Tax Faculty

Tax Representation

TAXREP 8/05

RETROSPECTIVE LEGISLATION

Text of letter sent to the Paymaster General on 10 February 2005 by the Chairman of the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to the Parliamentary Written Statement issued on 2 December 2004 at the time of the 2004 Pre-Budget Report

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RETROSPECTIVE LEGISLATION

INTRODUCTION

1. On 2 December the Paymaster General issued a written statement to Parliament announcing her intention to introduce retrospective legislation in relation to employment products. A copy of the letter is reproduced as Appendix 2.

2. The Chairman of the Tax Faculty wrote to the Paymaster General on 10 February 2005. A copy of that letter is reproduced in paragraphs 6 to 13 below.

WHO WE ARE

3. The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 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.

4. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. 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.

5. 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 11,000 members of the ICAEW who pay an additional subscription.

LETTER TO THE PAYMASTER GENERAL - TACKLING AVOIDANCE: EMPLOYMENT RELATED SECURITIES

6. We refer to the announcements made in the 2004 Pre-Budget Report (PBR) in respect of the above and the press release, draft legislation and explanatory notes published on 3 February 2005 implementing the proposals set out in the Technical Note accompanying the PBR.

7. We are considering the draft legislation and will be responding shortly. In advance of those comments, however, we would like to put on record our concerns about the written statement you made to the House of Commons on 2 December 2004. This is to the effect that the Government may in future resort to retrospective legislation in relation to what it considers to be unreasonable tax avoidance schemes involving employment income.

8. The relevant paragraph of your December statement is reproduced below:

'I am therefore giving notice of our intention to deal with any arrangements that emerge in future designed to frustrate our intention that employers and employees should pay the proper amount of tax and NICs on the rewards of employment. Where we become aware of arrangements which attempt to frustrate this intention we will introduce legislation to close them down, where necessary from today.'

9. As we have stated in the past, we fully appreciate and understand the Government's need to take action against tax avoidance of the sort set out in your statement (which for the sake of clarity we have referred to below as 'unreasonable tax avoidance'). However, we believe that unreasonable tax avoidance should be countered by way of properly targeted anti-avoidance legislation. It seems to us that the basic principle behind the disclosure of tax avoidance schemes rules introduced in the Finance Act 2004 was to achieve exactly that: namely to enable the Government to act quickly and close down unreasonable tax avoidance schemes by introducing properly targeted anti-avoidance legislation. We support that approach wholeheartedly.

10. However, we are now concerned that, even before the FA 2004 rules have been given time to bed down properly and their success measured, taxpayers face the prospect of targeted legislation introduced with retrospective effect. Although we appreciate that retrospective legislation may have some superficial attraction in countering unreasonable tax avoidance, we are opposed to it in principle, for the following reasons.

- It fails the test of certainty. We believe that certainty should be one of the fundamental principles of a good tax system as set out in our Ten Tenets for a Better Tax System (see Appendix [1]). Taxpayers are entitled to assume that any actions they take will be taxed in accordance with the law in existence at the time that the action is entered into. In relation to countering tax avoidance, the current practice of making a specific announcement that a scheme will be blocked from that day, even if draft legislation follows in due course, is well understood and is reasonably certain in its effect. This practice follows closely the guidelines agreed by the Government in the Parliamentary debate about the 1978 Finance Bill (the so-called *Rees rules*) where it was agreed that any warning about prospective retrospective legislation must be clear in form. We do not think that the announcement made on 2 December 2004 meets the required standard of certainty as set out in the Rees rules.

- The legal basis for retrospective legislation is now questionable, particularly in the wider context of EU and Human Rights laws. Emerging EU case law provides that the state cannot retrospectively remove a right without a transitional period (the so-called legitimate expectation right as found in *Marks-and-Spencer v C&E Commrs (C-62/00)*). If there is no transitional period, then the removal of the right will be illegal under EU law if it interferes with an EC treaty freedom and the state will be liable in damages. We accept that the extent of the legitimate expectation right has yet to be determined precisely in cases where tax avoidance may be an issue, but in our view emerging ECJ decisions suggest that the introduction of retrospective

legislation relying on the statement made on 2 December 2005 would still fail the legitimate expectation right, thus making such legislation illegal under EU law.

- Retrospective legislation has the potential to undermine the credibility of the UK tax system in the eyes of taxpayers. We believe that, by and large, the UK's tax system has a high degree of credibility: the tax rules are obeyed and taxpayer compliance and honesty are good. The new tax avoidance disclosure rules, for example, appear to be working well in identifying schemes at an early stage: they are reasonably certain and we believe that taxpayers and their agents are complying with them. However, if credibility in the system is undermined, it may have very undesirable consequences. For example it may lead to poorer compliance, potentially leading into non-compliance and possibly to evasion.

11. Put shortly, although we understand the Government's desire to counter unreasonable avoidance, for the above reasons we do not think that the introduction of retrospective legislation has a place in UK taxation. We are also concerned that it will damage inward investment into the UK. We urge the Government to ensure that any legislation it proposes does not have a retrospective element and for confirmation that it will adhere to this principal in the future.

12. We wish to emphasise that our above comments should not be read as condoning or supporting unreasonable tax avoidance. This is a very difficult area and the proposal raises serious issues. Indeed, we see that this has also been recognised by the Treasury Committee's report on the 2004 Pre-Budget Report, which was published on 27 January 2005. Paragraph 95 of the report noted the serious issues raised by retrospective legislation and the fact that the rules are likely to be challenged in the Courts. The Committee, however, stopped short of recommending that the Government rethink this aspect of the proposals, proposing instead that:

> *The Inland Revenue should, without jeopardising their position, publish a paper setting out their thinking on the principles which will guide the way they implement this announcement.*

13. We welcome the opportunity to work with the Government in trying to reach some fundamental principles which minimise unreasonable tax avoidance whilst respecting the right of taxpayers to plan their affairs within the law and ensuring legislation is never retrospective. We think that this approach would be in the best interests of Government, taxpayers and their advisers.

FJH/IKY
11 February 2005

Appendix 1

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory**: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain**: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple**: the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate**: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted**: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant**: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation**: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed**: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable**: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive**: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

Appendix 2

Paymaster General's statement on Finance Bill Measures – 2 December 2004

This Government is determined to ensure that all employers and employees pay the proper amount of tax and NICs on the rewards of employment, however those rewards are delivered. Despite the efforts of successive Governments, we continue to be presented with ever more complex and contrived attempts to avoid paying tax and NICs on rewards from employment, particularly in relation to bonuses in the City.

In the most recent year for which we have figures, well-rewarded individuals receiving bonuses of at least £1.5 billion in total sought to avoid paying their fair share of tax and NICs.

The disclosure rules in Finance Act 2004 have revealed that this kind of avoidance is still rife. Without prompt and decisive action we think there could be up to £2 billion paid this year in bonuses on which the amount of tax and NICs properly due is at risk, as a result of increasing ingenuity and inventiveness of the tax avoidance industry.

We cannot allow avoidance on this scale to continue. It is only right that everyone who should pay tax and NICs, does pay and that they pay their fair share when it is due. The overwhelming majority of employers and employees do pay their fair share. But for too long some employers and employees with the benefit of sophisticated tax advice have sought to avoid their responsibilities and to pass more of a burden onto the rest of us.

Early attempts at avoidance in this area took the form of paying bonuses and salaries in gold bullion, diamonds and fine wines. When these routes were closed, employers started to pay bonuses through shares and share options to reduce the amount of NICs they had to pay, avoid their obligation to operate PAYE, and reduce employees' tax bills. When, in 1998, assets readily convertible into cash were brought within PAYE, and NICs, avoidance schemes moved on to more complex arrangements.

Despite extensive reforms to the tax legislation in 2003, employers and their advisers are continuing to devise and operate ever more contrived avoidance schemes. One such example of which Inland Revenue has learnt involves payment of a bonus to an employee in the form of dividends on shares in a specially constructed company. This avoids tax at 40% and employer and employee NICs.

The Inland Revenue will be challenging such arrangements in the courts where it is appropriate to do so. We cannot however await the outcome in the courts before taking action. We intend that from today both tax and NICs legislation should achieve our objective of subjecting the rewards of employment to the proper amount of tax and NICs, however the rewards are delivered. Taxpayers who contribute their fair share have a right to expect that others will also do so. We also want to make it plain that to the extent that legislation may still not achieve our objective in the face of continuing avoidance, we will ensure it does.

To that end we will be including legislation in FB 05, effective from today, to close down the avoidance schemes we know about. A technical note explaining what we intend to do in FB 05 will be published today. We will also ensure that NICs is charged on these schemes with effect from today.

However, experience has taught us that we are not always able to anticipate the ingenuity and inventiveness of the avoidance industry. Nor should we have to. Our objective is clear and the time has come to close this activity down permanently.

I am therefore giving notice of our intention to deal with any arrangements that emerge in future designed to frustrate our intention that employers and employees should pay the proper amount of tax and NICs on the rewards of employment. Where we become aware of arrangements which attempt to frustrate this intention we will introduce legislation to close them down, where necessary from today.

This action will not affect employers and employees who organise their affairs in a straightforward and ordinary way - the vast majority. In particular, genuine employee share schemes and share option plans will not be affected. We continue to believe these make an important contribution to the Government's productivity agenda.