

# Tax Representation



## **TAXREP 41/07**

### **Finance Bill 2007: Evidence to the House of Lords Economic Affairs Sub Committee**

*Written evidence submitted on 10 May 2007 by the ICAEW Tax Faculty to the House of Lords Economic Affairs Sub-Committee taking evidence on the effect of certain aspects of the Finance Bill 2007*

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## INTRODUCTION

1 In advance of an oral hearing on 14th May 2007, the ICAEW Tax Faculty submitted written evidence to the House of Lords Economic Affairs Sub Committee conducting an inquiry into various aspects of the Finance Bill 2007. The Sub Committee requested written evidence in respect of the following three topics:

- Business tax reform package in the context of simplification; and
- Managed service companies; and
- Review of powers, deterrents and safeguards.

## WHO WE ARE

2 The Institute of Chartered Accountants (ICAEW) is the largest accountancy body in Europe, with more than 128,000 members. The Tax Faculty is the focus for tax within the ICAEW. It is responsible for technical tax submissions 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.

## DETAILED COMMENTS ON THE FINANCE BILL 2007

### Business tax reform package in the context of simplification

3 The business tax reform package consists of three main changes, namely:

- changes to the corporation tax rates;
- changes to the capital allowances rules; and
- changes to the rules for R & D tax credits.

4 The reforms are designed (as per Budget Note BN02) to achieve three main objectives, namely enhancing the international competitiveness of the UK, encouraging growth through investment and innovation and ensuring fairness. Simplification was not mentioned as one of the objectives of the reforms, although simplification was mentioned in relation to the reforms of the capital allowances rules.

5 In terms of simplification, the package of reforms look unlikely to reduce the overall burdens placed on businesses, particularly in the short-term, for the following reasons:

- the reduction of the headline rate will not take effect until 1 April 2008;
- the current rates of corporation tax have been retained for oil extraction activities;

- the small companies rate of corporation tax is being increased in 1% increments for three years, starting on 1 April 2007, necessitating changes to calculations in each year; and
- the proposed abolition of industrial buildings allowances (IBAs) and agricultural buildings allowances (ABAs) should in theory simplify the current complex system of capital allowances. However, this is counterbalanced by other changes:
  - there is a lengthy transitional period as these allowances will not be phased out completely until after 2010-11;
  - a number of fundamental changes have been made to the long-established rules for plant and machinery, in particular the change to the rate of writing down allowances for plant and machinery, the change in the rate for expenditure on long-life assets and proposed new rules for integral fixtures; and
  - consultation is about to start on a proposed new annual investment allowance of £50,000 on plant and machinery.

6 Current tax policy appears to be aimed broadly at aligning the tax treatment of transactions with the commercial accounting treatment. We agree with that approach. The changes to the rules to plant and machinery were justified as aligning allowances with the economic rate of depreciation at 20 per cent. However, in respect of IBAs and ABAs, the proposals will have the opposite effect, and tax allowances and depreciation are likely to diverge.

7 We have not seen a regulatory impact assessment in relation to these measures but believe that they will have significant financial implications for businesses in the relevant sectors in terms of their investment decisions.

8 We welcome the measures to improve the attractiveness of the R & D tax credits regime, particularly in relation to SMEs. However, some recent ICAEW research appears to suggest that the scheme is not as effective as it could be in encouraging companies to invest in R & D. We suspect that part of the reasons for this is the complexity of the rules and the inherent uncertainty at the time the claim is made that the investment will qualify for R & D tax credits relief. In order to improve certainty and thus encourage take-up, we think that there is a need to develop a pre-approval process.

### **Managed service companies (clause 25 and Schedule 3)**

9 We support the underlying principle of the legislation in relation to Managed Service Companies. However, we remain concerned that some of the detailed definitions need to be more closely targeted, in particular the definition of 'accountancy services'. The provisions will introduce further complexity into what is already a very complex area of tax, with the result that overall compliance costs for businesses will increase.

10 Looking at the wider picture, we remain concerned that the MSC provisions are just the latest example (the changes to the small companies rate of corporation tax and the IR 35 rules from 2000 are others) of 'sticking plaster' legislation that may be

papering over obvious cracks but does little to address the underlying structural difficulties in the UK tax system that give rise to the problem.

11 The major structural difficulty is the taxation of small businesses and, in particular, the difference between the tax (and NIC) treatment of employment vs self employment and incorporated vs unincorporated business structures. Many of these structural differences have existed for a long time, in particular the differences between income received by way of dividends rather than remuneration. However, changes to the tax systems in recent years have tended to widen the differences in treatment, resulting in considerable complexity in the tax system but which have also expanded the opportunities for tax planning.

12 One result is that many formerly unincorporated businesses now operate through a corporate structure, potentially lowering the tax and NIC charges. Changes taken in this Budget, in particular the increase in the small companies rate of corporation tax, will go some way to addressing these issues but the structural problems remain. We understand the continued concern of the Government (see paragraph 5.114 of the Budget Red Book) about 'tax-motivated' incorporation but such comments merely increase uncertainty for business. There is a need to re-energise the small business review and seek more long-term solutions to the on-going issues that arise due to the differing tax treatment of business income and entities.

### **Review of powers, deterrents and safeguards**

13 Generally we are concerned that some of these proposals will add further burdens on taxpayers.

#### *Criminal investigations (clauses 81 to 86)*

14 In relation to criminal investigations, we question whether HMRC ought to have criminal investigation powers as we think that serious organised tax crime ought to be dealt with by the Serious Organised Crime Office. It is vital that HMRC make clear publicly the circumstances in which the powers of arrest will be used. In its response to the January 2007 consultation document, HMRC said that it is developing guidance and that "this will be published as soon as possible and before any changes come into force". We attach great importance to this statement. In particular we think it important for HMRC to reassure people that it will always use the least intrusive of the powers that it has that is consistent with obtaining its objective. For example, we believe that HMRC ought to give a public assurance that they will not seek to obtain documents under a search warrant when they could obtain the document by applying for an order for delivery under section 20BA, TMA 1970.

#### *Mandatory filing of electronic returns (clause 92)*

15 Clause 92 makes further provision for the mandatory filing of tax returns by extending the existing provision in section 135 FA 2002 to include all taxes and duties for which HMRC are responsible. In other words the power to specify mandatory electronic filing of returns is extended to VAT and Duties formerly handled by HM Customs & Excise. Clause 93 extends a similar power for mandatory electronic payment from large employers to cover all taxes under the care of HMRC.

16 At this juncture we remain opposed to the principle of compulsion, and think that such an approach undermines the encouragement of e-business generally. We support measures to encourage electronic filing and payment, but our support is based on the belief that electronic business should in the long run be more efficient

for taxpayers and thus result in lower costs and improve productivity rather than because it is more convenient for HMRC. Business has moved to electronic solutions for reasons of reduced costs and greater flexibility, not because they were told to on pain of financial penalties.

- 17 We believe HMRC should concentrate on improving its electronic services, because our experience is that HMRC's electronic systems are still not sufficiently robust for taxpayers to use them with complete confidence. It is ironic that the Finance Bill contains further measures for compulsory electronic filing, but taxpayers still cannot contact HMRC using email, the de facto industry standard for business to business communication. Improved electronic services and the ability to email HMRC would be positive developments that will encourage take-up of electronic services.
- 18 In relation to business, according to the regulatory impact assessment published at the time of the Budget, HMRC estimates that up to 250,000 businesses will be required to obtain access to the internet. With an internet subscription costing about £10 per month, or £120 per year, the total costs to business if they had to go electronic under these provisions would be around £30m. In reality, many businesses are moving over to electronic solutions and using email and internet access, but the key point is that they are making the move for business reasons, not because they are being forced to use electronic services.
- 19 More generally, we remain concerned that certain groups of taxpayers, particularly the elderly and those who have no IT literacy, are unlikely to be able to file electronically, and we think it is unrealistic to expect them to, for example, queue up in a library to submit a tax return electronically.
- Penalties for Errors, (Clause 96/ Schedule 24)*
- 20 This clause introduces a new regime for charging penalties for incorrect tax returns and is a product of the ongoing HMRC Review of Powers. It will apply to returns for income tax, CGT, corporation tax, PAYE and CIS deductions, NICs and VAT, though it is expected that in future the model will be extended to other parts of the tax and tax credits system. Penalties for other aspects of tax administration, eg late filing, are the subject of separate reviews. Taxpayer behaviour is the key to the new penalty regime, and the way in which behaviour is understood and categorised by both HMRC and taxpayers will be crucial to the effective operation of the system, particularly with regard to the important principle that innocent error should not be penalised. However, we are concerned that detailed rules will be in HMRC published guidance and not in law, and will not therefore be subject to Parliamentary oversight.
- 21 The penalty percentages are higher than those which are charged in many cases under the current system, which allows mitigation at HMRC discretion. We see the merit in charging severe penalties for the most serious types of default but we are concerned that those at the less serious end of the behaviour spectrum will be more heavily penalised than at present, which may discourage voluntary compliance.
- 22 In relation to the drafting, we are concerned at the use of the phrase 'HMRC think'. The Explanatory Notes to the Schedule suggest this is little more than the use of modern language, but we disagree. 'HMRC think' does not suggest that HMRC are using their best judgement or taking a reasonable approach. We believe the use of this word is not helpful and will merely lead to confusion and court cases to determine its true meaning. It should instead be replaced where it occurs with a construction such as 'HMRC is satisfied' or 'HMRC reasonably believes'.

The Tax Faculty of the Institute of Chartered Accountants in England and Wales

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FJH  
17 May 2007