Tax Representation

TAX FACULTY

TAXREP 32/07 – 2007 Finance Bill

PARLIAMENTARY BRIEFING RELATING TO HIGH LEVEL ISSUES ARISING FROM THE 2007 FINANCE BILL
CIRCULATED 5 APRIL 2007

Finance Bill 2007

ICAEW priority issues

1. Capital allowances, Clause 35

Purpose

This clause makes fundamental changes to the capital allowances system which gives tax relief for business expenditure on certain industrial and agricultural buildings, which include hotels and farms. The final allowance or charge which was previously tax deductible or taxable on the disposal of these buildings is withdrawn for disposals taking place after 20th March 2007.

Issues

- The ICAEW does believe that the reform of tax reliefs for capital investment are probably long overdue, but we believe that fundamental changes like this should have been made only after full consultation. These changes appear designed more to ensure that the overall corporation tax take remained neutral rather than a considered attempt to reform the system. Coupled with the increase in small business corporation tax next year, this will have a serious impact on many small businesses

- This clause implements the first of the Chancellor's reforms which were announced in the 2007 Budget. In Finance Bill 2008, legislation will be introduced to begin the phase out of the existing 4% rate of annual writing down allowance for industrial and agricultural buildings as follows:

  2008/09 rate of allowances cut to 3%
  2009/10 rate of allowances cut to 2%
  2010/11 rate of allowances cut to 1%
  2011/12 rate of allowances cut to 0%

- Capital investment decisions require a stable and certain tax regime. The withdrawal of the balancing allowance and the proposed withdrawal of the annual writing down allowance have a retro active effect in that they change the impact of long-term investment decisions that were made many years ago, in some cases up to 24 years ago. Furthermore, those which have only recently invested may have loan covenants related to the purchase of the building which are secured on minimum levels of profitability. Withdrawing anticipated tax relief will affect profitability and could result in such loans being recalled, leading to a decline in the commercial property market.

- The key businesses to be affected will be hotels, farms and manufacturing businesses owning factories. The first of these will be forced to raise hotel room rates to compensate. The second two categories are already struggling to remain profitable and this proposal will make matters worse. Urgent consideration needs to be given to providing proper 'grandfathering' relief, so as to ensure that businesses making long-term investment decisions are not now disadvantaged.

ICAEW Finance Bill activity

- A more detailed briefing will be provided for committee

2. Managed Service Companies, Clause 25/ Schedule 3

Purpose

This clause introduces legislation to define a Managed Service Company (MSC) and changes the way in which workers paid by Managed Service Companies are taxed. Income received by individuals providing their services through MSCs will in future be treated as employment income. The consequence of this will be that MSCs will have to operate Pay As You Earn (PAYE) and deduct income tax and Class 1 National Insurance contributions on all payments made to individuals in respect of services provided through such companies, irrespective of whether this is paid as a salary or as a dividend.

The clause also makes the person who provided the company to the individual (the MSC provider) liable for any taxes owed to HM Treasury.

Issues

- In principle the ICAEW understands and supports the reasons for this change, but we would like the rules to be properly targeted at highly abusive MSC providers. However, we remain concerned that the draft legislation is too widely targeted and may catch arrangements which we believe are not the intended target of this legislation.

- The key factor which has driven taxpayer behaviour and which has resulted in the need for the current new legislation is that dividend income is taxed at a lower rate of tax than earned income and that corporate taxes are lower than personal taxes.

- The transfer of debt provisions will ensure that where an MSC incurs a PAYE / Class 1 National Insurance debt, and that debt cannot be recovered from the company, the debt may be transferred to specified persons. These will primarily be the MSC's director and the MSC Provider. There is an exclusion for certain services provided by accountants but the precise scope of the exclusion is unclear. Many of our members provide a variety of services for MSCs but are acting properly and within our ethical code and professional conduct rules. They are concerned that if the exclusion is not clarified, they could become liable for debts incurred by their clients when they have been acting entirely within the law and the professional conduct rules that govern their services. There needs to be a properly targeted exclusion clause. The new rules will also define director's liabilities in such a way that may impact on legitimate business structures. The ICAEW wants to ensure that members businesses are not harmed and to do this we need a full and open consultation.

ICAEW Finance Bill activity

- A more detailed briefing will be provided for committee

3. Venture capital schemes etc, Clause 50/ Schedule 16

Purpose

This clause and schedule introduce a number of changes in response to EU rules to the following tax favoured investment schemes in small and medium sized companies:

1. Enterprise Investment Scheme (EIS)
2. Corporate Venturing Scheme (CVS)
3. Approved EIS Funds
4. Venture Capital Trusts (VCTs).

Under these schemes, individuals or companies invest in small companies and in return receive exemption from capital gains tax, an income tax rebate of 20% or 30% of the investment and in addition for VCTs tax free income. There are limits on the amount that an individual or a company can invest in a company in any one year. The schemes were originally introduced to help provide capital to overcome a funding GAP for larger SMEs. This was in response to the Wilson Report which led to the establishment of the Business Expansion Scheme (BES) which developed into the schemes above and to the establishment of the Unlisted Securities Market (AIM). Academic studies have shown the importance of these schemes in encouraging entrepreneurial activity.

The changes introduced are technical and effect the qualification criteria for investments to qualify for these schemes and to prevent VCTs losing their tax favoured status. The changes include a maximum full time equivalent employees limit of 50 and restrict the amount of investment that a company can raise in any one year to £2 million.

Issues

- These changes have been introduced to prevent VCTs losing their tax favoured status under EU state aid rules. The Government has acknowledged that the changes will impact upon the effectiveness of VCTs in tackling the finance gap (see paragraph 3.78 of the Budget Book). The ICAEW supports the Government's efforts to lobby the EU Commission to review the state aid guidelines.

- Key concerns are that the employee number limit (to 50 full time equivalent employees) and the financial fundraising limit (to £2 million each year) will restrict the availability of venture capital finance to SMEs. In particular it will restrict the availability of capital for investment in fast growing companies. Venture capital tends not to be attractive to very small companies as they can fund their capital requirements through the personal funds of shareholders and through bank borrowing. Larger companies can raise funds through AIM/OFEX. In between it is very difficult to raise funds especially for R&D and intangible asset development. This is because there is no security for bank borrowing. Such companies also face an increase on the tax liability on their retained profits as a result of the increase in the Small Companies Rate

ICAEW Finance Bill activity

- A more detailed briefing will be provided for committee

4. Penalties for Errors, Clause 96/ Schedule 24

Purpose

This clause introduces a new regime for charging penalties for incorrect tax returns and is a product of the ongoing HMRC Review of Powers. It will apply to returns for income tax, CGT, corporation tax, PAYE and CIS deductions, NICs and VAT, though it is expected that in future the model will be extended to other parts of the tax and tax credits system. Penalties for other aspects of tax administration, eg late filing, are the subject of separate reviews. The details of the new penalty regime are set out in Schedule 24 and will come into force by Treasury order. HMRC have said that this is expected to be for return periods commencing after 31 March 2008 where the return is filed after 31 March 2009, ie there will be no penalties under the new system until after 31 March 2009

The key features of the new penalty regime are:

- No penalty at all where the taxpayer made a mistake but has taken reasonable care to complete the return correctly
- Stepped levels of penalty based on taxpayer behaviour
- Penalties charged as a percentage of tax lost, with increasingly large penalties for increasingly serious taxpayer default – for which there are three categories: carelessness (defined as 'failure to take reasonable care'), deliberate inaccuracy and deliberate inaccuracy with concealment
- Penalty percentages set in statute and will be: 30%, 70% and 100% for each of the above categories of behaviour
- Substantial penalty reductions for disclosure, especially when unprompted
- Penalties for overstating losses, including group relief, and for failing to point out errors in assessments made by HMRC
- Possible suspension of penalties for carelessness (at HMRC option) and then cancellation if subsequent compliance is demonstrated
- Penalties to be charged even where the taxpayer has relied on a third party, where that third party has not taken care
- HMRC will be able to pursue a company officer for a penalty where it has arisen through that officer's dishonesty

Issues

- Taxpayer behaviour is the key to the new penalty regime, and the way in which behaviour is understood and categorised by both HMRC and taxpayers will be crucial to the effective operation of the system, particularly with regard to the important principle that innocent error should not be penalised. Detailed rules will be in HMRC published guidance and not in law, and will not therefore be subject to Parliamentary oversight.

- The penalty percentages are higher than those which are charged in many cases under the current system, which allows mitigation at HMRC discretion. We see the merit in charging severe penalties for the most serious types of default but we are concerned that those at the less serous end of the behaviour spectrum will be more heavily penalised than at present. HMRC say (in their summary of Responses to 19 December Consultation Document) that their projections show that 'there will be no overall increase in the level of penalties … for failure to take reasonable care). We recommend that both representative bodies and Parliament should be shown the relevant research and projections which support this.

- Clause 2 of Schedule 24 enables HMRC to charge a penalty where there is an error (creating an understatement) in an assessment issued by HMRC and the taxpayer does not point this out within 30 days. We are concerned that this places a burden on taxpayers to check HMRC work, and that the time limit is too short. The clause requires HMRC to bear in mind whether the taxpayer knew or should have known about the under-assessment, but in our experience, HMRC's perception of what it is reasonable for a taxpayer to know can be unrealistic. Further, we understand that this clause is only intended to apply where HMRC make an assessment and therefore not to other calculations or statements which HMRC might issue to taxpayer. In our view this is insufficiently clear and the meaning of 'assessment' should be defined in the legislation.

- Clause 7 of Schedule 24 provides for a penalty where a loss has been understated. To the extent that the loss has been used to save tax, the penalty is based on the actual tax lost; if it has not been used yet, the penalty is based on the loss at a discounted rate; if there is no 'reasonable prospect' of using the loss to reduce a tax liability, the penalty is nil. While we do not disagree with the principle of a penalty where a loss has been negligently or deliberately overstated, the method of charging seems over-complicated (thus hard for taxpayers to understand), and judging whether there is any reasonable prospect of using a loss is a difficult subjective decision. Also, in our view the penalty should not be due until there is actual loss to the Exchequer. We propose that the penalty should be imposed when the loss arises but deferred until it is used.

- Clause 15 of Schedule 24 deals with appeals. There is to be a full right of appeal against all penalties, as to both the charge and the quantum, with two exceptions. These are in respect of suspended penalties and further penalty reductions in special circumstances, where the tribunal will only be able to review whether HMRC's decision was flawed. In our view, the tribunal should have full power to review **all** penalty decisions ab initio and substitute its own view.

ICAEW Finance Bill activity

- A more detailed briefing will be provided for committee

5. Extension of restriction on allowable capital losses, Clause 27

Purpose

This clause extends the capital gains tax targeted anti-avoidance rule (TAAR) from companies to individuals, personal representatives and trusts. It was announced in the Pre Budget Report 2006 with draft legislation, a statement of principles and guidance being issued at that time.

The clause has been introduced to prevent the contrived creation of capital losses and prevents such losses being set either against chargeable gains or, in some cases, against taxable income

- The current legislation is goes much wider than the intended target. The wording is so wide that practically any transaction resulting in the crystallising of a capital loss could be said to be within the scope of the legislation.

- The effective date for the TAAR is 6 December 2006 and it is possible that taxpayers have entered into transactions as part of their usual year end tax planning not knowing they are caught by the new rules.

- Concerns were clearly expressed during the consultation process on the draft legislation but Government has dismissed them and, rather than change the legislation, has stated that the legislation can be clarified through HMRC guidance. Enacting legislation that is wider than necessary and leaving it to HMRC's discretion to introduce guidance (which can be departed from, withdrawn or revised at any time) to determine when the legislation will be applied undermines confidence in the tax system.

- The legislation should be changed so that it is properly targeted and does not catch those who are not the intended target, such that they then need to rely on non-statutory guidance.

ICAEW Finance Bill activity

- A more detailed briefing will be provided for committee

6. Controlled foreign companies, Clause 47, Schedule 15

Purpose

This clause is designed as an immediate response to the European Court of Justice Judgment in the case *Cadbury Schweppes* C-196/04 in order to make the UK CFC rules compliant with the EC Treaty.

The Government has confirmed that a consultation document will be published in Spring 2007 which will consider possible options for reform of the foreign profits taxation and CFC regimes, together with the implications of any such reform for other aspects of the UK tax regime, such as interest relief. The provisions in Finance Bill 2007 exactly mirror the provisions published on 6 December 2006 which were accompanied by draft guidance. We responded to those drafts in our representation TAXREP 8/07.

Issues

- We do not believe that the proposals will make the amended UK CFC legislation compatible with the EC Treaty. The proposals provide that CFC profits will not be apportioned to the UK parent company to the extent that those profits derive from the 'net economic value' which arises directly to the group from the activities of employees working for the CFC in the EU/EEA territory.

- We believe that this narrow definition will mean that many genuine activities of potential CFCs will be caught and the UK rules will not be restricted to attacking 'wholly artificial arrangements' as they should be if they properly reflected the judgment in the Cadbury Schweppes case.

ICAEW Finance Bill activity

- A more detailed briefing will be provided for committee

7. Limitation period in old actions for mistake of law relating to direct tax, Clause 106

Purpose

To overturn the decision of the House of Lords in *Deutsche Morgan Grenfell Group plc v HM Commissioner of Inland Revenue and another* [2006] UKHL 49 and to ensure that the limitation period for recovery of direct tax, even if paid under a mistake of law, will continue to be six years from the date of payment of the tax rather than the date when it is know that there has been a mistake of law.

Issues

- We believe that the draft legislation is contrary to EU law as there is no allowance for a transitional period. In the case of *Marks & Spencer v Customs & Excise* C-62/00 the ECJ held that national legislation which retrospectively curtails limitation periods is incompatible with the principles of effectiveness and the protection of legitimate expectation if no transitional provision is made available

- Following the announcement of this proposal in the 2006 Pre-Budget Report we wrote to the Paymaster-General (PMG) on 9 January 2007 and that letter and the PMG's response of 1 February 2007 are published on the Tax Faculty website as TAXREP 9/07 see http://www.icaew.com/index.cfm?route=145505

- While we share the Government's concern to protect the public finances we do not believe that this should be at the expense of legislative proposals that disregard a clear rule of law laid down by the ECJ.

ICAEW Finance Bill activity

- A more detailed briefing will be provided for committee

8. Rates of Air Passenger Duty, Clause 12

Purpose

- To increase the rate of Air Passenger Duty (APD) for flights on or after 1st February 2007 irrespective of when those flights are booked.

Issues

- The specific increase in APD is not environmentally differentiated, for example between planes with different carbon efficiencies, and so cannot be classified as a 'green tax' increase. The increase in APD is not consistent with the changes to road tax and stamp duty within the Bill which are environmentally differentiated. The ICAEW will highlight how choosing the right policy tool that achieves the maximum reduction in CO2 emissions for the least cost will allow the UK to go further, faster in tackling climate change. Appreciating the impact on low income groups and small business is also essential.

- The change has retroactive effect as it 'catches' passengers who had already booked their flights before the date of the announcement. We believe the proposal should have been debated by the House of Commons so it has the opportunity to examine these issues.. The timing of the change was also highlighted by the Treasury Committee in its report on the 2006 Pre-Budget Report:

> 'As a general rule, we consider that, where increases in rates of duties or taxes are proposed in the pre-budget report, those increases should not come into force until after the House of Commons has had the opportunity to come to a formal decision on the proposed increase following the budget.
>
> We draw the attention of the House of Commons to the unusual timing of the implementation of the increases in air passenger duty, for which the Treasury has not cited any relevant precedents.'

ICAEW Finance Bill activity

- The ICAEW has drawn on its expertise of business information, effective tax systems and regulation to examine the issues at stake. We will provide a full briefing for second reading.

9. R&D Tax Relief, Clause 49

Purpose

- To the increase in the level of credit available and extend SME R&D tax credits to companies with 250-500 employees

Issues

- ICAEW research shows that the current scheme is not incentivising companies to invest in R&D as effectively as it might and needs reforming. Boosting R&D tax credits will give more firms the opportunity to invest in R&D. But companies should be able to know if government will help before they invest. The criteria for identifying expenditure that qualifies as R&D needs to be simplified, particularly for those seeking lower levels of tax credit. An optional pre-approval process should be developed with the ability for companies to know in advance if they will receive the funds.

ICAEW Finance Bill activity

- This will be covered fully in our second reading briefing

Further information

Please do contact the ICAEW if you require any further information:

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