 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales to the Treasury Committee in connection with the Inquiry into the 2008 Pre-Budget Report

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Institute of Chartered Accountants in England and Wales

Submission to Treasury Committee on the 2008 Pre-Budget Report

1. Overview

1.1 The ICAEW has concerns regarding the effectiveness and impact of both the headline VAT rate change and the Government's access to finance package, principally for small businesses, announced in the 2008 Pre-Budget Report (PBR).

1.2 The 2.5% reduction in the VAT rate is unlikely to have a major impact on consumer purchasing behaviour and, for many businesses, the administrative burdens and costs of pricing transition will outweigh any likely benefits.

1.3 Personal allowance changes, coupled with proposed increases in national insurance rates, will result in distortions and anomalies in effective marginal tax rates - producing a marginal tax rate of 60% for specific income bands.

1.4 The ICAEW awaits full details about how the majority of the measures outlined in the Government's access to finance package will work in practice. However, we are concerned that the relatively limited scale of intervention and the significant amount of time that it will take to set up and market new finance facilities will reduce any potentially positive impact on business confidence.

1.5 A number PBR announcements are largely welcomed by the ICAEW including: the proposal for a Taxpayers' Charter to have statutory backing; deferrals of proposed income shifting rules and the proposed increase in the small companies rate from 21% to 22%; the announcement to introduce flexible payment arrangements for taxpayers; and the proposal to extend loss relief carryback from one year to three years.

2. Economic assumptions

2.1 Taken together, the Pre-Budget Report (PBR) measures provide a fiscal stimulus package estimated to put £25bn into the economy. We do not know whether this spending will have the desired effect of staving off a major recession, but we are concerned with the assumptions which underpin this decision.

2.2 The PBR assumes that GDP will fall for the first six months of 2009 before GDP growth begins to recover (paragraph 2.17 of the Red Book). Many commentators are of the view that the recession will last throughout 2009 and into 2010 and that the assumptions and estimates underlying the PBR are too optimistic.

2.3 The danger is that the fiscal stimulus proposed will not lift the UK out of recession as predicted. If the UK is still in recession in 2010, the proposed fiscal tightening from that point may have the effect of prolonging the recession further.

3. Temporary reduction in the VAT rate from 17.5% to 15%

3.1 The ICAEW is concerned that:

- At a macroeconomic level, the temporary reduction will have only a minor impact on consumer purchasing behaviour, particularly for low income consumers;
- For many businesses the administrative burdens and costs of pricing transition will outweigh any likely benefits; and
- For those businesses that hold prices and thereby benefit from the VAT reduction, the effects of that advantage will be small compared to other cash flow difficulties - for instance as caused by falling demand or higher import prices due to the falling pound.

Impact on consumer purchasing behaviour

3.2 The Government estimates that the stimulus from the temporary reduction in the VAT rate, from 17.5% to 15%, will amount to about £12.5bn to the economy spread over 2008/09 and 2009/10.

3.3 The overall reduction in selling prices will not be 2.5%, the VAT reduction, but only 2.13%, the all-inclusive selling price reduction, as per the example below:

Example

> A computer costs £299 including VAT at 17.5%. The VAT element is £44.53 (17.5/117.5 x £299) and the price before VAT is £254.47. VAT of 15% on this price is £38.17, making the new price £292.64. Whilst the headline reduction in VAT is 2.5%, the actual saving is £6.36 and actual percentage reduction is price is only 2.13%.

3.4 While the VAT reduction will provide some help to consumers, for low to mid-range purchases this figure will be largely immaterial for many consumers. However, the reduction may provide a worthwhile stimulus to high value purchases such as new kitchens, conservatories, extensions etc.

3.5 If the reduction in the VAT rate is passed on, which may not always be the case, it will benefit all consumers. However, those consumers on lower incomes are expected to benefit relatively less, as a higher proportion of their spending will be on items unaffected by the VAT rate change, such as food and travel fares (zero-rated), or domestic fuel (5% VAT rate – unchanged).

For many businesses the administrative burdens and costs of pricing transition will outweigh any likely benefits

3.6 The ICAEW believes that the HM Treasury impact assessment for the VAT reduction policy, which estimates a total cost of £300m on businesses' time using the standard cost model, may have considerably underestimated the true cost to business. For small businesses and retail businesses in particular, the administrative burden and transition cost of accommodating the change in the headline VAT rate is likely to outweigh any benefits which businesses might receive from increased sales.

3.7 The figures and assumptions in the impact assessment need to be subject to rigorous analysis. For example, the impact assessment estimate for 'familiarisation with the changes' is half an hour for small businesses (costing £7) and up to three hours for larger businesses (costing £100). This is wholly unrealistic given that many businesses have relatively complicated VAT affairs.

3.8 We note that HMRC have already issued some 67 pages of guidance in 8 different publications explaining how to cope with the rate changes, and more is expected. Whilst we commend HMRC for trying to assist business, the amount of guidance already published further indicates the extent of the additional compliance cost placed on business.

3.9 The estimates for repricing costs are £25 for smaller businesses and £600 for larger businesses. Again, we think that this is a significant underestimate – newspaper reports have suggested that ASDA estimate that changing all the prices on the shelves will take 100 years in man hours.

3.10 Changing VAT rates in December, during the Christmas sales and ahead of the post Christmas sales, is a highly inconvenient time for retailers to take on transition cost.

3.11 The administrative cost for those smaller businesses on simplified VAT schemes, such as cash accounting and the Flat Rate scheme, will be significantly increased – introducing complexity to a business category for which the Government has sought to reduce VAT burdens. Businesses using the flat rate and cash accounting schemes will need advice on how to deal with the changes, tailored to their particular circumstances - including professional advice based on their individual circumstances, support in developing new spreadsheets and to deal with queries as they arise. All cash received after 1 December 2008 has to be traced back to the original invoice and VAT accounted for accordingly.

Case Study – The Institute of Chartered Accountants in England and Wales (ICAEW)

The ICAEW, an organisation employing around 600 people and servicing over 132,000 members and a large number of non-member commercial relationships, has already incurred considerable time-costs spread across a number of personnel in order to understand detailed issues about the rules relating to changes in the VAT rate and how they should be dealt with.

For example we need to decide what to do where members have already paid their 2009 subscriptions. Whilst the main ICAEW subscription is VAT exempt, some members have opted to receive additional services which are subject to VAT. These have been paid at 17.5%, but the VAT rate should now be 15%. The amounts involved are very small, typically just over £1 per member, but recrediting a small amount of money to members who have paid early and opted for these services will be a major administrative task. Similar businesses and organisations will be facing the same issues.

3.12 In view of the short time, one week, between the announcement of the change and its implementation, we anticipate a high error rate among businesses. We welcome HMRC's reassurance in their explanatory material that they will operate a 'light touch' arrangement in relation to errors or mistakes made in the first VAT return.

ICAEW Recommendations

- The Treasury Committee to scrutinise the HM Treasury Impact Assessment for the VAT reduction, and potentially refer the case to the Better Regulation Executive.
- HMRC to commit resources to create an advisory service for smaller businesses on simplified VAT schemes to assist in the change-over to lower VAT rate.
- HMRC 'light touch' arrangements to be extended for the duration of the VAT reduction period and thereafter as businesses adjust back to a higher rate.

4. Income tax and National Insurance Contributions (NIC)

4.1 The Pre-Budget Report proposed to increase the main NIC rates by 0.5% in 2011. The ICAEW believes that the proposal will:

- Increase business costs and potentially widen the gap between the tax treatment of incorporated businesses as compared to unincorporated businesses, which is contrary to the Government's policy set out in the 2007 Budget.
- Provide a disincentive to recruitment at a time when it is hoped that employment will start to increase.

4.2 In addition, the ICAEW believes that the proposed changes to the personal allowance rules in 2010 and the new 45% tax rate in 2011, coupled with the proposed increases in national insurance rates, will result in further distortions in effective tax rates. The withdrawal of personal allowances at one pound for every two pounds of income creates an effective **additional** tax rate of 20% in addition to the 40% income tax rate – i.e. an effective tax rate of 60% at income levels just above £100,000 and £140,000. This effect is demonstrated by the comparison of 'Case A' and 'Case B' in Table 1. as follows:

Table1.		
	Case A	Case B
Income	100,000	100,100
Less; personal allowance (say)	6,000	
Less; personal allowance (restricted by £50)		5,950
Taxable income	94,000	94,150
Income tax at 40%	37,600	37,660

4.3 This example demonstrates that income of £100 has resulted in a further tax charge of £60, an effective marginal tax rate of 60%.

4.4 Table 2. below sets out the effective marginal tax rates for income ranges, against source of income.

Table 2.
Effective marginal tax rates - top slice of Income

2010/11		*Earned Income*		*Unearned*	*Dividend*	
		Employment	*Self-Employment*	*Income*	*Income (Gross)*	
Income range: £	to £	%	%	%	%	
0	6,095	0.00	0.00	0.00	0.00	Limit estimated
6,096	6,475	11.00	8.00	0.00	0.00	
6,476	43,875	31.00	28.00	20.00	0.00	
43,876	100,000	41.00	41.00	40.00	22.50	
100,001	106,475	61.00	61.00	60.00	43.75*	
106,476	140,000	41.00	41.00	40.00	22.50	
140,001	146,475	61.00	61.00	60.00	43.75	
146,476	above	41.00	41.00	40.00	22.50	

2011/12		*Earned Income*		*Unearned*	*Dividend*
		Employment	*Self-Employment*	*Income*	*Income (Gross)*
Income: £	£	%	%	%	%
0	6,475	0.00	0.00	0.00	0.00
6,476	43,875	31.50	28.50	20.00	0.00
43,876	100,000	41.50	41.50	40.00	22.50
100,001	106,475	61.50	61.50	60.00	43.75*
106,476	140,000	41.50	41.50	40.00	22.50
140,001	146,475	61.50	61.50	60.00	43.75
146,476	150,000	41.50	41.50	40.00	22.50
150,001	above	46.50	46.50	45.00	27.50

* assumes personal allowance utilised by other income

Notes

1 The above ignores the 10% savings rate and age allowances.
2 It also does not consider the implications of gift aid or pension contributions.

4.5 As the above table shows, the proposals introduce considerable complexity into the income tax system and associated tax calculations and result in two effective marginal rates of tax of 61%. This increased complexity contrasts with the announcements in 2007 PBR designed to simplify the tax system, in particular the introduction of a flat-rate of Capital gains Tax (CGT).

4.6 The difference in rate between the top rate of income tax (45%) and CGT (18%) is now 27%, further increasing the incentive to ensure that returns are received by way of capital gains rather than income.

ICAEW Recommendations

- The Government should work with the professional bodies and other sources of expertise to remove distortions and anomalies introduced by the proposed changes to personal allowances. There are a number of possible changes available to policy makers[1], however any changes to the proposals will produce winners and losers as compared to the current proposals and these would need to be factored in to any decision.
- The ICAEW calls for clarification on the rates at which tax reliefs, such as pension contributions, will be given. We would expect that a 45% taxpayer will now be able to obtain tax relief on pension contributions at 45%, but the HM Treasury 2008 Pre-Budget Report information is not clear.

5. UK tax exemption of foreign dividends

5.1 Under the current UK tax rules, dividends paid up from overseas subsidiaries to UK parents are subject to UK corporation tax but with a credit for double tax relief.

5.2 The Government has been consulting for some time on a proposal to move to an exemption system for foreign dividends, a method that is used by most other EU countries. The PBR proposes:

- An exemption on foreign dividends received by large and medium sized companies (small companies are specifically excluded);
- A worldwide cap on debt interest based on net external finance costs; and
- A review of the controlled foreign companies (CFC) avoidance rules consistent with a further move towards a territorial approach.

5.3 The uncertainty as to whether the UK would proceed with an exemption system has damaged confidence in the UK and we therefore welcome in principle this announcement. Nevertheless, much of the detail of the proposed exemption still needs to be decided, together with the scope of the proposed interest cap and what the outcome of the review of the CFC rules will be.

[1] Possible alternatives include:

- Give all taxpayers a tax reduction set at an amount of tax equal to the basic rate on the personal allowance. For example, if the current personal allowance was £6,000, then all taxpayers would receive a tax reduction of £1,200 (£6,000 x 20%). This approach would reduce distortions and treat all taxpayers equally. However, tax charges would increase for those with earnings between the higher rate threshold and £100,000, whilst those with earnings above £146,475 would benefit.
- Withdraw the personal allowance more gradually for those earning over £100,000, say a £1 reduction for every £8 of income over £100,000. This would reduce the distortions of the proposed system and create a single effective tax rate for income over £100,000 until the personal allowance reduced to £nil. Taxpayers earning up to £100,000 would not be affected but the there would be winners and losers between £100,000 and the point where the personal allowance would be withdrawn in full.

ICAEW Recommendations

- The Government should now work with businesses and the profession to develop the detailed proposals. It will be extremely important to ensure that, taken as a whole, the rules are reasonable by comparison with our international competitors.

6. Taxpayers' Charter

6.1 The ICAEW fully supports the proposal that a Taxpayers' Charter, which HMRC has been consulting since the summer of 2008, will have statutory backing.

ICAEW Recommendations

6.2 We look forward to continuing our discussions with HMRC about the precise content of the Charter, which should contain the following features:

- The Charter should set out taxpayers' fundamental rights in their dealings with government departments in respect of tax, tax credits and related matters.
- The Charter should be underpinned by an effective route for redress for taxpayers when things go wrong.
- The Charter and its operation should be subject to an annual independent review.

7. Small business taxation

7.1 The ICAEW welcomes the announcement that the proposed income shifting rules have been deferred again and that the proposed increase in the small companies rate from 21% to 22%, due to come into force in April 2009, has been deferred for a year. Given the challenging economic environment, we think it is right that no changes are made in these areas.

7.2 The Government proposes to keep income shifting under review. We recognise the Government's concerns in this area but do not think that income shifting rules are the right approach to addressing any underlying problems that exist in the small business sector.

7.3 We proposed in our PBR submission that there should be a fundamental review of small business taxation. There have been a number of attempts to review the taxation of small businesses. A discussion paper, *'Small companies, the self-employed and the tax system'*, was published in December 2004, but progress over the past three and a half years has been slow. During recent years we have seen legislation announced which is aimed at solving perceived abuses in the small business arena. Our concern is that these measures have addressed some of the symptoms but not the underlying cause of the problem. Re-energising this review will help to provide a sound platform for policy development in the longer term.

ICAEW Recommendation

- The Government should discontinue its review of income shifting.
- The review of small business taxation must be re-energised as the most appropriate means of providing simplification, clarity and greater certainty to small business taxation.

8. Other measures to help business

8.1 The ICAEW welcomes the Government's announcement to introduce flexible payment arrangements which will help taxpayers struggling to pay tax bills. This approach will build upon HMRC's approach to tax debt problems experienced by farmers during the Foot & Mouth crisis. We believe that this system worked well in ensuring the financial survival of many farmers who otherwise may have faced ruin.

8.2 The ICAEW also welcomes the proposal to extend loss relief carryback from one year to three years. This should help businesses offset current losses against earlier profitable years and thereby receive a tax refund. This announcement reflects a similar measure introduced in 1991 at the time of an earlier economic downturn. The three year carryback was maintained until 1997 when the carryback period reverted to one year.

9. Access to finance package

9.1 The ICAEW supports the Government's efforts to improve access to finance for Small and Medium Sized Enterprises (SMEs) announced by the Chancellor in the Pre-Budget Report. However, given the relatively limited scale of intervention and the significant amount of time that it will take to set up and market new finance facilities, the ICAEW questions the overall impact on business confidence that the proposed measures will provide.

9.2 The ICAEW recognises the difficulties banks have in assessing the credit worthiness of businesses in the current environment. Commercial and domestic property value, which underpins much of the lending to SMEs, has been falling. In addition, adverse trading conditions negatively impact businesses' profitability and cashflow. These factors cause banks, already inclined to be more risk averse, to seek to reign in lending facilities.

9.3 In the Pre-Budget Report, the Government announced:

- The creation of a Small Business Finance temporary guarantee scheme to enable up to £1bn of new Government supported lending by banks.
- An Export Credits Guarantee Department's temporary scheme to support a £1bn facility to provide smaller exporters with better access to short term working capital.
- An RDA Loan Fund totalling £25 million, modelled on the Advantage West Midlands transition loan fund to help businesses over the next six months.
- A capital fund of £50 million providing equity or quasi-equity to SMEs who are overleveraged.

9.4 The ICAEW awaits details about how all of the above measures will work, i.e. when they will be available and how businesses will access them.

9.5 Within the overall small-scale equity market the proposed capital fund scheme does not represent a significant intervention. The ICAEW would also draw attention to the lack of previous experience for RDAs (apart from Advantage West Midlands) of RDA Loan Fund schemes to assist businesses in difficulties. Consequently we are concerned about the amount of time it will take to set up the appropriate structure to administer and market the scheme.

9.6 The Government also highlighted an EU announcement that the European Investment Bank (EIB) will make a £1bn fund available to SMEs in the UK by the end of 2008. There are only three banks utilising the existing EIB funding – Barclays, Alliance & Leicester and Close Brothers. Their use of the current facility is on a significantly lower scale than that now proposed. Some banks, who are not part of the current scheme, have expressed interest in negotiating a facility with EIB, however these negotiations will take time. Even when these facilities are in place it will take time for the new banks to train staff, market the scheme and start receiving applications.

ICAEW Recommendations

- The Small Business Finance Scheme (SBFS) should be available for a maximum period of three years, after which time lending should return to more normal conditions.
- If the above measures are to be effective across the UK, the route for firms to access the fund must be clear and made available as soon as possible.
- SBFS funding should operate as the 'Advantage Transition Bridge Fund' (ATBF) did when MG Rover collapsed into administration. The ICAEW regards the ATBF as an example of good practice and demonstrated the value of Insolvency Practitioners in evaluating which businesses had the best survival prospects, thereby saving hundreds of jobs.
- The ICAEW would encourage the Government to examine the viability of a state-backed credit insurance scheme for suppliers to companies that have had their cover withdraw - potentially similar to the recent proposals put forward by the French Government.

10. Further Contact Details

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ANNEX

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 132,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 10,000 members of the ICAEW who pay an additional subscription.

4. To find our more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.