

TAXREP 38/08

Finance Bill 2008: Second Reading Briefing and Committee of Whole House Briefing

Parliamentary Briefings on the Finance Bill 2008 submitted by the ICAEW on 16 April 2008 for the Second Reading and on 24 April 2008 for the Committee of Whole House stage.

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FINANCE BILL 2008: SECOND READING BRIEFING

The impact on UK international competitiveness and small business

Introduction

In its submission to the Chancellor ahead of the Budget, the ICAEW suggested a number of actions the Government could take now to improve UK competitiveness and productivity. We also recommended improvements to the proposals on capital gains tax (CGT), residence and domicile and income shifting.

It is in this context that we therefore welcome:

- The deferral of the income shifting proposals. We believe that the income shifting proposals were fundamentally flawed. They were administratively burdensome and poorly targeted. We hope the deferral will provide an opportunity to address the real issue, namely that there is a pressing need for a fundamental review of small business taxation. We urge the Government to expand the scope of the proposed consultation to include a strategic review of the Government's approach in this area.
- The Government's changes to the residence and domicile proposals. However, we remain concerned that the impact of the new £30,000 levy on the UK's international competitiveness has not been thoroughly considered and that the proposals will create compliance burdens for many non-domiciles on low earnings, not just the very wealthy. We also believe, that in the interests of certainty, the UK needs to introduce a statutory definition of residence.
- The new entrepreneurs' relief for CGT. Nevertheless, we remain concerned about detailed aspects of the proposals and whether the relief has been appropriately updated for the existing business environment rather than the old regime of retirement relief, on which it is based.

We believe the key lesson from these developments is that tax policy formulation needs to be improved, with better, more effective, consultation at an earlier stage – see our comments in 1 below.

We are also very concerned about the proposals in the Finance Bill to give Her Majesty's Revenue and Customs (HMRC) Officers sweeping powers to access business premises and information. We are particularly disappointed that these proposals were announced only six days after the closing date for comments on three key consultation papers arising out of the Powers review. We believe that taken together these provisions give far too much power to HMRC without adequate safeguards for taxpayers.

1. Formulation of tax policy

As British business takes steps to deal with growing uncertainty in the economy, the need for fairness, clarity and certainty in the tax system becomes all the more

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necessary. The effective running of the UK tax system is also vital to our international competitiveness and reputation. The Government should take steps to improve tax policy formation and avoid the considerable number of concerns that arose following the announcements in the 2007 Pre-Budget Report (PBR), in particular the reform of capital gains tax, the reform of the residence and domicile rules and the proposals on income shifting.

Since the PBR proposals, we have worked closely with HM Treasury and HMRC to clarify the policy objectives of the Government and to suggest improvements to the original proposals. We are pleased to see that in the light of the representations by the ICAEW Tax Faculty, and other representative bodies, organisations and taxpayers, the following major changes have been made to the original PBR proposals:

- CGT reform – entrepreneurs' relief was announced in January 2008;
- residence and domicile – a number of relaxations have been announced in the Budget, which we reflect on below; and
- income shifting – the proposals have now been deferred until 2009.

Notwithstanding these welcome changes, there are serious concerns about how tax policy was formulated and the difficulties it caused for taxpayers trying to make business decisions with limited information, changing policy and inadequate time to take appropriate action.

ICAEW recommendations:

- Government should consult on potential policy changes at a much earlier stage, ideally while a range of possible policy options are being considered. Good consultation, in line with Cabinet Office guidelines, requires an intention to listen to responses and consider them. This requires time.
- There should be sufficient time built into the programme to enable full consultation on the proposals with a wide variety of stakeholders.
- Full consultation needs to include detailed consideration of the effect of the measure on UK competitiveness and the need to ensure that the legitimate expectations of taxpayers are preserved.

2. HMRC information and inspection powers

'I am aware of concerns that have been expressed about the powers of public authorities to enter homes and business premises without permission- powers that have been granted piecemeal over the years in pursuit of generally agreed public goals....I share the concerns about the need for additional protections for the liberties and rights of the citizen.' Speech on Liberty, Prime Minister Gordon Brown, 25 October 2007

Following the merger of the Inland Revenue and HM Customs & Excise in 2005, HMRC has been consulting on establishing one set of powers to apply across the merged department and the taxes it handles. The ICAEW Tax Faculty has been taking an active part in this process, both by submitting formal responses to public consultations and via meetings and workshops with HMRC.

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The proposals in the Bill arise out of three major consultation exercises which were issued in January 2008 and on which comments were requested by 6 March 2008. We are disappointed that decisions on these consultations were then announced in the Budget, a mere six days after the closure of the consultation period. We question whether this was sufficient time in which properly to consider all the responses received and make a series of suitable recommendations. Even though informal consultation took place, the perception is that decisions were made before responses could be fully considered and few of the issues raised by the Tax Faculty can be found in the Finance Bill proposals. This is of particular concern given that many of the proposals in the consultation documents were highly controversial and that we are aware that many respondents expressed concerns similar to ours.

Provisions in this year's Finance Bill make new powers for the provision of information from taxpayers and third parties and new powers for HMRC officers to enter and inspect business premises and records without the need for a warrant. While we have no objection to aligning powers where this makes sense, the current review goes much further and proposes some wide-ranging new powers for HMRC. The ICAEW is seriously concerned that, taken as a whole, these provisions appear to be aimed primarily towards investigations of a 'criminal type' nature as distinct from civil enquiries into a taxpayers' affairs. The danger is that this shift tilts the balance of power far too much towards HMRC, giving it disproportionate powers to use against the vast majority of ordinary compliant taxpayers.

Particularly controversial issues which we consider need more careful consideration and continuing discussion include:

- the ability of HMRC to enter business premises with only a day's notice;
- the ability to inspect the tax position of a taxpayer in relation to a return that is not yet due, thus enabling HMRC to potentially mount 'fishing expeditions' with no right of the taxpayer to object;
- the right for HMRC to dictate record-keeping requirements; and
- the extension of penalty provisions for direct taxes set out in the FA 2007 to other taxes and duties, even though the FA 2007 penalty rules have not been given a chance to bed down and see how they work in practice.

We are concerned by the lack of taxpayer safeguards (such as rights of appeal) against some of these new powers, the increasing tendency of HMRC to seek broad powers in primary legislation, the actual use of which is to be prescribed in non-statutory guidance. We strongly believe that if statutory powers are to be subject to limits or conditions, then these safeguards should also be spelt out in statute.

In view of these serious concerns about the appropriateness and proportionality of these provisions, we do not think it is appropriate to include these new powers in the Finance Bill. We question the need to rush these provisions when the balance between the rights of tax payers and powers of HMRC is being so dramatically changed.

ICAEW recommendations:

- We would like to see these provisions withdrawn from the Finance Bill pending further consultation and that they are then included in a separate Bill.

- We would like to see these provisions deferred to give adequate time for consideration of the rights of tax payers.
- There should be a right of appeal against the power to inspect assets and premises. The use of any statutory power to visit business premises ought to be a last resort and only where the taxpayer has refused to make his records available at some other place, where fraud is suspected or where a visit to the premises is the only realistic way to carry out the check that the officer perceives is necessary.
- We are opposed to HMRC using these powers to carry out pre-return checking of direct tax returns. While such provisions are reasonable in respect of PAYE and VAT, Because of the frequency with which returns need to be submitted, such powers are not appropriate for direct tax returns where the tax return in question has not been submitted.

3. Income shifting and small business taxation issues

'We welcome the Chancellor of the Exchequer's decision to undertake a further consultation on the issue of income shifting. However, we are concerned that this proposed legislation would place an additional tax burden on small businesses and we note that it caused widespread concern during the previous consultation period. We recommend that the terms of the consultation be widened to constitute a full review of the principles of small business taxation to ensure that the taxation system rests on practical, workable rules for the small business community.' Treasury Select Committee report on the 2008 Budget, pg 67

Like the Treasury Select Committee, we welcome the Budget announcement to defer the implementation of the income shifting proposals. The proposed income shifting rules bore all the hallmarks of other recent measures in this area, namely the IR35 rules and managed service companies, which are in the nature of sticking plaster changes- in other words, piecemeal changes being made in a reactive way that are merely papering over the underlying problems, rather than providing a comprehensive solution, and which are damaging confidence in a key growth sector of the economy. We think that the proposed legislation would have been largely ineffective but would have imposed considerable administrative burdens and costs on businesses, coupled with a high level of uncertainty as to whether taxpayers were caught by the new rules.

We welcome the opportunity for further consultation on this issue. This should give sufficient time for proper consultation and we believe that this is an opportune time for a considered review of the UK's small business taxation policy.

We still believe the solution to the problem found in these areas is a reinvigoration of the small business tax review, launched in 2004. The only tangible outcome from this review that has been seen to date is to raise the small companies' rate of taxation. It could be used, however, as a constructive consultation process to identify some longer term answers to questions such as:

- how owner/managed businesses should be taxed;
- how this should interact with social security (including tax credits) provisions for families;

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- how this might be achieved in a way which is workable in practice by taxpayers who may not have a detailed understanding of tax rules nor the resources to seek expert help; and
- how it should be framed so that it is in accordance with our Ten Tenets for a Better Tax System (summarised in Annex A).

ICAEW recommendations:

- A thorough review is needed of all aspects of UK small business taxation policy and related areas.
- The small business tax review needs to be reinvigorated in consultation with stakeholders.

4. Capital Gains Tax reform and entrepreneurs' relief

The move to a flat-rate of CGT is a potentially welcome simplification but will create winners and losers. In particular, many employee shareholders who previously would have qualified for the effective 10% CGT rate because their shares qualified as business assets, will not qualify for the new entrepreneurs' relief and will therefore be faced with an 18% CGT rate.

The new entrepreneurs' relief will be a very useful and valuable relief for gains up to the £1m limit. We recognise that the £1m limit is a policy decision and understand the rationale for it. However, given that the new relief is aimed at entrepreneurs, rather than business people looking to retire, we are concerned that the £1m limit will not necessarily encourage 'serial' entrepreneurs to reinvest in new businesses.

The entrepreneurs' relief rules are based on the retirement relief rules as they existed before they were phased out in 1999. The rules for partnerships and companies are not identical, with the latter being generally more restrictive in that the shareholder must be an officer or employee and own 5% or more of the voting rights. The business world has moved on since 1999 and there is now an alternative business structure, the limited liability partnership (LLP), which combines some of the flexibility of a partnership structure but with an element of limited liability. While LLPs are treated as partnerships for tax purposes, we question whether the new relief takes proper account of this new type of business vehicle and, in particular, whether the old retirement relief restrictions on personal holding companies are still appropriate given the advent of LLPs as an alternative business structure. It is worth recalling that the retirement relief rules were not without problems and many of these are simply being re-enacted in the new relief.

Nevertheless, we welcome the introduction of some relief but are concerned that taxpayers should have been given more time to understand its implications. The announcement of the new relief was not made until 24 January 2008, despite statements that this would be done before Christmas, and the delay meant that the detailed draft legislation was not finally available until 28 February 2008, with the new rules coming into force on 6 April 2008.

We remain concerned that the proposed changes have not respected taxpayers' legitimate expectations. To take just one example, there are a number of situations

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where, under current rules, disposals of business assets will now qualify for business asset taper relief but, if they are disposed of after 6 April 2008, they will not qualify for entrepreneurs' relief. We believe that a fundamental principle of taxation is the preservation of legitimate expectations. We believe that the move to a flat-rate CGT would have been assisted by improved transitional rules, either by grandfathering existing reliefs and/or providing taxpayers with a longer period to reorganise their affairs.

We agree with the all party Treasury Select Committee recommendation in its report on the Budget that 'we note that the entrepreneurs' relief does not resolve all the problems created as side-effects by the changes to the CGT regime. We believe that, if the Government is seeking further to simplify taxation for small businesses, it will need to undertake a broader review and consultation which examines the fundamentals of the tax regime.'¹

ICAEW recommendations:

- The £1m limit should be kept under review and its effect on encouraging investment by serial entrepreneurs monitored.
- The conditions that must be met to claim entrepreneurs' relief need to be examined to see if they are appropriate, given that they are based on the old retirement relief code and that the business environment has moved on since those rules were in force.

5. Residence and Domicile

We welcome the changes announced in the Budget to the proposed new regime for non-domiciled individuals and changes to the residence rules. Similar comments in relation to legitimate expectations apply to the residence and domicile changes as they apply to CGT mentioned above. We are concerned, however, that the new regime is now highly complex, for instance the rebasing election available to trustees of non resident trusts. Schedule 7 runs to 55 pages and we are concerned that much of the drafting is opaque and its purpose difficult to understand, giving rise to considerable uncertainty as to the scope of the provisions. Also, the last minute rush to change policy meant that a number of provisions were not drafted in time and could only be included as references in the Explanatory Notes.

Clarity and certainty is vital to our internationally mobile workforce. The new rules highlight the need for a clear set of rules around who is and who is not resident in the UK. We do not have a statutory test unlike, say, the United States. We believe such a test would be a sensible addition to these proposals.

We also remain concerned that the new rules will impose considerable compliance burdens and costs on relatively low earning non-domiciled individuals. Such individuals are now much more likely to find themselves within the self assessment regime.

¹ Treasury Select Committee, Ninth Report of Session 2007-08, The 2008 Budget pg 59
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Impact on low earners

While the focus of these changes is on increased tax from the 'super rich', the need to formally claim the remittance basis and the loss of personal allowances and the CGT annual exemption will increase the tax rate on all non-domiciles. Many non-domiciles will not be particularly well off and they may not even realise that they face an increased tax bill in the UK.

In addition to the increased tax charges, the changes will also impose significantly higher administrative burdens and associated costs on many non-domiciles. This is because they will now need to take advice on their UK tax position and they may now need to complete a UK tax return whereas currently many non-domiciles do not need to do so. The raising of the de minimis limit from £1,000 to £2,000 announced in the Budget was a start but will do little to alleviate the compliance burdens that this change introduces. We remain of the view that the de minimis should be set at a higher level.

We remain concerned that HMRC will also need extra resources to implement and monitor these changes and that the strains that will be imposed could be considerable at a time when HMRC's budget is being cut in real terms over a three-year period. The alternative is that an over-stretched HMRC will be unable to enforce this legislation.

ICAEW recommendations:

- The residence and domicile changes have highlighted the need for the UK to introduce a statutory definition of residence. The UK is now out of line with international practice in maintaining a rule that is largely based on (often conflicting) case law and practice that does not deal satisfactorily with increased international mobility. A statutory definition of residence is needed to provide certainty to taxpayers, their advisers and to HMRC.
- a further review of the de minimis level to see whether it could be raised further in order to minimise compliance burdens.

Further information

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FINANCE BILL 2008: COMMITTEE OF WHOLE HOUSE BRIEFING

1. Clause 5, small companies' rates

We remain concerned about the increase in the corporation tax rate for smaller companies (with a further rate rise of 1% to follow next year). This change must also be seen in the light of the changes to the capital allowances rules. The phased withdrawal of industrial buildings allowances (IBAs) and agricultural buildings allowances (ABAs) and the reduction in the rate of writing down allowances on plant & machinery from 25% to 20% is likely to impact upon a number of the UK's SME business sectors, including manufacturing, farming and capital intensive sectors such as the hotel industry.

We recognise that the changes to the capital allowances rules, introduced in Finance Act 2007 and completed in this year's Bill were part of a balanced package that also saw the headline rate of corporation tax reduced from 30% to 28%. Nevertheless, smaller businesses will not benefit from the 2% cut in the main rate of corporation tax. HM Treasury believes that the new annual investment allowance (AIA) is very generous and will more than compensate the smaller businesses for the loss of any allowances under the existing regime. We recognise that the AIA is a potentially valuable relief but this will not assist businesses that have made investments based upon the existing rules, particularly the availability of IBAs and ABAs.

There is a lack of a clear strategic plan for small business tax policy. Small business tax policy needs a comprehensive review in consultation with stakeholders so that a clear strategic framework is established within which small businesses can plan and operate with certainty.

We still believe the solution to this problem is a reinvigoration of the HM Treasury's small business tax review, launched in 2004. It could be used as a constructive consultation process to identify some longer term answers to questions such as:

- how owner/managed businesses should be taxed;
- how this should interact with social security (including tax credits) provisions for families;
- how this might be achieved in a way which is workable in practice by taxpayers who may not have a detailed understanding of tax rules nor the resources to seek expert help

2. Clause 6 and Schedule 2, Rate etc

Clause 6 and Schedule 2 enact the Government's proposal, announced in the 2007 Pre Budget Report on 8 October 2007, to reform the Capital Gains Tax (CGT) rules and introduce a new 18% flat-rate of CGT. We have welcomed in principle the Chancellor's move to make a significant simplification of the existing CGT regime but we remain concerned about a number of aspects.

CGT policy

This is the third CGT regime in the space of ten years. There was no consultation on the proposed changes. The flat-rate marks a complete reversal of the taper relief rules, a regime that was introduced in 1998 and substantially amended in 2000 and

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2002. Taper relief provided a favourable rate of CGT for disposals of business assets and in respect of non-business assets encouraged the holding of assets for the longer term. Changing the CGT system in such a way does not provide the stability that businesses need to plan their affairs properly.

The need for proper transitional provisions

We welcomed the introduction of entrepreneurs' relief as a mechanism to alleviate the impact of the changes proposed in the PBR but are concerned that taxpayers should have been given more time to understand the implications of this new relief before it is implemented. The announcement of the new relief was not made until 24 January 2008 despite promises that this would be done before Christmas, and the delay meant that the detailed draft legislation was not finally available until 28 February 2008, when the new rules came into force on 6 April 2008.

Impact on employee shareholders

The move to a flat-rate CGT will create winners and losers. The winners appear to be holders of non-business assets, for example second homes, and particularly those who have held non-business assets for a short period, where their tax charge will fall from 40% to 18%. However, many employee shareholders who previously would have qualified for the 10% CGT rate as their shares qualified as business assets will not qualify for entrepreneur's relief and will therefore be faced with an 18% CGT rate. In the light of these changes, we believe that there is a lack of clarity about the direction of tax policy in relation to encouraging employee shareholders and the interaction of the new rules with existing reliefs to encourage employee share ownership such as the enterprise management incentives (EMI) scheme.

3. Clause 117 and Schedule 40, Penalties for errors

These provisions arise out of the HMRC Powers review. The Schedule extends the new penalty provisions that were introduced in Schedule 24 of the FA 2007 for the purposes of income tax, corporation tax, CGT and VAT to a further range of taxes, duties and levies, including inheritance tax, stamp duty land tax, stamp duty, petroleum revenue tax, insurance premium tax and a wide range of duties.

We are disappointed that the penalty provisions are being extended in this way when the commencement order for the FA 2007 has only recently been laid and where as a result of the transitional rules the impact of these changes is unlikely to be felt until 2010. The FA 2007 penalty provisions are far-reaching and we think it is right that these recently introduced provisions should be given time to bed down before consideration is given to extending them further. We think it is wrong in principle to extend provisions which have just been introduced where there is as yet no evidence that they will work or encourage good compliance.

Further, whilst in principle we favour alignment where this makes sense, we do not agree with alignment for the sake of alignment, particularly if it gives rise to other problems. We are not convinced that penalties based on underlying behaviour and which differentiate between prompted and unprompted disclosure are appropriate for one-off taxes such as inheritance tax and stamp duties.

In relation to inheritance tax, we think that they are inappropriate for personal representatives who are often unpaid laymen and who may have to try to piece together historical information from inadequate records which the deceased had

responsibility for creating. In such circumstances the penalty will not necessarily reflect the behaviour of the personal representatives – and may not even reflect that of the deceased, as records might exist of which the personal representatives are unaware.

In clause 117(3), it will be very confusing to taxpayers if new obligations are imposed on them piecemeal. The whole Schedule ought to be brought into effect on a single date.

Clause 117(4) gives HM Treasury wide power to rewrite these provisions in whatever way it thinks is appropriate. We do not think that HM Treasury should be given such wide powers to override the will of Parliament in a way that is detrimental to the taxpayer. Nor do we think they should be given a free rein to dictate any transitional provisions. This provision could be used in such a way as to alter fundamentally the penalties for which a person is liable and it should be for Parliament, not HM Treasury, to extend any penalty provisions. In clause 117(8), we think that an order should require a positive resolution of Parliament.

In para 3 of Schedule 40, new paragraph 1A(1)(c) should only apply where the inaccuracy was attributable to T 'knowingly' supplying false information. This appears to be what was envisaged by HMRC, as the explanatory notes refer to the information being 'deliberately' supplied.

Further information

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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.co.uk/index.cfm?route=128518>.