THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Faculty of Taxation

TAXREP 14/03

FINANCE BILL OF SPRING 2003

Memorandum submitted in May 2003 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the Chancellor of the Exchequer

CONTENTS

FINANCE BILL OF SPRING 2003

WHO WE ARE

1 The Tax Faculty is the focus within the Institute of Chartered Accountants in England and Wales for those Chartered Accountants working in the area of tax. It is a centre of excellence and the authoritative voice for the 123,000 members of the Institute on taxation matters. The Tax Faculty makes representations to Government and other authorities, and public pronouncements on major tax issues. Chartered Accountants are advisers to all of the top 100 FTSE companies and our members include those in tax practices and in businesses ranging from the largest to the smallest concerns.

KEY POINT SUMMARY

2 This memorandum contains points of general relevance to the 2003 Finance Bill together with specific comments on individual clauses.

3 Whilst all of the points we have made need to be addressed, we have highlighted our key points in this initial summary. In each case we have included a cross reference to our more detailed comments later in this memorandum.

Length and complexity

4 We are concerned with the length and complexity of this Finance Bill. Many of the clauses were not made available for earlier consultation and many are poorly drafted (paragraphs 9 to 13 below).

Poorly targeted: VAT evasion

5 Some of the VAT provisions (clauses 17 and 18) aimed at tackling fraudulent practices are so widely drafted that they can catch entirely innocent transactions (see paragraphs 14 and 29 to 37 below).

Stamp Duty Land Tax

6 This new tax (clause 42 et seq. and Schedules 3 to 19) takes up 134 pages of the Bill and includes much new material not published previously. The provisions are tortuously drafted and include new Revenue raising provisions that go beyond the stated objectives of modernisation i.e. fairness and e-business (paragraphs 15 to 20 and 61 to 81 below).

Conflict with EC law

7 The UK Government appears to be adopting a ‘pick and mix’ approach to EC law, by legislating to implement some and ignoring other decisions of the European Court of Justice. The approach being adopted appears highly vulnerable to further challenges at the ECJ and provides no certainty to taxpayers (paragraphs 21 to 23 below).

Conflict with Human Rights Act 1998

8 In our view the Bill contains various clauses that are likely to contravene the European Convention on Human Rights (see for example paragraph X below and clauses 17 and 18 referred to above). This is becoming such a serious issue that we think the time has come for the Government to go beyond the declaration required at the front of Bills and provide a separate ‘Human Rights Impact Assessment’ for each Finance Bill clause (paragraphs 24 and 25 below).

GENERAL COMMENTS

Length and complexity

9 At 447 pages, this is we understand the fourth longest Finance Bill on record by number of pages. However this Bill creates a new record: no Finance Bill in history has ever had 43 Schedules. Many of these provisions were not made available for earlier consultation: see for example the 72 pages rewriting the rules for unapproved employee share schemes. Many of the provisions are poorly drafted, and many involve a degree of complexity which is disproportionate to the objective which they are seeking to achieve: the unapproved employee share scheme rules are a case in point.

10 Whilst we appreciate the Government's desire to modernise many areas of the tax legislation, it is important that users of the legislation, both within the tax authorities and taxpayers and their advisers, are able to understand the new legislation. If there is such a volume of new legislation that advisers cannot be confident that they understand its intricacies, this creates uncertainty. Uncertainty is a very significant deterrent to undertaking commercial transactions.

11 We are also concerned about the extensive redrafting of rules only recently included in the new Income Tax (Employment and Pensions) Act 2003. We must question very seriously committing time and resources to this project if all that happens is that, within a few weeks of the legislation being enacted, the Government makes wholesale amendments to it with no consultation and using a drafting style which does not come close to the clarity of the original Rewrite material.

12 The position is not helped by the fact that the new rules refer to the amendments required to the new Act whereas almost everyone except for the draftsman will know the old legislation. We appreciate however that the draftsman had little choice and that the provisions have been replaced wholesale rather than piecemeal.

13 Many of the provisions are tortuously drafted in the 'old style', so that it is difficult to understand what the provision is designed to achieve. For example the deferred consideration provisions set out in clause 161 contain immensely complicated provisions drafted in the old legislative style. As and when that part of the legislation gets drafted in Tax Law Rewrite style the whole thing will have to be rewritten. This does not appear to be an effective use of Parliamentary Draftsmen's time.

Poorly targeted: VAT evasion

14 We understand the Government's concern with 'carousel' schemes and support any workable proposals to reduce such evasion. However, the proposed legislation (see clauses 17 and 18) to counter such evasion is too widely targeted. The proposals appear designed to catch the innocent rather than punish the guilty and appear vulnerable to challenge.

Stamp duty land tax

15 We are disappointed that the legislation is being introduced in its current state. We believe that a major new tax such as this ought to be introduced only after extensive consultation to ensure that all potential practical problems are identified and that comprehensive rules can be introduced to deal with them. The introduction of SDLT can be contrasted, for example, with last year's new system for taxing gains and losses from intellectual property. That was introduced only after extensive consultation

spread over three years, resulting in a tax that had the general acceptance of those who have to cope with it.

16 Consultation on SDLT in contrast was desultory. The Revenue set up a number of consultative groups, the membership of which appears to have been by invitation. This is the first major tax that we can recollect where the ICAEW was not invited to participate in the preliminary discussions. When we realised that we had been excluded we asked to be added to the consultees and were told to wait for the public consultation. We understand from others that the work of the consultative group was prematurely terminated last December and future planned meetings cancelled.

17 The draft legislation differs significantly from that published at the end of November 2002. The Revenue chose not to publish either the results of that consultation or the reasons for the changes. The Finance Bill clauses do not cover some major areas on which the government says that it is still consulting. These include sub-sale relief, transfers of land into partnerships and complex commercial transactions. We cannot see any compelling reason to stick to the 1 December 2003 target date for introduction of the tax. It would be far better to delay implementation for a year to give time for the major outstanding issues to be discussed thoroughly and for Parliament to legislate next year in relation to those areas.

18 We are concerned about the number of stamp duty land tax provisions which the Treasury are empowered to alter by statutory instrument. Not only does clause 109 seem to give the Treasury an overriding power to recast the entire legislation, but many of the other provisions give the Treasury specific power to amend them. We think this is wrong in principle.

19 We think that the name Stamp Duty Land Tax is cumbersome. The tax is not a stamp duty; it is a tax on transactions. The November 2002 consultation paper used the name Land Transaction Tax. That is an easier expression to use and more readily identifies the purpose of the tax. We are under the impression that EC law does not permit the introduction of taxes on transactions other than VAT. We would welcome clarification of the European vires for SDLT.

20 The proposed charge on leases has attracted a great deal of criticism from within the property industry as it is likely to increase significantly the tax burden on leases. We think it disappointing that this was not explained in either the Budget or the accompanying press releases. Tax increases ought to be imposed openly.

Conflict with EC law

21 We should be grateful for clarification as to the Government's statement (in PN6) that 'The Government is determined to protect the corporation tax system against legal challenges under European law, where these challenges have the potential to undermine international agreements.'. We and various other professional bodies have in the past submitted papers on the areas where we felt that the UK rules were vulnerable to challenge under the EC treaty. However, the Government has consistently failed to take pre-emptive action, with the result that taxpayers have resorted to litigation. We appreciate that the issues are complicated and that there is a danger that the rules might be changed to the detriment of UK to UK transactions, but we urge the Government to take positive steps to ensure that UK tax law is not vulnerable to challenges in the ECJ.

22 In particular, we do not think that the approach adopted by the UK in clause 22 concerning VAT input tax recovery is the right way to address possible conflicts with

EC law. The approach adopted, namely to legislate against an input tax recovery method agreed by the ECJ, appears suspect and vulnerable to challenge.

23 We would welcome the early opportunity to meet with you to discuss the problem areas and possible solutions.

Conflict with Human Rights Act 1998

24 In our view the Bill contains various clauses that are likely to contravene the European Convention on Human Rights and the Human Rights Act 1998.

25 With the increasing emphasis on draconian provisions to combat evasion (see for example the comments made above concerning clauses 17 and 18 in relation to VAT frauds and also clause 29 on penalties in relation to taxes and duties on importation and exportation), the impact of Human Rights on UK tax law is becoming of critical importance. The time has come for the Government to go beyond the declaration required at the front of Acts of Parliament that they comply with the Human Rights Convention. Each Bill should provide a separate 'Human Rights Impact Assessment' of each provision, containing detailed analysis as to the impact on Human Rights.

Use of regulations

26 As stated in previous years, far too many substantive tax provisions are being enacted by way of Treasury Regulations. As we have stated many times in the past, we believe that substantive legislation ought to be contained in Acts of Parliament which are subject to more detailed Parliamentary scrutiny than secondary legislation.

27 We accept that the use of Regulations is sensible to deal with administrative rules where the criteria are laid out in primary legislation, and possibly fairly esoteric specialist areas which are likely to affect a comparatively small number of taxpayers. However, we feel that, in general, recourse to statutory instruments ought to be discouraged. As already noted above, we think it is wrong in principle for Regulations to be enacted which allow, for example, the Treasury to vary the scope of transactions subject to tax (see clause 109 of the stamp duty land tax provisions).

Regulatory impact assessments

28 We are disappointed with the Revenue's reluctance to prepare detailed Regulatory Impact Assessments. We believe that Regulatory Impact Assessments have a vital role in analysing the costs and benefits of a particular course of action. We believe that there are a number of provisions, for example the new rules on foster carers, where the costs of complying with the rules are out of line with the expected results. Regulatory impact assessments also need to ensure that they cover all facets of any policy change.

Abbreviations

The following abbreviations apply:

CAA 2001	Capital Allowances Act 2001
EC	European Community
ECJ	European Court of Justice
EU	European Union
FA	Finance Act
ICTA 1988	Income and Corporation Taxes Act 1988
ITEPA 2003	Income Tax (Earnings and Pensions) Act 2003
PACE	Police and Criminal Evidence Act 1984

TCGA 1992	Taxation of Chargeable Gains Act 1992
VATA 1994	Value Added Tax Act 1994

PART 2

VALUE ADDED TAX

VAT anti-fraud measures – general comments on clauses 17 & 18

29 There is no doubt that there are significant revenue losses from missing trader and carousel fraud and that these systematic attacks on the VAT system continue. Customs have estimated that carousel fraud cost the UK between £1.7 and £2.75bn in 2001-02. These frauds exploit an inherent weakness, namely the 'VAT-free' movement of goods between Member States that has existed in the EC VAT system since 1993, and of which all Member States have been fully aware.

30 We do not condone fraud in any circumstances, and we would normally wholeheartedly support any action designed to combat or eradicate it. There is some good sense and sound administration in the purpose lying behind clauses 17 and 18 of the Finance Bill, but they should be limited to attacking situations where it can be shown that a business is itself fraudulent or knows that another business is acting fraudulently. Even then, we would question whether the additional powers are necessary, since section 72, VATA 1994 already contains extensive provisions on the fraudulent evasion of VAT, into which category all of these frauds would fall.

31 However, we do not support clauses 17 and 18 of the Finance Bill as currently drafted since the proposals:

- apply equally to the innocent as well as the guilty;
- contain wholly inadequate safeguards;
- appear to require businesses to police the entire supply chain;
- will in practice require some legitimate businesses to cease trading;
- require Customs to breach taxpayer confidentiality in respect of other businesses if the appeal rights of the taxpayer are to be respected;
- can be expected to reduce the very co-operation from businesses that Customs most requires to combat this type of fraud; and
- in the case of clause 18, do not even require there to be a fraud.

32 It is not sufficient to say that Customs only intend to invoke these clauses in limited circumstances. The legislation should be properly targeted and not drafted so widely that it applies to innocent taxpayers. It is not acceptable for a wide class of taxpayers to be taxed under the law, only to be untaxed by internal safeguards within Customs which have no legal effect. Limited experience of similar, but more restricted, laws in other countries indicates that tax administrations tend to pursue the legitimate businesses in the supply chain, since these are the ones who remain after the fraud has taken place.

33

33 We have twice before expressed our most serious concerns about draft VAT legislation. The first was with the penalty provisions enacted in 1985, which we considered too draconian and inflexible, with excessively heavy penalties for innocent errors. The

second concerned the introduction of the three year capping provisions in 1996, which we considered were not only grossly unfair to business, but broke EC Law. In both cases we were assured that our concerns were both unnecessary and unfounded. In both cases we were subsequently proved correct.

34 If the clauses are enacted in their present form, we believe that they will inevitably lead to litigation as innocent businesses seek to defend themselves from meeting the VAT liability of a fraudulent third party. Such litigation is likely to proceed to both the ECJ and the European Court of Human Rights. Customs could also be liable to pay damages to businesses which their actions cause to suffer financially. It will be several years before the position is finally determined, and in the meantime the clauses may well become unworkable with many pending appeals. During this period of uncertainty the frauds will no doubt continue.

35 We consider that the correct approach is to target those people who are committing the frauds, and to encourage honest businesses to report any suspicions in confidence to Customs at an early stage. In our view this is more likely to be successful than seeking to hold any business in the supply chain liable, irrespective of whether they knew that any fraud had taken place.

36 Consideration could be given to introducing provisions similar to those in the 'gold scheme' in the 1980s, where the business customer was required to pay the VAT directly to Customs.

37 If either of the above approaches is not accepted, then at the very least clauses 17 and 18 should be amended to ensure that no business can be penalised unless it can be shown that it was aware of the fraudulent activity in question. Clause 18 should be amended to make it clear that it only applies in cases of fraud.

Clause 17 – Requirement of evidence or security

38 The current law allows Customs, where they 'think it necessary for the protection of the revenue', to require a business to provide security (normally a bank guarantee) in order to be entitled to deduct input VAT or receive a VAT repayment. The security required is linked to the perceived risk posed by that business. We see this as a sensible and proportionate provision.

39 However, clause 17, amending the current law, is very different. Under this clause, Customs will be able to require any business to provide a guarantee in respect of the risk posed by another business in the chain of supply. There is no need for the businesses to have the same owners, or to be connected or linked in any way - all that is required is that they have supplied the same goods or services at some stage in the chain. Thus, as we read the draft legislation, in a chain of supply A-B-C-D-E, A could be required to provide security for the perceived risk posed by any or all of B, C, D or E, and so on. It is possible to read new sub-paragraph (2)(b) of paragraph 4 of Schedule 11, VATA as restricting the requirement to the direct links (so that C could only be required to provide security in respect of B or D), but this is far from clear.

40 Either way, we find this clause unacceptable. It raises major questions in terms of:

- taxpayer confidentiality;
- practicality;
- proportionality in both UK and EC Law, and

- Human Rights law.

41 Our detailed concerns with this provision are set out below:

i) We find it unacceptable in principle that one business can be held liable for the actions of another, unless it can be proved that they are acting in collusion.

ii) The clause appears to apply whether or not the business required to provide the security was even aware of the existence of the other, potentially fraudulent, business.

iii) The provision is likely to bear down hardest on smaller businesses, who in many cases will be unable to provide a security from their own resources. They will instead need to provide it by means of a bank guarantee, which a bank is likely to regard as part of the credit facility available to that business.

iv) A business which is unable to provide a guarantee is in practice likely to have to cease trading. It is not acceptable that Customs are granted wide powers to, in effect, close down a business as a result of the actions of an unconnected business. Any use of this power by Customs needs to be very carefully controlled and there must be appropriate safeguards.

v) The amount of the security that can be required is not linked to any VAT liability of the business required to provide it, and more than one business could be required to provide security in respect of the same exposure. If, in the example above, Customs were concerned that C might default owing £100,000, then clause 17 would allow them to require A, B, D, and E **each** to provide security for that £100,000. The Explanatory Notes to Clause 17 state 'the amount required to be deposited will be proportionate to the total tax at risk in the supply chain', but it is unclear whether this would be applied to each business, or to all the businesses in aggregate.

vi) Customs' Budget Notice CE 14 states that businesses will always be warned in advance that they will be required to provide security for a third party, but there is no reference to this in the clause. If a business receives such a warning in respect of a direct customer or supplier (eg C in respect of B or D), then it may wish to cease dealing with the other business. But there could well be civil law problems if it has signed long-term contracts. But if the warning is in respect of an indirect customer or supplier (eg C in respect of A or E), we find it difficult to see what the business can be expected to do. We are also concerned that if Customs warn third parties not to trade with a specific business, they could be sued for defamation or damages if they could not substantiate the allegations made.

vii) The appeals process is highly unsatisfactory. Clause 17(7), introducing the new section 84(4E) into the VATA 1994, has the effect that a business will lose the appeal if Customs can satisfy the tribunal there has been evasion or attempted evasion of VAT (new section 84(4E)(a)), or that, without the security requirement, it is likely that there will be evasion (new section 84(4E)(b)). With new section 84(4E)(a), there is no requirement for Customs to show that the business appealing was itself in any way involved with the evasion or attempted evasion, or even had any knowledge or suspicion of it. With new section 84(4E)(b), there must presumably be some link.

viii) Any business appealing to the tribunal against a requirement to provide security for a third party is likely to have considerable difficulty in obtaining the necessary facts. Customs may refuse to provide these on the grounds that it would breach taxpayer confidentiality, as they relate to another business. Even if the appellant were told the name and address of that other business, he would have no right to obtain information from them. The appellant would then be unable to challenge Customs view that there had been evasion somewhere in the supply chain, as they would have no knowledge. Similarly, an appellant cannot require Customs to inform him whether other businesses in the chain have been required to provide security, and, if so, for how much.

42 In the light of these concerns, we request that this clause is withdrawn.

Clause 18 - Joint and several liability for unpaid VAT of another trader

43 This clause concerns the supply of telephones, telecoms equipment, computers and software, including in both cases accessories and parts.

44 Where a business purchases such goods and, at the time of the purchase, knows or has reasonable grounds to suspect that some or all of the VAT payable by another business in the supply chain (whether before or after him) will not be paid, then that business can be held liable for the VAT of the non-paying third party. If this were the whole effect of the clause, and it were restricted to cases of fraud, then it would be welcomed. But this clause goes much further.

45 Our detailed concerns with this clause are set out below.

i) As we have said, the clause is not restricted to cases of fraud, but, as drafted, would apply also to bad debts. If we take again an A-B-C-D-E supply chain example, it could apply if C suspects that his supplier B has financial difficulties (for example because B asks for immediate payment when this has not been done previously). C could similarly be held liable if D has not paid C for all previous supplies and C imposed the same requirement. The clause would even bite if it could be shown that C knew generally from the trade that E had financial difficulties, whether or not C knew that D would sell the goods to E.

ii) A business is deemed to have reasonable grounds for suspicion if the price it pays was less than the lowest open market price, although this can be rebutted if the business can show the price was unconnected with the failure of the third party to pay the VAT. A supplier who was in financial difficulties might wish to sell goods cheaply in return for prompt payment. By going through with the purchase, the purchaser, having paid the VAT to the supplier, would also in effect be guaranteeing to make a second payment of that same VAT directly to Customs should the supplier default.

iii) There is a second presumption that a business is deemed to have reasonable grounds for suspicion if the price it pays was less than the price paid on any earlier supply in the chain. Once again this can be rebutted if the business can show the price was unconnected with the failure of the third party to pay the VAT. It is not necessary for the business to be aware of any earlier price paid for the clause to apply. In practice it is difficult to see how a business is able to establish what prices have been paid on earlier transactions involving the same goods - these are normally commercially confidential. E would need to establish at what price not only D, but also A, B and C (of all of whom E may be unaware) had bought/sold the goods. With no power to require D to provide the information on D’s purchases, much less to identify C and so on, the clause places requirements on E that he cannot possibly satisfy.

iv) There is no definition of parts or accessories, and we are unclear as to how far back in the production process this could go. Taken to an extreme, the clause could affect the supplier of screws used in the manufacture of the equipment.

v) There are a number of practical questions when a business is formally held liable for the debts of a third party that also cause concern:

- Will the business be given details of the total amount of the default and which other businesses in the supply chain are also being held liable, and if so, for how much in each case?

- How will Customs decide which businesses in the supply chain should be held liable? For example, if E defaults owing £100,000, and A, B, C, and D meet the conditions, will they each be held liable for £100,000, or for £25,000, or for some other amount?

- If for £100,000 each, then what will happen if A pays £50,000? Will the liability of B, C and D be reduced accordingly?

- If for £25,000 each and A defaults, will the liability of B, C and D be increased pro rata?

46 There are many other questions illustrating the practical difficulties that will arise. But these illustrate that any business held liable will find it difficult to defend itself on appeal if it does not have full information on the case. Since Customs may refuse (indeed they may be bound to do so) to provide that information on the grounds of taxpayer confidentiality, it is difficult to see how a business can properly defend itself, which raises serious issues in both EC and Human Rights law.

Clause 19 and Schedule 1 – Face value vouchers

47 We believe that the proposed treatment of face-value vouchers in new Schedule 10A, VATA 1994 is not appropriate. This is because it fails to recognise the true nature of such vouchers as a means of payment for goods or services which is VAT-exempt. The proposals are also likely to impose an unfair liability by requiring the issuer of such vouchers to bear any tax not accounted for by some other person supplying goods or services paid for by their use. This could well be outside the issuer's control, and may be an infringement of human rights.

48 The proposals are likely also to result in more tax being collected than is properly due. In many cases where vouchers are used to obtain goods or services chargeable at the zero or lower rate of VAT the proposals will result in tax being due at the standard rate on vouchers supplied through intermediaries. This would appear to breach the fundamental principle of VAT that the tax collected in relation to a particular supply of goods or services should be proportionate to the value of that supply.

Clause 21 - Business Gifts

49 We welcome the intention to simplify these rules. However, by introducing any period of one year in which a succession of business gifts can be aggregated means that businesses will have to keep rolling 12-month records, thus reducing much of the effect of the simplification. We would suggest that either businesses be permitted to choose a

12-month period, or that one should be determined by law - for example the VAT year, the accounting year, or to 31 December. That would provide greater simplification.

Clause 22 – Non-business use of business property

50 It is the intention of this provision to prevent full input tax deduction on the purchase of land, buildings and civil engineering works where there is also an element of private use. It seeks to do this by ceasing to treat the subsequent private use as a supply of services for consideration.

51 This clause appears to be seeking to disapply the ruling of the ECJ. In the case *of Lennartz v Finanzamt Munchen III* (Case C-97/90), the ECJ ruled that "A taxable person who uses goods for the purposes of an economic activity has the right on the acquisition of those goods to deduct input tax in accordance with the rules laid down in Article 17 of the Sixth Directive, however small the proportion of business use". The Court further stated that "A rule or administrative practice imposing a general restriction on the right of deduction in cases where there is limited, but none the less genuine, business use constitutes a derogation from Article 17 of the directive and is valid only if the requirements of Article 27(1) or Article 27(5) of the directive are met."

52 This clause therefore appears contrary to EC law. In our view, the intention of this provision, namely the denial of initial input tax recovery, can only be achieved if a derogation under Article 27(1) is sought and granted. Until such time, this clause may result in further litigation, creating uncertainty and costs for both taxpayers and Customs, with the end result likely to be that this clause is held to be illegal. Unless and until a derogation has been obtained, this clause should be removed from the Finance Bill.

PART 3

TAXES AND DUTIES ON IMPORTATION AND EXPORTATION: PENALTIES

Preliminary

Clause 24 – Introductory

53 This part deals with the introduction of civil penalties for less serious offences connected with the import or export of goods to or from the UK. We are well aware of the problems being faced by Customs and Excise in relation to the management and control of certain movements of goods and understand the logic behind the introduction of these provisions as set down in BN 01/03.

54 We are, however, concerned by the way these clauses have been drafted and whether the proposals meet the requirements of Human Rights legislation.

The penalties

Clause 25 – Penalty for evasion

55 This penalty is at a criminal level and therefore any person falling foul of it will be entitled to PACE treatment in its application. We are concerned that the absence of due process will give rise to numerous appeals which will result in the setting aside of the penalty and, therefore reduce the efficacy of the clause. We believe that the clause should be redrafted to include adequate safeguards for taxpayers.

Clause 26 – Penalty for contravention of relevant rule

56 The maximum penalty for contravention is £2,500, but it is not clear if this is an absolute penalty for a given series of breaches or whether it is the maximum that can apply to each. Thus, if there are 20 invoices covering the import of a consignment of the same goods all destined for different customers, and there was a common breach would the fine be £2,500 or £50,000. If the maximum fine was limited to £2,500 this would not be at a criminal level but, on the other hand, if the fine is £50,000 then any procedures for enforcement would have to follow PACE.

Reduction in amount of penalty

Clause 29 – Reduction of penalty under section 25 or 26

57 We recognise that this clause is intended to replicate section 70(4), VATA 1994 in respect of clauses 25 and 26. We have a serious concern, however, that where penalties are considered to be of a criminal level, clause 29 (3)(c) seeks to deny taxpayers a defence that goes to the heart of the motive test. A penalty under Clause 26 is relievable on the grounds that the taxpayer had a reasonable excuse. But if the taxpayer is precluded from arguing that they acted in good faith then this effectively sabotages any possible argument the taxpayer might have that they had a reasonable excuse.. The denial of this defence, moreover, allows for a challenge on the grounds of infringement of Human Rights legislation and therefore weakens the efficacy of the clause. This comment would apply equally to the existing section 70 provisions where they are applicable to penalties of a criminal level.

Evidence

Clause 38 – Admissibility of certain statements and documents

58 Our comments in relation to Clauses 38, 98 and 203 are all related to the difference in treatment accorded to direct and indirect taxes and the existence of the hitherto clear Hansard procedure for direct tax which precluded criminal prosecution where a successful negotiation of civil penalty and full disclosure has been made.

59 We believe the reservation of the right to use information obtained in the process of a successfully negotiated civil settlement without adequate safeguards is contrary to the Human Rights Act 1998 and contravenes the Human Rights Convention. Information obtained as part of a settlement should be inadmissable and a taxpayer who has successfully agreed a settlement should be free from the fear of criminal prosecution unless he has broken the requirements of disclosure. Clause 203 has, we feel, removed the certainty given in the House last November in respect of Hansard. Clause 38 replicates the existing anomaly within section 60(4), VATA 1994 and clause 98 introduces it in the context of stamp duty land tax.

60 Lastly in this respect we have long sought to have a "joined up" approach whereby a disclosure for the purposes of one tax will be accepted as a disclosure for all taxes provided the taxpayer makes it clear at the time the disclosure is made. This would be an ideal opportunity to introduce this simple but significant improvement to the civil penalties regime.

PART 4

STAMP DUTY LAND TAX

Land transactions

Clause 44 – contract and conveyance

61 We believe that the use of such vague phrases as 'takes possession of … substantially the whole of the subject matter of the contract' and 'a substantial amount of the consideration is paid or provided' make for bad law. Clause 44 affects many more transactions than section 115, FA 2002, on which we assume it is based, yet is more widely drawn than that section. For example a person may be allowed into possession to fit out premises, but we can see no obvious reason why that should trigger the tax charge. Taxpayers need certainty. It should be unacceptable to introduce vague legislation leaving the Inland Revenue to define its scope by a Statement of Practice or such other guidance as they might from time to time give or withdraw.

Clause 45 – Contract and conveyance: effect of transfer of rights

62 We note that the Government now says that it will be consulting on a 'possible targeted replacement' for subsale relief, whereas the November consultation document indicated that further legislation for such relief 'is required'. We believe that such a relief is important to the smooth operation of the property market. We would mention that the explanatory note to this clause contains an error in the Background note; A and B are the wrong way round.

Chargeable interests, chargeable transactions and chargeable consideration

Clause 48 – Chargeable interests

63 We are concerned that the scope of a 'chargeable interest' is drawn so widely as to include, for example, an interest of a beneficiary in a trust whose assets include land, and it is then left to the Treasury by regulation to cut down the scope of the section to exclude those interests which are not intended to be caught. This creates a serious risk that some transactions may be taxable merely because the Treasury does not identify them as intended to be outside the scope of the tax.

Clause 49 & Schedule 3 – Chargeable transactions

Schedule 3, para 3

64 We think that consideration ought to be given to extending the relief on divorce to co-habitees who split up. The tax system seems increasingly to be moving towards looking on co-habitees as if they were a married couple.

Clause 50 and Schedule 4 – Chargeable consideration

Schedule 4, para 6

65 We are disappointed that no attempt has been made to define a partition or division. In the past these concepts have given rise to practical difficulties where joint interests in a number of parcels of land form part of a single transaction.

Clause 51 – Contingent, uncertain or unascertained consideration

66 As we said in our representations on the draft clauses, we deprecate the continuance of the contingency principle. We are particularly concerned at the need to estimate 'unascertainable' consideration on a 'reasonable' basis. If something cannot be ascertained we doubt that in most cases it can be estimated either. There is obviously immense scope for disagreement as to what estimate is 'reasonable' in such circumstances. We are unclear why the solution adopted in section 242, FA 1994 of using the market value of the land is no longer felt to be an appropriate measure.

Amount of tax chargeable

Clause 56 & Schedule 5 – Amount of tax chargeable: rent

67 The purpose of this provision is unclear. The Chancellor indicated in his budget that he would 'trigger this reform … only if, after consultation with the industry, there is no effective alternative for tackling avoidance'. This suggests that it is intended as an anti-avoidance provision. It appears to impose a tax charge substantially higher than under present legislation, which suggests the intention may equally be to raise revenue. Perhaps the likelihood that it may not be triggered explains why the effect of the proposed rules seems likely to be erratic. If the legislation is likely to be triggered it ought at least to include instructions for how calculations are to be rounded. It would also be sensible for the Revenue to publish a calculator on their website.

Reliefs

Clause 58 – Part-exchange of residential property

68 It is unclear why the relief for the part-exchange of a dwelling does not apply to a dwelling purchased for occupation by someone in job-related accommodation in the same way as the capital gains tax relief on which it appears to be based.

Clause 59 – Relocation relief

69 Subsection 1(a) is unduly restrictive. It ought also to apply where the dwelling was previously the employee's only or main residence and he was prevented from occupying it as a dwelling during the one year period because his employment was exercised elsewhere. For example suppose an employee living in Fulham is posted to Brussels and two years later he is relocated to Exeter. It is unclear why the relief should not apply to the purchase of his house in Fulham bearing in mind that it would have applied had he never been sent to Brussels.

Returns and other administrative matters

Clause 76 – Duty to deliver land transaction return

70 We are unclear why subsection 3(b) requires the return to be 'accompanied by' payment of the tax. Why cannot payment simply be made within the same time limit? A taxpayer may want an agent to file the return but to pay the tax himself, or he may wish to file the return manually and pay the tax electronically.

71 The clause envisages that tax will always be payable. This is not correct as in some cases a return has to be filed in order to claim a relief from tax. Accordingly we believe that words such as 'if any' ought to be inserted after 'tax' in subsection 3(a).

Clause 77 – Notifiable transactions

Subclause (3)

72 It can be difficult to know whether or not a transaction is exempt from charge under Schedule 3 as this is sometimes over-ridden by other provisions, such as clause 53. It is usual in the modern drafting style to list such exceptions in the main provision. It would be helpful if this could be done in Schedule 3.

Clause 78 and Schedule 10 – Returns, enquiries, assessments and related matters

Schedule 10, para 12

73 Whilst the 'pay now, check later' enquiry system may be sensible in relation to income tax, we think it a very cumbersome way to check one-off transactions. In particular if a non-UK resident purchaser resells the property within the nine-month period there must be a significant risk of non co-operation and non-enforceability of any additional tax found to be due. This risk does not exist under the current system where any necessary checks are made before the document is stamped.

Clause 79 and Schedule 11 – Registration of land transactions

Schedule 11, para 1(b)

74 As the date on which a self-certificate is produced to the Land Registry starts the enquiry window, there ought to be an obligation on the Registrar to record that date, perhaps by date-stamping the certificate or making an entry on the register.

Compliance

Clause 93 and Schedule 13 – Information powers

75 In paragraph 1(3) of Schedule 13, the "reasonable opportunity" to deliver the documents or provide the information should be specified as, say, not less than 30 days (see paragraph 3(2)). The same point arises in paragraph 6(3) in respect of requests from third parties.

Clause 95 – Offence of fraudulent evasion of tax

76 Our recollection is that when the offence of fraudulent evasion of income tax was introduced in section 144, FA 2000, assurances were given that this was a limited provision applying for income tax only and not to other taxes such as capital gains tax. Why is it now thought to be appropriate for SDLT?

Clause 96 – Penalty for assisting in preparation of incorrect return etc

77 This provision mirrors section 99, TMA 1970. As such it is not objectionable. However we feel it wrong that the same document should be capable of attracting

penalties under both provisions. This effectively doubles the statutory maximum penalty.

Clause 97 – Power to allow further time and reasonable excuse for failure

78 This largely mirrors section 118(2), TMA 1970. However section 118(2) allows the appeal Commissioners to extend the time limit if the Revenue do not do so. We feel that for consistency they should have a similar power under clause 97.

Clause 98 – Admissability of evidence not affected by offer of settlement etc

79 See our earlier comments above in respect of Clause 38.

Supplementary provisions

Clause 109 – General power to vary this Part by regulations

80 We are concerned at the very wide nature of this clause. It appears to give the Treasury power almost to scrap the entire tax and start again. We appreciate that because the tax is being introduced prematurely while consultation on major areas is still going on there needs to be a power to implement the result of such consultations. Nevertheless the breadth of the clause seems quite extraordinary.

Interpretation

Clause 117 – Meaning of major interest in land

81 We are disappointed that the expression 'major interest' has been used in the legislation with a completely different meaning to that for the same term in the VAT legislation. We would have hoped that 'joined-up government' would avoid the confusion caused by using the same expression to mean different things in two sets of legislation that are both likely to affect a single transaction.

PART 7

INCOME TAX, CORPORATION TAX AND CAPITAL GAINS TAX: GENERAL

Employment income and related matters

Clause 135 – Provision of services through intermediary

82 We question why it is now considered necessary to broaden the scope of the IR35 legislation to cover all payments for services. The effect is to bring payments in respect of non-business/domestic services within the scope of the IR35 rules.

83 The IR35 rules were originally written to exclude domestic staff. Treasury Notes to Clause 59 of Finance Bill 2000, which introduced the legislation, stated that 'services provided to individuals, such as a gardener who works for a house will not be affected.'. We believe that only a small number of nannies and domestic workers are employed by personal service companies. The costs of setting up such arrangements has precluded a large take-up. We would have expected to see a Regulatory Impact Assessment or similar evidence to show that there was a real risk of revenue being lost before this change was put forward. In the absence of such an assessment, we do not think that this clause is necessary.

84 As we stated in our Finance Bill representations last year, we can no longer discern the policy of the Government towards small businesses. On the one hand, the structure of the tax system seems increasingly to be encouraging such businesses to incorporate. On the other hand, where such businesses do incorporate, the Government seems to perceive incorporation as a form of tax avoidance. We would be grateful for a clear statement as to Government policy in respect of encouraging small businesses.

85 The Finance Bill will alter the income tax rules but the related NIC changes are to be laid by regulations at a later date, Unless the NIC and income tax changes take effect from the same date, it will be necessary to do two IR35 calculations for the year to 5 April 2004. This provision should apply from the same date that the corresponding NIC provisions are enacted.

Clause 136 – Exemption where homeworker's additional expenses met by employer

86 We welcome this initial step to give a statutory exemption from income tax for the reimbursement of additional household expenses which are incurred from homeworking. We believe nearly one million employees currently work from home. This is an important area for the modernisation of working practices in the UK and we would welcome clarification as to the Government's policy in respect of home working.

87 We are conscious that encouraging homeworking through the tax system will create further complexity. We would welcome a full consultation on how homeworking might be encouraged and the costs and benefits involved. The consultation will need to include consideration of the impact of Uniform Business Rates and the difficulties relating to travel expenses.

88 The clause provides for an exemption for 'reasonable expenses'. There is an announcement in Rev BN3 to the effect that claims for up to £2 per week will be

allowed without the need for supporting evidence. This is a sensible administrative relaxation but the amount is trivial. We propose that the amount be increased to £5 per week.

Clause 138 and Schedule 21 – Approved share schemes and plans

89 We welcome many of the simplification measures proposed in the Schedule, for example the move to allow plans to be altered without prior Revenue consent will help reduce administration.

90 We are, however, concerned with certain retrospective elements to the Schedule relating to the change to the PAYE and NIC treatment of options under Company Share Option Plans. A common situation would be where an employee exercises an option, thus making the employer responsible for withholding PAYE and NIC. If the employee has already been paid for the month, say, the employer will not have sufficient funds to pay the PAYE and NIC to the Revenue. Under the suggested clause employers may find that they have to pay the PAYE and NIC to the Revenue without having any method of recovery from the employees. The employer will also now have its own NIC liability on the exercise of the options.

Clause 139 and Schedule 22 – Employee securities and options

91 We welcome the repeal of the dependent subsidiary charge. We also welcome, up to a point, the acceptance that it is not right for the charges on conditional interests and on removal of restrictions to catch the whole of the post-acquisition appreciation in value which may occur up to the time of the triggering event.

92 That said, we must register a strong protest with this Clause and Schedule. Whilst we understand the Government's need to act to prevent avoidance, we are disappointed that the legislation on share-based remuneration, other than approved schemes, has been fundamentally redrafted with (as far as we are aware) no prior consultation or publicity.

93 We also protest about the great complexity of the new provisions. Schedule 22 takes up **72 pages** of the Bill. We are also disappointed that proposals are published making a substantial amendment to the newly rewritten Income Tax (Earnings and Pensions) Act 2003 only ten days after the latter act came into force. Whilst we understand the need to refer to the newly rewritten provisions in this Bill, this practice makes it almost impossible to follow without providing a cross reference to the previous provisions. The provisions appear to have expanded the scope of the original legislation but it is far from easy to identify where these changes have occurred.

94 It does not appear that these amendments were drafted by the Rewrite team, and we do not think that had that team been asked to draft these provisions, they would have done it this way. Many of the provisions appear incomprehensible, for example new section 428. We now appear to have a position which we had always feared, namely that after spending so much time and effort in rewriting the UK tax code, the rules become overlaid with poorly drafted and incomprehensible new legislation. This poor redrafting of a large section of newly rewritten provisions is disappointing. We are concerned that our members will start to question our commitment of time and resources to the project if all that happens is that, within a few weeks of the legislation being enacted, the Government makes wholesale amendments to it with no consultation.

95 The result is that the case for us continuing our involvement in the Rewrite of the UK tax rules is undermined. We would welcome clarification as to the Government's policy concerning the Tax Law Rewrite Project given the above comments.

96 Given that these were new provisions which had not been subject to prior consultation, it was vital that the Explanatory Notes provided assistance. However, they barely scratch the surface of the more complicated sections and the way in which the whole scope of these provisions has been expanded. For example the Explanatory Notes mention that remuneration in the form of Government securities has been brought into the net, but the new definition of "securities" in section 420 appears also to bring in futures and contracts for differences even where the underlying subject matter has nothing to do with shares or securities in the normal sense.

97 Warrants to subscribe are treated as "securities" by new section 420(1)(c), but options are excluded by section 420(5)(e) which is expressed to take priority. Is not a warrant simply a type of option?

98 The commencement rule for the new provisions on convertibles (top of page 275) appears to give rise to a double charge on shares issued at less than market value before the appointed day and converted after that day. The value of the conversion right will have been taxed under existing law at the date of issue (when new section 427 did not apply), it is taxed again (at its current value) when conversion occurs, and there is no offset. This needs to be amended.

99 The reference to payments for group relief in new sections 446A(2)(b) and 446K(2)(b) should include a reference to the analogous payments for transfer of a section 179, TCGA 1992 liability set out in section 179A(11). It should also include a reference to non-payment, either for group relief or for transfer of a section 179 liability.

100 It is difficult to follow the interaction between new sections 428 and 446E. However we see no justification for section 446E(1)(b) imposing a charge on 5th April each year where the value of the shares has been affected by a depreciatory transaction, if nothing else happens on that date. The employee derives no tax advantage from the depreciatory transaction at that time. The advantage would arise, and is negated by section 446E(1)(a), if and when the restrictions are later removed.

101 We cannot see a justification for imposing a charge every 5th April for six years by reference to the same depreciatory transaction, which is what happens if the transaction has a lasting effect on the value of the shares. The formula in section 428(1) may in fact reduce the later section 446E(1)(b) charges in these circumstances, but we are not convinced that it wholly prevents a multiple charge on the same reduction in value in all cases. In any event, the section 446E(1)(b) charge is, at the very least, an unnecessary and substantial complication.

102 Similarly, it is wrong for section 446L to impose a charge on non-commercial increases of value each 5th April, when nothing else happens on that date and the employee gets no actual benefit at all from the increase in value (which is in any case hypothetical, being dependent on the vagaries of share valuation).

103 It is also not fair that section 446L(7)(b) has the effect that "non-commercial increases" are taxed with no set-off of "non-commercial reductions" even, apparently, where the increases and reductions both arise from non-arms length transactions effected within

the same group and not as part of a tax avoidance scheme.

104 There appears to be a typographical error in new paragraph 446F (2)(b) of Schedule 22 where the year “2002” should be “2003”.

Clause 140 – Corporation tax relief for employee share acquisitions

105 In paragraph 33(2), we believe the definition of ’relevant expenses’ is too wide and would apparently deny or restrict relief, for example, if a deduction has been claimed in the last pre 1 January 2003 accounting period for incidental costs associated with the administration of a share issue actually made in the following accounting period. It would appear that what is needed is an exclusion from the definition of ’relevant expenses’ for the same classes of expense as are listed in paragraph 25(3).

Clause 142 and Schedule 24 – Restriction of deductions for employee benefit contributions

106 We welcome publication of the detail of this clause in advance of the Finance Bill as part of the Pre-Budget Report in November 2002. We have previously made representations on this and other matters covered in the Pre-Budget Report (TAXREP 8/03 *Comments on the Pre-Budget Report (November 2002) and provisions for Corporation Tax Relief for Employee Share Acquisitions).*

107 We note the Government’s intention is to allow a tax deduction only to the extent that, and at the time when, the employees themselves are taxable. However many legitimate payments to genuine EBTs will not now rank for relief, for instance payments to be used for charitable purposes by EBTs which have charitable objects and make payments to charities relevant to employees, without directly benefiting known employees. In addition some benefits received by employees via EBTs, but which are specifically exempted from tax under the benefit in kind legislation, will result in no deduction being available to the company for the expense incurred via the EBT. If a similar benefit is provided direct to the employee it will continue to rank for tax relief in the hands of the company. For instance benefits exempt under section 155, ICTA 1988. The provision should be amended to ensure that such payments continue to be deductible.

108 In paragraph 2 of the draft Schedule a deduction is also disallowed if the benefit is provided by a UK-based employer to a foreign-based employee who would be exempt from tax on UK duties under a treaty. A deduction should be allowed in these circumstances.

109 The drafting of paragraph 2(3) also appears defective. We presume that the intention is that sub-paragraph (a) of paragraph 2(3) will apply solely to decide whether the payment would be liable to income tax, and sub-paragraph (b) will apply solely to decide whether it would be subject to NIC. As current drafted it appears that, in strictness, both tests must be applied for both purposes and we think that the clause should be amended.

110 It is also unclear what happens if the benefit is taxable but the measure of the tax charge is completely unrelated to the cost of providing it, e.g. the provision of cars for disabled employees.

Clause 143 – PAYE on notional payments: reimbursement period

111 We welcome the extension of the period for an individual employee to repay the tax liability from 30 to 90 days. However, this will not overcome all the problems arising out of what used to be section 144A, ICTA 1988. One solution when repayment is not made within the 90 day period would be to treat the unpaid amount as a loan. Alternatively an amendment could be inserted to extend the 90 day period, in appropriate circumstances, "to such longer period as the Revenue may allow".

112 We would also welcome some consistency across provisions in the Taxes Acts as to the time periods allowed. For example, the time period allowed here for reimbursement is 90 days. However, the notification period for share options under the Enterprise Management Incentives scheme is 92 days. We think that a three month time period should be standardised at 92 days.

Clause 145 – Payroll Giving: extension of 10% supplement to 5th April 2004

113 We welcome the extension for a further year. This provision was originally introduced in 2000 for a three year period. This measure has proved enormously helpful for charities. The Finance Bill Explanatory Notes indicate that the amount given under the payroll deduction scheme has increased by £18 million each year. Consideration should now be given to putting the scheme onto a permanent basis. Such a move should further increase the amount given to charities and would also to provide certainty for charities and allow them to plan for the longer term.

Taxation of non-resident companies and related matters

Clause 147 – Meaning of Permanent Establishment

114 The OECD published as a Consultative Document in March 2001 Part 1 of their Permanent Establishment paper and a revised document is to be published this coming summer. We question whether the UK Government could be held to be "jumping the gun" by revising its Permanent Establishment rules and definitions before the final version of the OECD equivalent provisions are finalised.

115 More seriously, the OECD concept of permanent establishment has not been imported satisfactorily into domestic law. The most important problem is in relation to the use of the word 'business' in the proposed legislation. Although the language of articles five and seven in the model OECD treaty are by reference to 'business profits', the equivalent UK concept is profits of a 'trade'. 'Business' in UK tax law has a very different meaning. Since the intention is to deal with non-resident companies trading in the UK, the references to 'business' in the draft legislation should be replaced with references to 'trade'.

116 This problem also arises in relation to dependent agents. The authority of the agents should only apply to authorities to carry on the trade in question and not to authority to do business. This in particular will give rise to widespread compliance issues for potential agents who constitute permanent establishments even where there was no trade. These provisions should be amended accordingly.

117 We also note in particular that Clause 147(1)(b) proposes that an agent who 'habitually exercises *authority* to do business of behalf of a company' will constitute a Permanent Establishment of that company in the country where the agent operates. The OECD

Model Treaty still only treats an agent as a Permanent Establishment when the agent '[has] and habitually [exercises] the right to conclude *contracts*' in that country. We believe that the UK law should follow closely the relevant OECD model until such time as the OECD model is amended.

118 Subsection 2(h) indicates that a Permanent Establishment will include "a building site or construction or installation project". Most UK treaties qualify this definition by requiring the site or project to be in existence for 12 months or more which is in accordance with the OECD Model Treaty. We suggest that this qualification be incorporated into the new UK statutory definition.

119 We note that subsection 5 does not include a category (e) along the lines of the existing OECD Model Treaty. This subsection states that any combination of the activities listed under the equivalent of 5 (a) to (d) would also not constitute a Permanent Establishment. We recommend that an additional subsection along these lines be included for the avoidance of doubt and to ensure that the UK rules are consistent with the OECD rules.

120 This provision applies to accounting periods beginning on or after 1 January 2003. It is not acceptable for these provisions to apply before the relevant provisions are enacted. The start date should be amended so that it applies to accounting periods beginning on or after Royal Assent.

Clause 148 and Schedule 25 – Non-resident companies: basis of charge to corporation tax

121 We believe that if the decisions of the ECJ are followed in the cases of *Lankhorst Hohorst* and *St Gobain* then "thin capitalisation" rules applied to Permanent Establishments of companies resident in other EU Member States cannot be more burdensome than the UK domestic rules.

122 Under new section 11AA(3)(b), ICTA 1988 there is a more burdensome requirement than would apply in the case of a purely UK domestic arrangement and we therefore believe that this provision may contravene the EU treaty.

123 The start date should be accounting periods beginning on or after Royal Assent rather than 1 January 2003.

Chargeable gains

Clause 158 – Reporting limits and annual exempt amount

124 We welcome the ongoing attempts to simplify the reporting procedures. However, this provision is far too complicated as compared to the simplification achieved. We suggest that this clause is deleted and instead the reporting cut-off is increased from two to four times the annual exemption.

Clause 159 – Taper relief: assets qualifying as business assets

125 This is a welcome relaxation of the definition of business assets for the purposes of taper relief and an example of the success of consultation.

126 However, we do not see any reason for delaying this section taking effect until 6 April 2004. We recommend that the change should be introduced with immediate effect.

Clause 16 - Earn out rights to be treated as securities unless contrary election

127 Once again we welcome a sensible change which is another example of the success of ongoing consultation.

Clause 161 – Deferred unascertained consideration: election for treatment of loss

128 The change this clause is designed to implement is welcome. However, the provisions themselves are overly complicated and unnecessarily restrictive. It would have been much simpler to provide that where a loss arises on a right to unascertainable consideration it can be treated as arising in the year in which the right was acquired and then carried forward.

129 The restriction of the election to circumstances where a gain has arisen on the original disposal is also unnecessary and should be removed. For example: Mr. A. acquires shares in a trading company for £100,000. He sells the shares for £50,000 and an earn-out right which is valued at that time at £40,000. He therefore makes an allowable capital loss of £10,000. He has gains on other assets of £50,000. Two years later the earn-out is calculated and amounts to only £10,000. He realises a loss on the earn-out right of £30,000 (£40,000 - £10,000) but he has no other gains against which to set the loss. His "real" loss on the capital disposal is £40,000 but he has received relief for only £10,000.

Clause 162 and Schedule 29 - Transfers of value: attribution of gains to beneficiaries

130 It is clear from the Budget Press Release (REV BN33) that Clause 162 and Schedule 29 are intended to counter schemes made possible by section 90(5)(a), TCGA 1992. Accordingly, a much better approach would have been is simply to repeal the offending sub-section.

131 Instead, the approach of these provisions is to amend an existing piece of legislation, Schedule 4C TCGA 1992, which is extremely poorly drafted. The result is highly complicated legislation which is very broad is scope.

132 We are very concerned that innocent transactions not intended to be caught by Schedule 4C will now fall within it. Conversely, however, these provisions are so complicated that they will inevitably open up new avoidance opportunities.

133 Accordingly these provisions should be withdrawn and section 90(5)(a) repealed.

134 In the longer term there should be consultation on the replacement of Schedules 4B and 4C of TCGA 1992 with provisions which counter artificial schemes without both catching innocent transactions and creating new loopholes.

Capital allowances and related matters

Clause 163 – Avoidance affecting proceeds of balancing event

135 If the proposals in new section 570A, CAA 2001 apply then the vendor is denied the balancing allowance altogether, which is a penal provision. We believe that it is more appropriate to reduce the allowance from the excessive amount to one of the following:

- an amount that is just and reasonable; or
- what the allowance would have been if the transaction had taken place at arm's length; or
- the allowance based on prices that would have prevailed if the parties to the transaction had been unconnected.

Clause 164 – Extension of first year allowances for ICT expenditure by small companies

136 This extension of the first year allowances is welcome. The Government should consider putting this enhanced allowance onto a permanent basis.

137 The title of the clause states that it applies to 'small companies'. We think this should read 'small businesses'.

Clause 166 and Schedule 30 – First year allowances for expenditure on environmentally beneficial plant and machinery

138 We would welcome guidance as to the circumstances under which a certificate of environmental benefit, once issued, might be revoked (new section 45I(4), CAA 2001). However it appears entirely unreasonable that the effect of revocation is to withdraw the first year allowance *ab initio*, at least in a case where the taxpayer has relied on the certificate in good faith and revocation is due to an error or change of mind on the part of the issuing department.

139 We also find it difficult to discern the exact effect of new section 45J without seeing an example of the Treasury order in question. However, from section 45J(2), it appears that the order would simply specify a maximum amount which can be treated as section 45H expenditure in respect of the component in question. That would not in itself displace the basic rule that the amount qualifying for capital allowances of any sort cannot exceed the expenditure actually incurred on the asset in question. Hence it appears that an apportionment would still be necessary in order to establish the expenditure actually incurred on the component, and that the disapplication of section 542(3) CAA 2001 by section 45J(5) is therefore inappropriate.

140 The view may have been taken that this would not be a practical issue, perhaps in the expectation that the amount specified in the order would itself be arrived at by an apportionment of the selling price of the plant in question and would in practice never be greater than the price reasonably attributable to the component. However, even if that is correct as regards the original acquisition, one may still need to establish the expenditure actually incurred on the component for other reasons, in particular for the purpose of applying section 62 CAA 2001 if the component is subsequently sold as a separate item.

141 What seems to be needed is either to remove section 45J(5), or to eliminate the need for apportionment more completely by rewording subsection (2) so that the order would specify an amount to be treated as qualifying expenditure on acquisition of the component for all purposes of the CAA 2001.

Clause 167 and Schedule 31– Relief for research and development

142 We welcome the reduction in the minimum aggregate expenditure from £25,000 to £10,000.

143 We responded to the request in the November 2002 Pre-Budget Report to make suggestions as to how the operation of the existing scheme could be improved. We presented our Representations in January 2003 (*TAXREP 1/03 – R&D Tax Credits – Guidance on and possible improvements to the operation of the existing system).*

144 We recommended that companies should have the option of applying the precise costs of employees working on R&D projects rather than the 80:20 rule. The current proposal is to replace the 80:20 rule with a mandatory precise attribution method. We would recommend that companies be given the option to retain the 80:20 rule as some businesses, particularly smaller ones, will find that system is easier to operate albeit others find precise attribution to be more compatible with their accounting systems.

Life insurance and pensions

Clause 170 and Schedule 34 – Policies of life insurance: miscellaneous amendments

145 We welcome the amendment in relation to group life policies under which the exemption from tax continues even though several of the policyholders have died during the currency of the policy.

Miscellaneous

Clause 175 and Schedule 36 – Foster carers

146 We query why foster carers have not been totally exempted from tax as have payments to adopters (clause 174) and would welcome clarification of the underlying policy reason for this difference.

147 We would like to see a Regulatory Impact Assessment as we cannot believe that significant amounts of income tax are involved in these cases. According to the Explanatory Notes the Government's aim is "to encourage the recruitment and retention of foster carers' but we are not convinced that this clause will achieve this objective. We feel the Government needs to adopt a bolder approach if it seeks this objective.

148 Currently foster carers are regarded as realising a profit only to the extent that the local authority identifies the payment as a reward. This provision will mean that if receipts exceed the specified limits, the excess will be taxable unless the carer keeps sufficient records to show that there is no profit.

149 Furthermore, the drafting of the foster carer provisions is tortuous and incredibly complicated for what is meant to be a measure of assistance.

PART 8

OTHER TAXES

Inheritance tax

Clause 183 Authorised unit trusts, OEICs and common investment funds

150 We welcome this amendment to the inheritance tax rules to extend the excluded property rules to include authorised unit trusts, OEICs and common investment funds. The clause recognises the importance attached to the competitiveness of the UK economy. We hope that this is the first step in the review of collective savings products and that this treatment will be extended to other forms of investment such as life assurance policies and investment trusts.

Insurance premium tax

Clause 191 – Higher rate of tax: divided companies

151 This clause amends the insurance premium tax (IPT) legislation so as to bring cells or divisions of Protected Cell Companies (PCCs) and similar companies within the IPT higher rate. The clause is described as an anti-avoidance measure, and we understand the logic behind the clause. However, we note that the case of *Gil Insurance and others (Case C-308/01)* is currently before the European Court of Justice. That case raises issues as to whether the UK higher rate of IPT is lawful in European VAT Law, whether it is an unlawful state aid, and if so, whether it should be repaid to those businesses required by UK law to charge it.

152 We note that the Court of Appeal in the 1999 *Lunn Poly* case [1999] STC 350 has already decided that the differential rates of insurance premium tax constituted a state aid under the EU Treaty, and since the European Commission had not been notified nor given its approval, the differential rates were illegal.

153 If Customs are unsuccessful in the ECJ case, the risk must be that clause 191 will also be ruled unlawful. We believe that this clause should be withdrawn pending the decsion in that case.

PART 9

MISCELLANEOUS AND SUPPLEMENTARY PROVISIONS

Provisions consequential on changes to company law

Clause 193 and Schedule 41 – Companies in administration

154 The provisions of paragraph 1 of Schedule 41 will bring an accounting period of a company to an end on the appointment of an administrator.

155 We do not see why this clause has been introduced and we think that it should be withdrawn. The effect will be to not allow chargeable gains arising on the disposal of assets during the administration period to be set against trading losses arising prior to the date of administration. The idea of administration is to enable a company to be rescued from insolvency. One of the options open to the administrator will be to sell surplus assets to raise money. These disposals may realise gains, but why should not these be set against losses? This provision does little to encourage the 'rescue' culture that the Government is so keen to encourage. Neither is this provision consistent with recent announcements to remove the preferential right of the Crown in an insolvency. This proposal in effect gives the Crown a preferential right to part of the assets as compared to the shareholders of the company in administration.

International matters

Clause 194 – Exchange of information between tax authorities of member States

156 Clause 194(4) should also contain a reference to Council Directive 2001/44/EC**.**

157 The Savings Directive is to be introduced with effect from 1 January 2004. For the UK the first reporting period will be to 5 April 2004 which is a much shorter timeframe than for the other EU countries which use the calendar year and will have a first reporting period running up to 31st December 2004. For this reason it is important for draft Regulations to be available as soon as possible.

Clause 195 – Agreements for mutual exchange of tax information

158 In the Explanatory Notes it is stated that 'this clause makes a minor amendment to existing powers to exchange information under Double Taxation Agreements and Tax Information Exchange Agreements'. This explanation is misleading. The proposal in sub-clause (1) is to change the wording in the UK tax treaties in respect of the exchange of information. Instead of referring to that information which is 'necessary for carrying out' the tax laws of the UK and its treaty partner it will refer to information which is 'foreseeably relevant to the administration and enforcement of' such laws. The Explanatory Note indicates that the increased powers are in line with current broad interpretations of what is considered 'necessary'. However, we are concerned that the test as to what information it is appropriate to exchange has been extended without any prior consultation and whether it is lawful for the UK to unilaterally make changes to the UK's double taxation treaties.

159 Further, subsection (3) backdates this provision so that it relates to *any* existing treaty which uses the term 'necessary for the carrying out of'. The retrospective element raises important constitutional and public policy issues. If the starting point is a duty of

confidentiality, then any limitation of this must be properly justified. Even if a case can be made for broadening the scope of the authority to provide information to foreign tax administrations in the future, an attempt to do this for the past is a cause for concern. Not all of the 106 UK treaty partners enjoy the high standards of government that we enjoy. We are concerned that the retrospective element is contrary to the Human Rights Act 1998 and Article 8 of the Convention. We believe that this clause should be withdrawn.

Clauses 196 – Savings income: Community obligations and international arrangements

160 This clause gives a broad authority to the Treasury to make regulations to implement the Savings Directive. However, the implementation of exchange of information is a matter that should be debated in Parliament and the secondary legislation approach is inappropriate, particularly as there has been little attention given to taxpayer safeguards. The clause should be redrafted so that any legislative provisions that relate to exchange of information can be debated in Parliament.

Clause 197 and Schedule 42 – Controlled foreign companies: exempt activities

161 This clause and Schedule extend the Controlled Foreign Company ('CFC') provisions to payment protection companies. The effect of this provision is very wide, as any UK-owned business carried on via a CFC with a wide (eg retail) customer base with a large proportion of UK customers will be caught, unless engaged in long term or large risk insurance.

162 We are concerned with the complexity of the new provisions, introducing as they do a new test of persons who are 'habitually resident' in the UK (as a source of tainted income in respect of payment protection premiums). However, aside from the complexity issue, we believe that this provision is yet another example of a provision that may be contrary to EC law. Insofar as, for example, the payment protection companies are Irish International Financial Services Companies ('IFSCs') or 12.5% companies, this provision appears to ignore the EC treaty and ECJ case law by targeting the establishment of payment protection businesses in another, lower tax, Member State. In respect of companies located in Ireland, this problem is compounded by the removal of Ireland from the Excluded Countries Regulations, a step which we question is legal under EC law.

Clause 198 – Application of CFC provisions to Hong Kong and Macao companies

163 We welcome this provision.

Administrative matters

Clause 201 – Mandatory electronic payment by large employers

164 We think that it is wrong in principle to charge a penalty merely because the taxpayer did not pay 'electronically' in a manner specified by the Inland Revenue. The Government should be seeking to encourage taxpayers to pay electronically, not coerce them to do so. The proposed penalty regulation set out in sub-section (9) is poorly drafted but in any event it lacks proportionality: a fine of up to 10% of the tax payment is entirely disproportionate for a regulatory failure of the type.

165 Although the clause appears to be aimed primarily at electronic payments of PAYE, the penalty applies to 'any tax' administered by the Inland Revenue. We would welcome clarification as to whether the Government intends to apply this provision to all taxes and if so what is the timetable for implementation.

166 The substantive provisions are delegated to regulations which have not yet been published. We must also repeat our strong belief that major legislation should be introduced by primary legislation, with the opportunity for more adequate Parliamentary scrutiny. We would welcome clarification that the regulations will be released in draft for consultation before they are finalised.

167 We think that this clause should be withdrawn. If the clause is not withdrawn, the penalty should be set at a modest flat-rate penalty related to any extra costs by the Revenue in processing non-electronic payments. However, we do not believe that a penalty is the appropriate course of action. We consider that instead of providing for a penalty, the Government instead should provide an incentive for all taxpayers to pay electronically or a fixed surcharge on non-electronic payments.

168 We believe that the definition of 'large employer' should be amended so that it is consistent with the Companies Act definition. We are also concerned that the new Regulations will apply to charities that have large numbers of employees but where the employees are paid low salaries so that the PAYE payments are low. Consideration should be given to providing an alternative monetary threshold.

Clause 203 – Admissibility of evidence not affected by offer of settlement etc

169 Please refer to our comments above on clause 38.

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