

# Tax Representation



**TAXREP 16/08**

## **2008 BUDGET: THE KEY TAX ISSUES**

*Memorandum submitted in February 2008 by the ICAEW Tax Faculty to the Chancellor of the Exchequer*

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

TAXREP 16/08

# 2008 BUDGET: THE KEY TAX ISSUES

## IMPROVING TAX POLICY FORMULATION

- 1 The Pre-Budget Report (PBR) on 9 October 2007 launched three major reforms to the existing tax system, namely:
  - income shifting;
  - residence and domicile; and
  - capital gains tax reform.
- 2 Whilst we appreciate that changes were expected in the first two areas, the approach to formulating tax policy that resulted from these particular proposals is a matter of serious concern. In particular we believe that these highly controversial changes have been announced without proper prior consultation, inadequate transitional provisions and a lack of appreciation of the likely behavioural impacts and compliance costs they will impose. Further, the announcements showed a lack of appreciation of the potential damage they could inflict on the international reputation of the UK as a place to live, work and invest.
- 3 This whole process has seriously undermined confidence in the UK as a place in which business can plan for the future with certainty. Whilst we have been working with HM Treasury and HM Revenue & Customs (HMRC) officials since the PBR to help improve these proposals, this is far too late in the process and there is a pressing need to build in adequate consultation at a much earlier stage. It is essential that the views of taxpayers and other stakeholders with relevant experience, for example the ICAEW, are sought when policy ideas are being formulated rather after the policy has been decided. If this had been done, we believe that policies in these areas could have been formulated that met the Government's needs but which also enjoyed the wide support of stakeholders.
- 4 We believe there is a risk of challenge under the EU law doctrine of legitimate expectation if changes are introduced too quickly and without a proper transitional period. We are concerned that these proposals may fall into that category, with the result that the provisions may be challenged in the courts, leading to costs and uncertainty for all stakeholders.

### **Recommendations**

- 5 Tax policy formulation needs to be undertaken so as to:
  - allow adequate time for full consultation with a wide variety of stakeholders; and
  - ensure that the legitimate expectations of taxpayers are preserved. In the case of these measures, we think that taxpayers should have been given more time to reorganise their affairs.
  - we remain of the view that some of the highly detailed measures in these proposals should be deferred to allow more time to consult with stakeholders


such as the ICAEW Tax Faculty. This would ensure that the measures are fair and reasonable, properly targeted and remain internationally competitive.

## **INCOME SHIFTING AND SMALL BUSINESS TAX POLICY**

### **Income Shifting- an increase in the administrative burdens**

- 6 We have strong reservations about the introduction of the Income Shifting proposals as set out in draft legislation. We believe that the rules are too widely drafted and will create considerable uncertainty for taxpayers operating through companies and partnership who will not know whether they are, or are not, within the provisions.
- 7 The proposals in effect introduce transfer pricing type rules to those operating through certain businesses. The transfer pricing rules are considered so onerous that they apply only to the largest UK companies, but the UK now proposes to impose similar requirements upon small family businesses. We think the requirements are unrealistic and impractical in a self assessment system where it will be difficult to value, on open market terms, a family member's contribution, for example, to a business with the degree of accuracy that is needed.
- 8 We also believe that the compliance costs associated with this legislation have been considerably underestimated in the Consultation Impact Assessment, whilst the likely revenue yield will be potentially much lower than the amount stated in the document.

### ***Recommendation***

- 9 We recommend that:
-  businesses with profits and turnover below defined limits should be exempted from the Income Shifting rules. This approach follows the precedent in the transfer pricing rules for taking out smaller businesses.

### **The Small Business Review must be re-energised**

- 10 We are concerned that instead of providing a clear direction for small business taxation, piecemeal changes that are being made in a reactive way that is damaging confidence in what is a key growth sector of the economy.
- 11 There have been a number of attempts to review the taxation of small businesses, but since the discussion paper, Small Companies, the self-employed and the tax system, was published in December 2004, progress has been slow. In our opinion, this is a wasted opportunity. During recent years we have seen legislation aimed at solving perceived abuses in the small business arena, such as the notorious IR35 provisions, the Managed Service Companies legislation in 2007 and now the Income Shifting proposals published in December 2007. Each of these carries a considerable administrative burden and when added together they seem more likely to act as a deterrent to business growth rather than raising large amounts of revenue for the Exchequer. They are also 'sticking plaster' legislation that does not deal with the need to look at the taxation of small businesses in a more coherent and holistic fashion.
- 12 This is an opportune time for the UK Government to re-energise its own review of the small business tax system. The aim should be to remove the tax distortions between the various different business structures so as to ensure that business decisions are

led first and foremost by the commercial needs of the business rather than dictated by tax advantages or disadvantages.

- 12 Small businesses have seen a number of tax rises in the past year and this looks set to continue. Large businesses were compensated for the adverse changes to the capital allowances regime, announced in Budget 2007, by the 2 per cent reduction in the headline rate of corporation tax from April 2008. For small business there is not a decrease but an increase, with the headline rate increasing from 19 per cent at the time of Budget 2007 to 22 per cent from April 2009. The withdrawal of industrial buildings allowances was particularly harsh for those smaller farmers and hoteliers who had factored the allowances into their business cash flow projections. The proposed introduction of the new £50,000 Annual Investment Allowance (AIA) is not seen as sufficiently adequate recompense.

### **Recommendations**

- 13 We recommend that:
- there is an announcement in the Budget that the small business tax review will be restarted in consultation with businesses and their advisers with the aim of providing a comprehensive review of small business taxation which takes account of all of the issues identified above; and
  - a detailed report and recommendations for change should be published in the 2008 PBR.

## **RESIDENCE AND DOMICILE**

- 14 A consultation process on residence and domicile was begun back in 2002 and a number of suggestions have been made since then as to how the existing system could be improved, but there was little outward sign of progress until the changes announced in the PBR. This was followed by a Consultation Document on 6 December 2007 and draft legislation on 18 January 2008. We submitted on 21 December 2007 an initial response to the December 2007 Consultation Document in which we noted:
- ‘The taxation of international people and issues of residence and domicile are of crucial importance if the UK is to maintain its pre-eminence as an international centre of business. Accordingly any changes should be subject to a full and open consultation from a wide variety of stakeholders.’
- 15 These proposals have aroused considerable public controversy. Much of this controversy could have been avoided if full consultation had been undertaken beforehand so as to ensure that the resultant proposals took account of views of all relevant stakeholders and that any changes allowed for a reasonable transitional period so as to respect taxpayers’ legitimate expectations. We remain concerned that the £30,000 charge has no international precedent and that it will be seen as damaging the UK’s pre-eminence as an international centre of business. We remain concerned as to whether the levy will be creditable for foreign tax purposes and although we appreciate that HMRC has recognised this problem and is seeking to address it we understand that it may not be creditable for US tax purposes.

- 16 We are particularly concerned at the impact of these proposals on the lower paid/middle income non-domiciled taxpayers. These sectors will not be within the £30,000 charge but they will also be faced with increased tax charges and the need to submit a UK tax return, factors which have hitherto largely been unnoticed as the focus to date has been on the wealthy non-domiciles who are likely to pay the £30,000 charge. This change will result in a substantial increase in compliance costs for non-domiciles and will require an increase in resources and staffing for HMRC.
- 17 We have just submitted further representations on these proposals which take into account the draft clauses published on 18 January 2008. In these latest representations, we note that there is a need for:
- greater clarity on the figures and assumptions used;
  - a clear and statutory test of residence;
  - tax compliance issues to be addressed; and
  - a clear assessment to be made of the administrative burden that will be placed on HMRC.

### **Recommendations**

- 18 In the light of the very serious misgivings that the current proposals have aroused we recommend that:
- the calculations and assumptions underlying the revenue and cost projections should be published and a detailed assessment made of the likely behavioural implications before the proposed £30,000 levy is introduced;
  - the £30,000 charge is decoupled from some of the more complex measures and the start date for the latter deferred until 6 April 2009 to allow time for more detailed consultation and a reasonable transitional period. Our representation on the detailed legislation highlights the areas which we consider will require drafting amendments to make them clear and workable;
  - consideration is given to raising the de minimis limit for unremitted income and gains so as to ease the potential compliance burdens on lower and middle earning non-domiciles;
  - an assessment of the impact of the increased administrative burden that will be placed on HMRC as a result of these proposals;
  - consideration of any future changes is deferred until the current proposals have been assimilated and the full effects have been quantified; and
  - a statutory test of residence is introduced in order to provide certainty in this area.

## **CAPITAL GAINS TAX REFORM**

- 19 We welcome in principle the Chancellor's move to make a significant simplification of the existing capital gains tax (CGT) regime. However, right from the initial announcement we have been concerned that the measure is being rushed in with no prior consultation and no real understanding of the detailed impact that the proposed measures will have. We welcome the announcement on 24 January 2008 of entrepreneurs' relief which addresses one of the failings of the initial proposals. However, it still leaves many issues either unresolved or in an unsatisfactory position.
- 20 We made an initial response to the PBR proposals in our TAXREP 69/07, in which our main concerns were that the measures would be unfair to a number of taxpayers

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because the legitimate expectations of taxpayers were not being respected. For example, under the current rules farmers who have been in business for many years and are now selling up are likely to pay CGT at a rate well below 10%, whereas under the new rules any gain will be taxed at 18% (subject to the availability of the new entrepreneurs' relief). We believe that there should be reasonable transitional arrangements so as to preserve the legitimate expectations of taxpayers.

### **Recommendations**

21 We recommend:

- there is an urgent need for the draft legislation on the new entrepreneur's relief to be published as soon as possible (it was not available at the time we submitted this representation mere weeks before it was due to take effect); and
- there remain a number of policy issues that need to be addressed, in particular how gains rolled in to qualifying corporate bonds will be treated given the legitimate expectations of taxpayers that the gain would be taxed under the rules applicable at the time of the transaction.

## **TAX SIMPLIFICATION**

22 We welcome the recent explicit commitment of the Government to a radical programme of simplification of the tax system. We have been calling for simplification of the tax system for more than ten years and simplification is one of the core elements of our Ten Tenets to a Better Tax System (attached as an Annex).

23 In its 2007 PBR, the Government noted that in simplifying business tax;

‘the Government is renewing its commitment by launching a significant programme of tax simplification – setting out new principles, new reviews and a package of measures – to enhance UK productivity and competitiveness.’

24 Despite this high level approach we are concerned that the Government has ‘dived into the detail’ without first articulating an agreed tax simplification strategy. At the present time there appear to be a number of different initiatives but there is no clarity as to the overarching strategy and principles that we believe should underpin such a major work of simplification.

25 We look forward to the opportunity of working with Government to develop a robust framework under which a major simplification of the UK tax system can be carried out.

### **Recommendations**

26 In designing a tax simplification programme:

- It should be largely revenue neutral.
- Any simplification measures need to take account of the overall winners or losers of any proposals and the implications taken into account for a wide variety of taxpayer circumstances.

- If there are losers, the reasonable expectations of those taxpayers need to be respected and there need to be appropriate transitional rules.
- Tax simplification is a competitive issue for the UK – there needs to be research into how other countries approach these issues to identify and share the solutions these other countries have identified.

## HMRC'S SERVICE STANDARDS

### HMRC's IT systems

- 27 We remain concerned that HMRC appears to be under resourced for the wide range of tasks the department now undertakes. We believe that the speed at which the change programme – and the associated cost and headcount reductions – has been implemented has resulted in a diminution in service standards. While we commend HMRC for the progress made on VAT registration processing and on some other areas of service delivery, the evidence provided by our members suggests that standards in many areas are still well short of an acceptable level. We continue to work closely with HMRC to achieve an improvement in service standards and value the working relationships that have been established at all levels.
- 28 The recent problems with the Self Assessment on line service concern us and we believe that in order to restore confidence HMRC should reaffirm its commitment to the Carter Principle: that no new service should be launched until it has been fully tested and that the date of introduction should be deferred if the systems prove to be insufficiently robust and reliable. We remain committed to supporting the Government's policy of moving towards e-filing of business and personal tax returns but we are firmly of the view that take up of e-services should be driven by the business case and not by mandation, particularly while there continues to be a lack of confidence in HMRC's systems. The considerable year on year increase in the number of e-filed returns has been driven by the business case and not by the threat of mandation.

### Recommendations

- 29 In order to restore confidence in HMRC's IT systems we believe that:
- HMRC should reaffirm its commitment to the Carter principle: namely that no new service should be launched until it has been fully tested; and
  - the date of introduction of any new system should be deferred if the systems prove to be insufficiently robust and reliable.

### VAT registration delays

- 30 We were very concerned during 2007 with the excessive delays in processing VAT registrations as a result of measures to reduce Missing Trader Intra Community (MTIC), or carousel, fraud. We welcome the fact that as at December 2007 HMRC were processing registration applications that they considered to be low risk, which represent 70 per cent of total applications, within 14 days of receipt of the application.
- 31 Where HMRC consider that there is a high risk of potential involvement in VAT carousel fraud, the application is subject to further, more detailed checks. Historically, these have been about 10 per cent of all applications, although by December 2007 it had dropped to some 5 per cent. The average delay for new high



risk applications is currently 75 days, or 2.5 months, although there is a backlog of 1,600 cases where the delays are considerably longer. HMRC current aim is to reduce the delay for current applications to an average of 50 days by the end of March 2008.

- 32 HMRC say that the remaining applications, which is about one quarter of the total, are incomplete, and they are required to seek further information from taxpayers and/or advisers before processing can start. This figure appears to be increasing, despite the Top Tips recently published by HMRC after consultation with the ICAEW and others.

### ***Recommendations***

- 33 We recommend that HMRC:

- take appropriate steps to seek to reduce the time taken to deal with the bulk of the higher risk applications so that the average delay is reduced from the current 75 days towards the normal target of 14 days;
- review and analyse further with stakeholders the reasons why such a high percentage of applications are currently incomplete and take appropriate steps to reduce this number.

## **EMPLOYMENT TAXES AND NIC: COLLECTION OF TAX AND NIC ON BENEFITS-IN-KIND**

- 34 HMRC is currently consulting on a proposal to make employers account via the payroll for tax and NIC on all benefits-in-kind. This follows on from the success of payrolling benefits-in-kind in Eire and in the USA and the fact that some UK employers already voluntarily account through the payroll for selected benefits for some employees. However, in Eire for example, the benefits code is straightforward and the guidance published by the Irish Revenue demonstrates that the system and the way in which it is administered by the Irish Revenue is more pragmatic than in the UK, which together mean that the average payroll preparer is able to calculate the tax and social security contributions correctly first time and there is normally no need to revisit calculations and liabilities subsequently.
- 35 At present, for many small businesses employers, the year end returns of benefits-in-kind forms P11D are prepared after the year end by the external accountant who prepares the business accounts. The average small businessman employer therefore has no need to know the detailed tax and NIC rules for the benefits-in-kind that he provides, so he is able himself to do the monthly payroll tax and NIC calculations for his employees without too much difficulty. However, if benefits-in-kind had to be accounted for via the payroll, many employers, not just small businessmen, would probably have to pay someone else to do the payroll.
- 36 Even if the proposal for payrolling is abandoned, a full-scale review and simplification of the UK's benefits-in-kind code and an assessment of employer compliance costs is long overdue, especially in view of the forthcoming new penalties regime which is likely to mean a higher likelihood of payroll preparers who are not tax/NIC experts getting it wrong and facing a penalty.



### **Recommendations**

- 37 Given the current complex benefits-in-kind tax and NIC regime and in the light of serious misgivings about whether payrolling benefits is workable for many employers, we recommend that Government should, in consultation with representatives of employers, payroll bureaux and tax accountants:
- undertake a root and branch review of the benefits-in-kind tax and NIC rules, including an examination of employer compliance costs, with the aim of simplifying radically the existing tax and NIC rules; and
  - Undertake not to introduce compulsory payrolling of benefits-in-kind without undertaking the aforementioned exercise.
- 38 The object of both recommendations is to enable the average payroll preparer to calculate tax and NIC liabilities right first time in the majority of circumstances.

### **TRUSTS AND IHT ALIGNMENT – TRANSITIONAL PERIOD 22 MARCH 2006 TO 5 APRIL 2008**

- 39 Finance Act 2006 (FA 2006) made major changes to the Inheritance tax (IHT) treatment of trusts with effect from 22 March 2006. The Government, recognising that the changes were far-reaching, provided a transitional period, which ends on 5 April 2008, which is intended to allow time for trustees to rearrange their trusts, including the interests in possession of beneficiaries without necessarily changing the identity of the beneficiaries, to mitigate the impact of the changes without a charge to IHT arising.
- 40 Statements made by HMRC as to how they interpret certain parts of the amended law, in particular section 53(2) and (2A) Inheritance Tax Act 1984 as amended by FA 2006, have given rise to so much doubt that even experienced advisers are unable to advise with certainty on whether a charge to IHT will arise when a pre-22 March 2006 is terminated or on the circumstances when such an interest in possession is terminated. The consequence is that trustees are unable to take action to mitigate the impact of the changes.
- 41 The problem came to light in September 2007 but despite correspondence no clarification has been forthcoming from HMRC pending their receiving counsel's opinion (which they have now recently received), and the transitional period has nearly ended. The matter is explained in more detail in our letter dated 15 February 2008.

### **Recommendations**

- 42 We believe that Government should:
- confirm that the law relating to whether a charge to IHT will arise on a termination of an interest in possession, section 53(2A) IHT Act 1984, means exactly what it says on a literal reading; and
  - extend the transitional period for a year to 5 April 2009.
- 43 These two steps would ensure that the intention of the Government in 2006 to provide a transitional period during which trustees can act with certainty is achieved.

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## REVIEW OF HMRC'S POWERS

- 44 We have already commented on three areas above – namely CGT reform, changes to the residence and domicile rules, and income shifting – where the Government is pressing ahead with major changes too fast and with inadequate consultation. We have also pointed out the lack of joined-up policy thinking on two areas – simplification and small business tax – which are also suffering from detailed changes without time for proper consideration.
- 45 At the same time, HMRC is conducting a major review of its powers and taxpayer safeguards, which is leading to probably the most radical changes to the tax system for many years. Exactly the same concerns apply to this area too – too many legislative changes are being pushed through too fast, with inadequate public consultation.
- 46 The HMRC Powers Review produced three major consultation documents together with draft legislation in January 2008, with only two months for comment – and this at the same time as all the other major consultations we have mentioned. We would like the proposals in at least one of these, *Penalties Reform: The Next Stage*, to be deferred for a year. The two other consultations, on compliance checks and tax payments and debt, deal with proposals that were the subject of first-round consultations last year.
- 47 For penalties, on the other hand, it is true that the principles for the Finance Act 2007 penalty regime for five main areas of tax were the subject of consultation. However, this new consultation proposes extending these principles to nine other, disparate heads of duty. It also proposes a penalty regime for a different type of default, failure to notify chargeability. There are completely new issues to consider here and it needs a full (12 week) public consultation.
- 48 We are expecting the legislation from the three current consultations (unless the one on penalties can be deferred) to go into the 2008 Finance Bill, together with clauses on a fourth area, the reform of the tax appeals system. There may indeed be other powers changes announced in the 2008 Budget and destined for legislation this year. Although in theory these clauses will be subject to Parliamentary scrutiny, in practice we suspect that Parliament will not give these important and detailed clauses the thorough scrutiny that is needed.
- 49 A further concern is that the changes to HMRC's powers are being made piecemeal - we are presented with 'packets' of proposals in separate consultation documents. It is difficult to get an idea of the bigger picture, to see how these separate changes will fit together and what the end result will be. The risk here is that the changes will not fit together in a coherent whole and things will be missed or will not be done in the best way. Such problems will only come to light further down the road, when the legislation applies in practice. We believe it is time for the publication of a revised 'route map' to help show the overall strategy being followed.
- 50 We do however welcome the proposals for a Taxpayers' Charter and look forward to contributing to this important project.

- 51 Finally, the approach which the Powers Review is adopting, which is becoming widespread across all areas of tax, is to put the legislative framework in statute but then deal with the detailed operation of the rules in HMRC guidance. We find this very unsatisfactory in that HMRC's guidance has no statutory force, can easily be changed or removed from the HMRC website, and is inaccessible to most taxpayers. This does not provide adequate taxpayer safeguards.

### ***Recommendations***

- 52 We recommend that:

- HMRC consults with a wide variety of stakeholders so as to ensure that any revised package of powers is fair and reasonable.
- The consultation process needs to allow sufficient time for these views to be gathered and distilled.

## **TAXATION OF OVERSEAS COMPANY PROFITS**

- 53 The Government issued a discussion draft on 25 June 2007 to which we responded in September (TAXREP 61/07). Like many other commentators we were disappointed with some of the proposals, in particular in relation to controlled companies, but we felt the consultation was well organised and thorough and we look forward to a continuing dialogue when the anticipated Consultation Document is published at the time of the Budget or shortly afterwards.

### ***Recommendation***

- 54 We recommend that:

- The government should continue to consult fully with business and representative bodies to ensure that any new system of taxation of overseas company profits preserves the UK's competitive position in the global economy.

## **FURTHER CONTACT**

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## ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.
3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 10,000 members of the ICAEW who pay an additional subscription.
4. To find out more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at [taxfac@icaew.com](mailto:taxfac@icaew.com) or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

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

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99; see <http://www.icaew.com/index.cfm?route=118111>