THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Tax Faculty

Tax Representation

TAXREP 13/06

FINANCE (NO 2) BILL 2006

Memorandum submitted on 15 May 2006 to Government by the Tax Faculty of the Institute of Chartered Accountants in England and Wales

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FINANCE (NO 2) BILL 2006

INTRODUCTION

1. We are writing to provide our comments on the provisions contained in the Finance (No 2) Bill 2006.

2. We have issued a number of briefing papers for MPs in respect of clauses that have already been discussed in the House and the first two Standing Committee debates. We will continue to issue briefing papers on key clauses as the Finance Bill debate progresses through Standing Committee. The purpose of this paper is to bring together in one place our comments on the Finance Bill, including our general comments on the overarching themes in the Bill. The comments in this paper are consistent with our earlier briefing papers.

3. As in previous years, we have judged the Finance (No 2) Bill 2006 by reference to our 'ten tenets for a better tax system'. These are the ten key principles that we believe should underpin a good tax system and they are set out in Appendix 1.

4. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Appendix 2.

GENERAL COMMENTS

The need for proper consultation

5. We welcome the Government's commitment to consultation. However, this commitment has been undermined by a failure to consult on key changes proposed by this Bill. In particular, the changes to the inheritance tax rules for accumulation and maintenance trusts and interest in possession trusts were both unwelcome and unexpected, particularly as there has been an ongoing consultation for the past two years or more on the modernisation of trust taxation and these crucial issues were not discussed. Apart from the lack of consultation on this matter, this raises questions in our minds as to the value for us as stakeholders in making submissions when they have no relation to the eventual report and decision .We do not think that these proposals were such that there should have been no prior consultation.

6. Although we appreciate that it is not strictly a Finance Bill point, similar comments apply in relation to the proposals in the report by Lord Carter on HMRC's on-line services to bring forward the income tax filing date from 31 January to 30 September for paper filing and 30 November for electronic filing.

7. These two measures alone have resulted in considerable disappointment and undermined the credibility of the consultation process. Whilst we will continue to work constructively to resolve such issues, it needs to be appreciated that we are under pressure from our members to explain whether there is much point and value in contributing to lengthy consultation exercises. We urge the Government to consider very carefully the need for full and open discussion right at the start of policy formation and, if necessary, an extended consultation period to enable new ideas to be fully considered.

The need for reasonable transitional arrangements

8. A number of measures in this Finance Bill have been introduced with inadequate transitional provisions. The almost immediate withdrawal of the home computer exemption (clause 61) has resulted in considerable wasted costs by employers. The transitional provisions for trusts affected by the changes to the inheritance tax rules (in clause 157 and Schedule 20) will mean huge upheaval and resultant costs for all existing trusts and wills. Whilst it is perfectly proper for Government to make policy changes, the inclusion of reasonable transitional arrangements would have done much to reduce the furore that has resulted from these measures.

Use of Statutory Instruments for major legislation changes

9. Many clauses in the Bill contain little detail, but instead are enabling legislation for statutory instruments (SIs). This is an increasing trend seen over the past few years. Whilst this is an acceptable procedure when the primary legislation sets out clearly the principal law, leaving the SIs to add minor detail, it is not acceptable when the SI contains major elements which should in our view be in the primary law.

10. The use of SIs in this way decreases the opportunity for both Parliamentary scrutiny and public debate, and in particular makes it very difficult at a later stage to determine what Parliament intended. As a temporary measure this year, we consider that all such SIs in this year's Finance Bill should be legislated under the affirmative procedure so as to permit at least some Parliamentary scrutiny. We would welcome confirmation that this will be the case. We also think that the whole issue of the legislative process, scrutiny, comment and contribution should be aired to ensure the preservation of democratic principles.

The need for properly targeted legislation

11. Some of the anti-avoidance rules, for example clauses 76 on financial arrangements and 79 on transfer of assets abroad, appear to be more widely targeted than needed with the result that they will catch transactions not designed to avoid tax. We understand fully the need to counter avoidance, but remain concerned that the legislation should be properly targeted so that transactions with no tax avoidance motive are not caught.

Potential breaches of EU rules

12. We are concerned that a number of clauses in the Finance Bill are in potential breach of our EU treaty obligations. As we have seen in the past, this inevitably leads to uncertainty and litigation. Particular examples of clauses where we think this is a problem are clause 2 on evasion of tobacco duty, clauses 19 to 22 on missing trader intra-community fraud, power to inspect goods, record-keeping directions and credit vouchers and clause 81 on leases of plant and machinery and we refer you to our comments below on those clauses.

Highly complicated

13. Much of this Finance Bill is highly complicated and the full meaning of its provisions not immediately obvious. For example, whilst many of the provisions set out in Schedule 6 on financial arrangements are laudable in seeking to stop tax avoidance, they add yet another layer of complexity to the UK tax system. It would aid clarity if there were clearer statements of the 'mischief' at which anti avoidance provisions such as these are aimed.

14. As to whether the full meaning of the provisions is clear, we need only turn to the provisions of Schedule 20 on trusts. These are relevant for deaths on or after Budget Day but no one, including HMRC staff, can yet confirm precisely the circumstances in which they will apply.

UK competitiveness

15. We are concerned that this latest Bill will continue to undermine the UK's traditionally very strong competitive position vis-a-vis other major industrialised nations and will make the UK a less attractive location for investment in the future.

16. We appreciate that the UK's competitive position depends upon a number of factors and that potential investors in the UK will consider the whole business environment and not just the tax system in isolation. Our experience is that the UK is becoming regarded as a more difficult place to do business, with the complexity of the tax system being perceived as a disincentive to invest. We know that international competitiveness is an issue that concerns the Government and we think the Government needs to consider with the tax profession new ways of countering avoidance that do not blunt the UK's competitiveness.

The need for more scrutiny of the Finance Bill and greater strategic oversight

17. The above comments underlie a concern that we have felt for some time, namely that the UK tax system has been spinning out of control. There does not appear to be enough time for detailed scrutiny of the provisions, nor does there appear to be any parliamentary mechanism designed to provide a strategic oversight and direction of the UK tax system.

18. We think that there is a need for greater Parliamentary scrutiny and oversight of the UK tax system. Whilst we recognise the value of bodies such as the House of Lords Economic Affairs Committee Finance Bill Sub-committee to which we have given evidence, we think that there should be a permanent committee charged with this task. We accept entirely that tax policy is a question for the Government of the day to decide. Instead, we see the role of this committee more as an enduring management role, largely independent of the Government of the day and perhaps including some members from the House of Lords. In discharging its role, we would expect it to seek evidence and advice from all those who have a stake in the UK tax system, including businesses, tax advisers and HMRC.

PART 1

EXCISE DUTIES

Clause 2 - Tobacco products duty: evasion

19. We find it difficult to understand why clause 2 is necessary, and would welcome clarification. In legal terms, section 77A Customs and Excise Management Act 1979 and Schedule 11 VATA 1994 provide powers to HMRC that appear to fulfil the same objective. In practical terms, as stated at paragraph 5.6 of the HMT/HMRC March 2006 paper New Responses to New Challenges: Reinforcing the Tackling Tobacco Smuggling Strategy, voluntary cooperation between HMRC and UK tobacco manufacturers through the 'Memorandum of Understanding' ('MoU') procedure has been acknowledged as a success:

> 'MoUs between HMRC and the UK tobacco manufacturers have been an important element of the strategy, and have played a crucial role in restricting the availability of genuine cigarettes to smugglers. Since its peak in 2000/01, the incidence of UK manufactured cigarettes being smuggled into the UK has fallen markedly, from about 75 per cent of large seizures to 28 per cent in 2003/04.'

20. It is difficult to see how a provision which duplicates existing law and introduces a penalty of up to £5 million can 'facilitate and encourage dialogue between the tobacco manufacturers and the Government', particularly since the clause will be impossible to implement in practice. We doubt whether it is effective under European law, because:

- The tests that manufacturers are expected to carry out are too subjective. The clause implies that it is possible for a business to second guess the intentions and future actions of a customer. This is an impossible requirement. The test should be objective, ie the manufacturer should be advised not to trade with specific named customers.

- The clause gives sweeping powers to HMRC and is disproportionate.

- Some of the provisions can be introduced by secondary legislation. Although this procedure can be acceptable in certain circumstances, given the impact on the recipient of a notice under these provisions, for this clause it is not.

- There are jurisdiction and territoriality problems with this clause. For example, it is difficult to see how HMRC can enforce the clause on any non-UK manufacturer, for the simple reason that such a person is outside the jurisdiction of the UK government and courts.

- The provisions of this clause may result in legitimate transactions being obstructed, thereby restricting trade, and leaving HMRC open to claims for damages.

- In new section 7C(3), the review by HMRC does not provide for it to be carried out by any particular person, for example someone different from the officer who authorised the notice. Any such review should be at Board level.

- There appears to be no adequate provision for independent review of the actions of HMRC. In new section 7C, as there is no amendment proposed to section 83 VATA 1994, it is not clear on what grounds a taxpayer can appeal to the Tribunal.

- The giving of a notice under these clauses should be subject to HMRC having to apply to the Tribunal in advance. If Government/HMRC really wish to defeat smuggling, then it will have to be done by consensus rather than confrontation with manufacturers, therefore any such hearing should be inter partes.

- The size of the fine (up to £5million) means that it is criminal in nature, and so we question whether it either appropriate or lawful for it to be imposed administratively, and not by a court.

21. In short, it seems likely to us that unless tobacco manufacturers are content with the wording of this clause, it risks being the subject of lengthy litigation in the UK and at the ECJ.

PART 2

VALUE ADDED TAX

Land

Clause 17 - Buildings and land

22. It is not possible to comment in any meaningful way as the clause contains only enabling provisions. In any event, this clause should be withdrawn. As we have stated in our general comments, we do not consider it appropriate to rewrite primary legislation by means of Statutory Instruments. Revisions to Schedule 10 of the VATA should be amended in a Finance Act, and thus subject to proper Parliamentary scrutiny and public debate.

33. We contributed to HMRC's consultation exercise on the redrafted Schedule 10, and consider that there should be further consultation on the rewrite of all of the Schedule once the responses to the first consultation have been analysed and another draft of the law produced. Given the complexity of the existing legislation, we consider that the final text of the law should be generally accepted by HMRC and taxpayer representatives alike as being not only in conformity with EU law and the EU Treaty, but as being practical to administer. The final outcome should take into account the views of those who have contributed to publicly-available exposure drafts, as is the case with the direct tax Tax Law Rewrite Project.

Imported works of art etc

Clause 18 - Value of imported works of art etc: auctioneer's commission

24. This clause implements the ECJ judgment of 9 February 2006, which decided that the UK had failed to implement the law correctly. The effect of the judgment is to increase the VAT chargeable on auctioneers' commissions from 5% to the 17.5% standard rate. Whilst it is necessary to implement the judgment, it nevertheless compounds the damage caused to the London art market when the UK agreed in 1994 to the change in European Law.

Avoidance and fraud

General comments on the avoidance and fraud clauses 19 - 22

25. Both tobacco smuggling and Missing Trader Intra-Community ('MTIC') fraud have been endemic in the UK for many years, despite the efforts and increased resources devoted by HMRC. Between them, they cost the taxpayer up to £5 billion per year. Fraud and tax evasion are unacceptable in a democratic society, and the ICAEW supports measures to reduce and/or eradicate it. We particularly welcome the decision to apply the reverse charge to supplies of goods liable to be used on MTIC fraud down the supply chain until the retail stage as we (along with others) have been recommending this for some years.

26. Nevertheless we cannot support the way the reverse charge will be applied, since it appears more designed to transfer the responsibility for policing or controlling the fraud from the state to the taxpayer than to deal with the fraud itself, and can be applied by HMRC in ways that do not respect the rights of the innocent taxpayer. Whilst that may not contravene UK law, it is not an attractive picture.

27. We are concerned about the need to respect taxpayers' rights, a need that has been demonstrated in a number of recent court decisions. Examples at the ECJ include Fulcrum/Optigen/Bond House and the Advocate Generals' Opinions in FTI and Kittel-Recolta and in the UK the VAT and Duties Tribunals decisions in Totel Distribution (18956), UK Tradecorp (several eg 18992) and Deluni Mobile (19205).

28. More seriously for the Government's strategy itself, some of these Finance Bill provisions raise serious questions as to whether they do conform to the requirements of European Law, which has long-established provisions protecting the rights of innocent taxpayers.

29. It would be most unfortunate if these provisions merely lead to further litigation and Government defeats in the courts. We suggest that a more proportionate approach could both achieve the desired objectives and procure the cooperation of business as a whole.

30. Both the European Commission and the then HM Customs & Excise were well aware at the time of the obvious risk of MTIC fraud from the inception of the Single Market changes from 1 January 1993. However, the VAT system then introduced was considered temporary and was only expected to last for three years. Thirteen years later, Member States have still not agreed on the replacement system, and there is little sign of that happening for many years to come, if ever. As a European Commission official stated in a letter published in the Tax Journal of 24 April 2006:

> 'the conditions for carousel fraud stem in large measure from the refusal of certain Member States, including the UK, to move to the "definitive" VAT system proposed by the Commission in the late 1980s and agreed in principle by the Council in 1991: it is the non-taxation of intra-Community supplies (exports to other Member States) that gives the "missing trader" his opportunity to steal from honest taxpayers.'

31. In our representations on the 2003 Finance Bill, we were concerned that the 2003 legislation provided insufficient safeguards for legitimate business, and it is now clear that this is indeed the case. We also stated at the time the risk would be that HMRC would take action against legitimate businesses in the chain (since those are the ones which remain after the fraud has taken place) and this is what has happened. We remain of the view that it is inappropriate for HMRC to have introduced legislation and to pursue court cases against businesses where there is no evidence of involvement in the fraud.

32. We also think it unfortunate that UK businesses have had to go to the ECJ and that it was not possible for the UK itself to take a measured and proportionate approach.

33. As the Advocate General in the European Court of Justice said in February 2005 in his Opinion in the Optigen case such an approach:

> '… would drastically shift the burden of the problem from the tax authorities to the private sector, at the expense of legitimate trade and the proper functioning of the VAT system.'

34. We have learned from our participation in HMRC's MTIC fraud workshops that there is a major and at times violent criminal element involved in these frauds. This is a cause for serious concern and it requires serious counter measures We are therefore puzzled as to why HMRC appear to be tackling MTIC fraud as if it were 'simply' tax evasion, rather than an activity carried out by criminal gangs, and question whether HMRC themselves have the resources or necessary experience to combat this sort of activity. Given that this is serious fraud, it would appear far more appropriate for the Serious Organised Crime Agency to lead on this with HMRC providing technical advice and back-up.

Clause 19 - Missing trader intra-community fraud

General comments

35. As mentioned above, we welcome the decision to apply the reverse charge to supplies of goods liable to be used on MTIC fraud down the supply chain until the retail stage. We (along with others) have been recommending this for some years. We note the UK's request to the European Commission for a derogation to this effect. The use of the reverse charge will provide a partial, but substantial, solution to the problem. As HMRC know, the change will create a further avenue for fraud - a dishonest purchaser will fail to apply the reverse charge and will be able to sell the goods 'VAT free'. However, we agree with HMRC that the extent of this new fraud is likely to be considerably less than if MTIC fraud itself were allowed to continue in its present form.

36. The Government's strategy should be to work with business and their representatives, the European Commission and other EU Member States to prevent MTIC fraud. This is unlikely to be achieved in the UK if we continue to pass legislation which makes honest businesses responsible for paying VAT misappropriated by others in the chain of transactions. As a European Commission official stated in a letter published in the Tax Journal of 24 April 2006, explaining why the Commission had intervened against the UK in the Optigen case:

> 'It is naturally necessary to take vigorous measures to combat tax fraud, but that objective does not justify making innocent bystanders pay for the crimes of others.'

37. As they stand, the provisions in clause 21 are likely to create further similar injustices, further court cases, and further defeats for the UK.

Detailed comments

38. Turning now to the legislation itself, we have the following comments.

The 'disregarded amount'

39. We understand that the 'disregarded amount' in new section 55A(1)(d) applies only for the purposes of ascertaining liability to be registered.

40. We see little point in having a disregard of £1,000 which is only going to affect businesses with turnover of between £60-61,000. It seems to introduce unnecessary complexity and we would welcome clarification of its rationale.

41. We would welcome confirmation in new section 55A(3) of how the wording 'in so far as their total value exceeds' is applied where transactions exceed the disregarded amount. For example, on the basis of a disregard of £1,000 and transactions of £10,000, are we correct in concluding that the first £1,000 is ignored and only £9,000 is taken into account for the purposes of Schedule 1?

Impossible proofs

42. New section 55A(6) sets out the conditions when the reverse charge will apply and the recipient, rather than the supplier, needs to account for the VAT due on the supply. The clause states:

> (6) If—
> (a) a taxable person makes a supply of goods to a person ("the recipient") at any time,
> (b) the supply is of goods to which this section applies and is not an excepted supply, and
> (c) the recipient is a taxable person at that time and is supplied in connection with the carrying on by him of any business,
>
> it is for the recipient, on the supplier's behalf, to account for and pay tax on the supply and not for the supplier.

43. First, it is not clear what is meant by 'on the supplier's behalf'. If the supplier is to be held jointly and severally (or otherwise) liable for the VAT due if the recipient does not in fact account for the VAT under the reverse charge procedure, then, unless the supplier has acted recklessly or is a party to the fraud, it is yet again a question of 'making innocent bystanders pay for the crimes of others'.

44. Secondly, it is unclear how the supplier can verify for certain that the two conditions in sub-paragraph (c) have been met.

45. The taxpayer making the supply of the 'relevant', but not 'excepted' goods, will have to determine under new sub-section 55A(6)(c) that:

- his customer is registered for VAT at the time the supply is made, and
- that the customer will use the goods for a business purpose.

46. If either test is failed, the supplier will have to pay the VAT over to HMRC, even though he neither charged it to, nor received it from, his customer. The first test is difficult – whilst the supplier can telephone HMRC to confirm the VAT registration number and name and address of the customer, many businesses have more than one address. Hijacked VAT numbers are also used in this type of fraud, giving an appearance of legality. The second test requires the supplier to decide what his customer will in fact do with the goods.

47. We consider that it is not possible for any supplier, acting in good faith and with normal diligence, to obtain absolute proof that these two conditions have been met, since he is neither entitled nor privy to the necessary information. As a result, he is faced with what is known in EC Law as an impossible proof, or probatio diabolica. The clause therefore risks being unlawful since it does not meet the principle of legal certainty. Irrespective of the legal position, we question whether it is moral or appropriate for a tax authority to legislate to impose impossible conditions on taxpayers.

48. One partial solution to such legal challenges is for the supplier to have an unfettered right of appeal to the courts on a 'reasonable excuse' basis, namely that he did take all reasonable steps to ensure that the conditions were met. In addition, HMRC should publish guidance on what they consider those steps should be.

Relevant supplies - cat and mouse

49. Given that the supplies within the clause, namely 'relevant supplies', have to be listed in a Treasury Order under new section 55A(9), there remains the risk that fraudsters will ensure that the goods they use as part of their MTIC fraud are not those within the provisions of this clause. This will create a cat and mouse situation with HMRC having to include additional goods within the regime once they discover what goods are being used by the MTIC fraudsters. The fraud could also move to services.

Clause 20 - Power to inspect goods

50. We can see the value of this clause, as it will deter the multiple use of the same goods in MTIC frauds. Nevertheless, we are concerned that this clause goes far further than necessary, and contains insufficient safeguards. It gives HMRC the power to have any goods (whether linked to MTIC fraud or not) completely unpacked and then marked.

51. The legislation must require HMRC to apply the new law in a proportionate way, and only to MTIC fraud. To ensure this, there should be a requirement for HMRC to act reasonably, with a full right of appeal to the VAT Tribunal, and the new sub-paragraph 10(2A)(a) should include a provision to ensure that marks are such that they do not damage or spoil the goods or its packaging or otherwise decrease their value. There should also be a specific provision requiring HMRC to pay compensation if the value of the goods is impaired, or their sale unreasonable delayed. We accept that under current law, businesses have to bear the cost of any damage or repackaging when HMRC inspect goods or take samples, but normally only a few

items are involved. These new provisions can be applied to all the goods held by a business, and it is both unreasonable and disproportionate for a business to be required to bear what could be very significant extra costs.

52. In new sub-paragraph 10(2A)(b), we would welcome clarification of the meaning of 'information … relating to the goods'. We suggest that this should be the same as the information required to be shown on a tax invoice.

Clause 21 - Directions to keep records where belief VAT might not be paid

General comments

53. If clause 21 is used to require a business to keep what are normal business records, then it is unexceptionable, except that HMRC already have the power to do that under existing law.

54. If it is asking them to keep records out of the ordinary, for example, for reasons that have nothing to do with the business itself but with another business of which the first may not even have heard, then that must be subject to the proportionality test. It could force businesses to additional expense, perhaps hiring further staff.

Right of appeal

55. Sub-clause 21(4) extends the list of matters that can be appealed to a tribunal in section 83 VATA 1994 to include the direction to keep records introduced by this clause but sub-clause (5) amends section 84 VATA 1994 to block any effective right of appeal.

56. The appeal procedures probably contravene EU, and human rights law, for the following reasons.

57. The Tribunal can only apply the 'reasonable' test to HMRC, so it is not even a proper appeal - only the facts that HMRC had at the time of their decision can be reviewed.

58. A right of appeal is meaningless if it is limited to cases where the taxpayer has to show that HMRC could not reasonably have been satisfied that there were grounds for issuing a direction. Quite apart from the fact that the taxpayer does not know what information HMRC have (and HMRC might not be prepared to inform him, since it may not involve the taxpayer at all but another business totally unknown to him), the Tribunals have interpreted this restriction in appeal rights to mean that they cannot even look at all the evidence available to them at the time of the hearing. They are instead limited to looking at what information was available to HMRC when they made the direction, and deciding if in the light of that material the direction was reasonable. In effect, if HMRC only have half the facts when they make the direction, perhaps because the facts were not available or because HMRC have been unable fully to investigate them, there is nothing the Tribunal can do about it other than to request HMRC informally to review its decision whilst turning down the appeal.

59. We can see the sense the Direction remaining in force so that businesses must keep the required records until an appeal is heard, but the quid pro quo for that must be that:

- the business has a full right of appeal and the courts an unfettered jurisdiction to decide,
- the onus of proof must be on HMRC, since only they will have all the information and the business may well know nothing, and
- HMRC will pay compensation for any extra record-keeping costs, without the business incurring the cost of having to sue, if the court holds that HMRC have acted unreasonably.

60. If left unchanged, these provisions will merely lead to further litigation and Government defeats in the courts, particularly the ECJ. We do not think that UK businesses should have to seek relief at the ECJ when the UK could take a measured and proportionate approach in the legislation. HMRC do need to appreciate that the war against fraud will only be won by engaging the cooperation of legitimate businessmen and advisers, not by alienating them.

Changes to amount of penalty

61. Clause 21(2) inserts a new section 69B into VATA 1994 which provides that a person is liable to a fixed penalty for failing to comply with a direction to keep records. Sub-section 69B(4) provides that where there is a 'change in the value of money' the Treasury may by Order substitute new sums in place of those specified. We assume that this is intended to be a simple means of indexation or approximate indexation to keep the penalties level in real terms; however, confirmation would be appreciated. We would also welcome clarification of how the 'change in the value of money' in new section 69B(4) will be measured.

62. The maximum penalty for failing to comply with a direction to keep records is £6000, which can be regarded as a criminal sanction, particularly for a small business. We consider it preferable that changes to criminal penalties are specifically legislated for by Parliament in primary legislation, rather than put through without proper debate in an SI.

PART 3

INCOME TAX, CORPORATION TAX AND CAPITAL GAINS TAX

CHAPTER 1

INCOME TAX AND CORPORATION TAX: CHARGE AND RATE BANDS

Corporation tax

Clause 24 – Charge and main rate for financial year 2007

63 The ICAEW is concerned that the main rate of UK corporation tax, 30 per cent, is no longer regarded as internationally competitive. A recent presentation by Michel Aujean, Director of Analyses and Tax Policies at the European Commission, showed that the headline corporation tax rate of the ‘old’ 15 Member States of the European Union has come down from 35 per cent in 1996 to 25.9 per cent in 2006. The issue is particularly acute in relation to Ireland, which has a 12.5% rate of corporation tax. Whilst tax is only one of a number of issues to consider when making investments, the Irish approach appears to be particularly successful in attracting inward investment that might otherwise have come to the UK.

64 We think that Government should undertake a formal review with business of the main rate of corporation tax with a view to reducing it.

Clause 26 – Abolition of corporation tax starting rate and non-corporate distribution rate

65 We welcome the fact that this measure will help to simplify the corporation tax system. However, for some companies, this measure will result in a tax increase and will mean that many companies with very small levels of income will now have a corporation tax liability.

66 We have suggested that as a deregulatory measure, there should be a de minimis whereby clubs and societies, including residents’ associations, amenity societies and the like, do not have to complete returns or pay corporation tax where their taxable income is less than £500.

CHAPTER 2

RELIEFS FOR BUSINESS

Group relief

Clause 27 and Schedule 1 – Group relief where surrendering company not resident in UK

67 Clause 27 and Schedule 1 are designed to give effect to the European Court of Justice decision in the case of Marks & Spencer plc v David Halsey (C-446/03).

68 We believe that, as currently drafted, paragraphs 6(4) and 7(4) are impossible to comply with and neither provision complies with the EU legal principle of effective remedy. The conditions in paragraph 6(4) are impossible to meet because the trader has to make sure that a third party has taken 'every step' to ensure that the loss in question has been taken into account or relieved. In the case of Marks & Spencer ('M&S'), that would have required M&S to know how Galeries Lafayette (the purchaser) had used the losses in question and, moreover, for M&S to procure that Galeries Lafayette did (or did not) pursue certain courses of action with respect to the losses. Our understanding is that M&S would have had no enforceable means of procuring this information and did not have the ability to procure that Galeries Lafayette did (or did not) pursue a particular course of action in respect of the M&S France SA's losses.

69 The proposed ICAEW amendment which we put forward for debate in Standing Committee requires the claimant to take 'every **reasonable** step'. We believe that the interposition of the word 'reasonable' means that the test is in conformity with the EU principle of effective remedy.

70 The Marks & Spencer case has been referred back to the UK Courts to determine the practical implications of the decision. In the UK High Court, Park J gave his Judgment on 10 April 2006 ([2006] EWHC 881). The judgment considers the 'relevant time at which M&S has to demonstrate that the conditions of paragraph 55 [of the ECJ decision] were satisfied in relation to the losses of [the German and Belgian subsidiaries]. The first option is 'the end of the accounting period of loss' of those subsidiaries and this is the time limit set out in the existing paragraph 7(4) of the Finance Bill. However Park J states at paragraph 44 of his judgment that '[This] time is too soon, and would be likely to rule out virtually every case'. In other words, if the law is enacted as currently drafted it will be almost impossible for any claims to be made. Park J goes on to say (in paragraph 44) that in his judgment the correct time for the claim is 'the time or times when M&S made the claim or claims for group relief.

Proposed amendments

71 Replace existing paragraph 6(4) of Schedule 1 with the following:

6(4) An amount is regarded for the purposes of this paragraph as meeting conditions A and B if (but only if) every reasonable step to secure that the amount is so taken into account or relieved is taken (whether by the company or any other person).

72 Taking account of the recommendation of Park J in his judgment, replace existing paragraph 7(4) of Schedule 1 with the following:

7(4) In determining for the purposes of conditions A and B whether an amount can be so taken into account or relieved, the time at which the determination is to be made is the time when the company makes the claim or claims for group relief.

Clause 29 – Claims for relief for research and development

73 We understand that the rationale behind the shortening of the time limit from six to two years is to align the deadline with comparable deadlines and that there has been some anecdotal evidence that the longer deadline leads to more indefensible claims. The presumption is that longer deadlines lead to delays in filing claims, by which time the detailed information required may not be available.

74 We are not necessarily convinced by the logic of the policy decision to shorten the deadline. However, if we accept that it is a reasonable decision, the change needs to be publicised actively. Many taxpayers will be used to the longer deadline and, unless they are warned of the change, companies could miss the opportunity to file claims. This applies in particular for periods falling after 31 March 2002 but before 31 March 2006 where the filing deadline has been shortened, for example a company with a year end of 31 December 2005 which would have had a filing deadline of 31 December 2011 prior to the Finance Bill will now have a filing deadline of 31 March 2008. Companies likely to be in this position should be notified of the shortened time limit.

Capital allowances

Clause 30 – Temporary increase in amount of first-year allowances for small enterprises

75 This clause enacts the Budget announcement increasing, for one year only, the rates of first year capital allowances for small businesses. It continues a pattern of small and temporary changes which a recent study has found to be ineffectual in encouraging business investment. The benefits of such minor changes in the rate of First Year Allowance ('FYA') for small business are disproportionately offset by the regulatory impact of uncertainty in the tax rates and the need to keep up-to-date with the changes.

76 The rates of FYA for expenditure on plant and machinery for small businesses have recently been as follows:

Period	First Year Capital Allowance
1998 - 2004	40%
2004 - 2005	50%
2005 - 2006	40%
2006 - 2007	50%
2007 - 2008	40% (current expectation based on 2006 Budget)

77 A recent ICAEW research report by the Manchester and Nottingham Universities Business Schools on 'The Role of Tax Incentives', utilising interviews with small and medium businesses, found that except for the most generous capital allowances (e.g. for energy saving equipment where the allowance is 100%), the tax advantages of capital investment are considered by small and many medium businesses only **after** the decision to invest has been made. Whilst minor changes in the rate such as a 10% increase for one year will provide additional resources to business after expenditure has been incurred, it is insufficient to influence in advance business' decisions to invest.

- If Government policy is to encourage businesses to invest, the incentives on offer will need to be increased over and above those currently on offer. Given that research suggests that rates of 50% will not encourage investment, this would suggest rates of FYA of between 75% and 100%.
- In order to assist with business planning and investment decisions, any changes to the rates of capital allowances should be announced well in advance and maintained for a reasonable period of time. We would suggest three years. However, we understand that this might fall foul of the State Aid rules and would welcome confirmation that this issue has been considered and whether this would be the case.

CHAPTER 3

FILMS AND SOUND RECORDINGS

Introductory

Clause 31 – Meaning of 'film' and related expressions

78 Clause 31(2) sets out the conditions under which each part of a series of films is treated as one film, so for example a series of 26 parts or less each of which lasts one hour is treated as one film. A children's TV show might have fifty 20-minute episodes and it seems odd that this sort of production will be ineligible for single film treatment. We suggest that this anomaly should be addressed.

Film tax relief

Clause 41 – Conditions of relief: UK expenditure

79 This clause refers to the proportion of expenditure which must be in the UK. We would welcome confirmation that this is not considered to breach EU State Aid rules.

CHAPTER 4

CHARITIES

Clause 54 – Charities: Transactions with substantial donors

80 Whilst we appreciate that these rules are presumably designed to counter tax avoidance, the rules are widely drafted and we believe that a number of charities will be hit unexpectedly by these rules. Given that many of the cases caught by the new rules probably concerned straightforward and reasonable tax planning, we believe that there should have been full consultation on this measure beforehand.

81 Further, we think that there should have been transitional rules to protect any arrangements entered into before 22 March 2006.

82 A person is a substantial donor if they make payments of an aggregate of at least £100,000 over any 6 year period (new section 506A(2)). If a person makes regular small payments but then in one year makes a very large payment which takes the aggregate over the £100,000 limit, that would mean that all the payments within the previous six year period would have to be treated as made by a substantial donor. The charity would then have to review any transaction with that person and file amended returns if necessary. We suggest that there should be a de minimis limit below which donations would not count towards the £100,000 threshold.

83 A payment by a charity of remuneration is treated as non-charitable remuneration unless it is excepted (new section 506A(5)). It appears that if the charity is a company any remuneration cannot be excepted even if, as is common, the directors call themselves trustees.

84 A decision of the Commissioners for HMRC (e.g. on whether terms are disadvantageous to the charity) may be reviewed by the Special Commissioners when there is an appeal against an assessment relating to new section 506A (new section 506C(8)). It is not clear where the burden of proof lies in relation to this appeal. Is it akin to judicial review where a decision can be set aside where it is wholly ('Wednesbury') unreasonable? This needs to be clarified.

85 The numbering of the sub-sections in new section 506C needs correcting as there are two sets of sub-sections (2) and (3) in the current HMSO version of the Finance Bill.

CHAPTER 5

PERSONAL TAXATION

Mobile telephones and computers

Clause 60 – Mobile telephones

86 If significant private use of mobile telephones is to be taxable once again, we suggest that there should be a flat rate charge, as was the case before it was abolished from 6 April 1999. This proposal will avoid the need for complex benefit calculations resulting from the availability of a wide variety of payment plans.

87 Given that the benefit is not the calls made but the availability of the phone, we would welcome confirmation of the position where mobile phones contain SIM cards with two telephone numbers, for example, one number for business and one for private use.

88 Where more than one telephone is provided, a not uncommon situation for those who go abroad so that users can take advantage of local rates rather than use the 'roam' facility or have to change the SIM card, please confirm who will decide which instrument is covered by this exemption.

89 Where telephones are provided to those otherwise earning under £8,500, for example non-executive directors and part timers, it will be difficult to value in advance the potential benefit of the phone. Employers will have to put in place procedures to identify if the benefit of the mobile phone takes the individual over the £8,500 threshold. Unless a scale charge is adopted, such procedures are likely to cost more than any resulting taxable benefits.

Clause 61 – Computer equipment

90 Although we understand that this measure stems from the Government's desire to change the focus on to encouraging pensioners and the unwaged to join the digital revolution, the lack of prior consultation and a reasonable transitional provision has resulted in considerable criticism of this measure. The sudden withdrawal of the scheme without any prior consultation has resulted in considerable amounts of wasted time and costs by employers intending to implement schemes this year (including the DWP and DTI) and computer equipment suppliers.

91 Given the Government's desire for citizens to embrace its digital strategy, we think that the way in which this measure has been withdrawn has been unhelpful and undermined the overall drive to encourage the digital revolution. Many current policy initiatives are aimed at encouraging the use of computers and modern technology – a case in point being the online filing proposals in Lord Carter's report – and this proposal undermines those policy initiatives.

92 Given this background, we are not convinced that the Home Computer Initiative (HCI) should have been withdrawn at this particular juncture. If the Government is

concerned that it was being abused, we think the definition of computer should have been redrafted so as to exclude other equipment such as iPODs and games consoles.

93 We believe that the Government's approach should be to consult on the proposed refocus of its policy:

- to tighten the definition of a computer;
- to set an end date for the scheme that will allow for an orderly transition; and
- to consider how pensioners and others might be encouraged to join the digital revolution.

94 We think that these steps will help to defuse the considerable concern that this measure has aroused and encourage continued support for the Government's digital strategy.

95 Please confirm that section 316 ITEPA 2003 will apply where the private use of a computer provided by an employer is insignificant, so that the benefit will be exempt and there will be no need for the employer to report it.

96 Any employee who makes significant private use of a computer provided by his employer will have a taxable benefit in respect of the private use element. The Finance Bill contains no provisions to set out how the benefit of private use will be calculated. The additional burdens on employers, particularly in smaller businesses, will be considerable although any tax charges are likely to be very low. One solution would be to introduce a scale charge.

Vouchers and tokens

Clause 63 – Power to exempt use of vouchers or tokens to obtain exempt benefits

97 We welcome this provision.

CHAPTER 6

THE LONDON OLYMPIC GAMES AND PARALYMPIC GAMES

Clause 65 - London Organising Committee

98 We would welcome clarification as to whether the tax exemption given is considered more generous than those available to other charities carrying on trading activities.

99 The existing charity tax trading rules are fraught with complexity and for the future we request that consideration is given to extending this clause so that it applies more generally to the income of charities.

Clause 68 – Competitors and staff

100 Whilst we appreciate that this is not strictly a Finance Bill point, we would welcome clarification that any exemptions granted under this section will apply also for NIC.

CHAPTER 7

CHARGEABLE GAINS

Capital losses

Clause 70 – Restrictions on companies buying losses or gains

101 This clause tightens up the capital loss anti-avoidance measures, but the result is considerable complexity that very few taxpayers and advisers are likely to understand.

102 The predecessor legislation on group company pre entry losses was introduced in 1993 and 1998 and is contained in TCGA 1992 Schedules 7A and 7AA respectively. In clause 70(2), in new section 184F(4) we think it is laudable to repeal Schedule 7AA. However, new sections 184A-I have been superimposed. New sections 184A and B impose a purposive test. Those who can comply with that still have to pass the mechanistic test in Schedule 7A TCGA 1992. As if that is not enough, there are new sections 184G-H which act as reverse section 734 tests.

103 We think that these provisions need to be reviewed to see if they can be simplified. We are happy to assist with such a review.

104 It would also aid clarity if all of these provisions were consolidated into a single place in the legislation.

CHAPTER 8

AVOIDANCE: MISCELLANEOUS

Financial instruments

Clause 76 and Schedule 6 – Avoidance involving financial arrangements

105 We accept the Government's need to counter avoidance and have always considered that this should be achieved by way of properly targeted anti-avoidance legislation. The problem we see now is that this approach is generating great complexity in the tax system, with many clauses drafted more widely than they need to be and with few taxpayers actually understanding the relevant provisions. We wonder whether in the longer term this is the right approach to countering tax avoidance, and think that the time has come for a review the current approach to countering tax avoidance before the UK tax system drowns in a sea of complexity. We would like to participate in that review.

International matters

Clause 78 – Controlled foreign company and treaty non-resident companies

106 We welcome Conditions A and B which prevent the main provisions applying in the stated circumstances. However we believe clause 78(3), introducing new sub-sections 90(3) – (4) into the Finance Act 2002, is likely to inhibit cross-border merger and acquisition activity both inward bound to the UK and outward bound from the UK.

Clause 79 – Transfer of assets abroad

Introduction

107 The transfer of assets abroad rules are very broad in application given the definitions of 'transfer of assets' and 'associated operations'.

108 Their objective should be to successfully target deliberate avoidance of tax by the transfer of assets abroad without imposing a punitive tax regime on individuals who may make a transfer of assets abroad for non-tax reasons, e.g. establishing a business overseas.

109 The rules in the new draft clauses in Schedule 7 to the Finance Bill are pivotal to achieving this objective.

Burden of argument

110 Under the new provisions, the taxpayer is require to demonstrate 'that it would not be reasonable to draw the conclusion ...' that tax avoidance was the purpose of the transaction. If there is a dispute between HMRC and the taxpayer as to whether exemption under section 741A is available, the terms of this section would appear to

suggest that it would not suffice for a taxpayer to demonstrate before the Court that on balance his analysis is the better one. Would the taxpayer need to go further and demonstrate that the conclusion drawn by HMRC is unreasonable (i.e. one which no reasonable person could have arrived at)?

111 There is no such burden of argument imposed on the taxpayer in other provisions concerning a tax avoidance motive (see for example section 703 ICTA 1988, section 137 TCGA 1982).

112 It would be fairer to the taxpayer to alter the wording such that he is merely required to demonstrate that the conditions in section 741A(1) and (2) are satisfied with a separate section specifying that all the circumstances of the case are to be looked at in considering this.

Condition A

113 We would welcome guidance on the circumstances in which HMRC believe Condition A would be satisfied.

114 Paragraph 60 of the HMRC document 'Transfer of Assets Abroad – Technical Notes on Draft Clause'" sets outs HMRC's view that the new provisions will require that all relevant circumstances of the case must be considered including the 'actual objective outcome of the transactions'.

115 If the actual objective outcome of the transactions is that there is no reduction in the amount of UK tax payable then arguably there would be no need for HMRC to invoke the provisions in section 739 (which would render the exemption in section 741A otiose).

116 Does HMRC envisage any scenarios in which the actual objective outcome of the transactions results in the reduction of UK tax but where the exemption under s741A (1) (a) would still be allowed by virtue of Condition A being satisfied?

Condition B

117 The condition will not be satisfied if any transfer or associated operation is not one that would have been made between independent persons acting at arm's length. If such a transaction occurs, the exemption will be denied even if in all other respects the transactions did not involve any element of tax avoidance.

118 For example, one can envisage a scenario where a UK resident individual establishes a foreign company to trade in another country (which may have higher corporation tax rates than the UK). If the individual provides finance or other assets from his own resources to this company on favourable terms he may view this as 'commercial' to the extent that initially the company may not be generating sufficient revenue to pay interest on the finance or rent for the use of the assets. Nonetheless, the exemption will be denied even if the establishment of the foreign company was entirely motivated by commercial factors.

119 A more equitable approach would be to consider the commerciality of such transactions as one of the factors to be taken into account in determining whether the transactions were more than incidentally designed for the purposes of avoiding liability to taxation rather than making it a pre-condition for the exemption with no discretion on the point being allowed to HMRC.

Clearance

120 The current HMRC policy is for any application for exemption under section 741 to be dealt with under the Self Assessment system. This means that if an individual entered into a transaction, such as establishing a foreign company on 7 April 2006, he would have to claim the exemption in his 2007 tax return.

121 Assuming the taxpayer submitted his return before the 31 January 2008 deadline and that full disclosure were made, HMRC would then have until 31 January 2009 to open an enquiry into the tax return. This effectively means that a taxpayer would not know for certain whether he has a UK tax liability in respect of the company's income until almost three years after the date the company was established.

122 A solution to this issue would be the introduction of a formal clearance procedure such as exists under section 138 TCGA 1992, or at least a change of policy from HMRC to give a ruling on the motive defence at a much earlier stage than is the case under Self Assessment.

123 We are disappointed to have received a letter dated 12 May 2006 indicating that Ministers are not proposing to have a clearance system. The letter does indicate that the Government are willing to consider without commitment any further supporting evidence that might be put forward showing why a clearance system is necessary. We will now consult further with our members and consider what further supporting evidence it would be appropriate to put forward in support of our request for a clearance system.

Pre-owned assets

Clause 80 - Restriction of exemption from charge to income tax

124 The restriction to the exemption from the income tax charge where property is comprised in a person’s estate is not properly targeted and catches many situations that should not be caught. The mischief at which the clause is aimed is where property is part of an individual’s estate as a result of section 49 IHTA 1984 but will revert to a settlor when that interest comes to an end on death. The clause therefore needs to be more specifically aimed at that since at present it appears to deny the benefit of the relief where an individual has the relevant property in his estate even where the revertor to settlor exemption is not available.

125 It should apply only to interests created on or after 5 December 2005 and not to other interests.

126 Paragraph 11 of schedule 15 to FA 2004 needs to be amended to reflect the IHT changes in Schedule 20 of this Bill. The principle to be applied is that Schedule 15 FA 2004 imposes an income tax charge in cases of what is seen as IHT avoidance. Where certain interests in possession have now become relevant property, and so are within the IHT regime, there can by definition be no IHT avoidance. It is therefore necessary to ensure that there is no income tax charge under Schedule 15.

CHAPTER 9

MISCELLANEOUS PROVISIONS

Leasing of plant and machinery

Clause 81 and Schedules 8 & 9 – Leases of plant or machinery

127 The thrust of Schedule 8 is to move capital allowances on long funding leases (greater than seven years) from the lessor to the lessee.

128 Whilst we appreciate the policy purpose for this provision, we have a number of concerns. It may disadvantage small business start ups seeking lease finance where they would prefer capital allowances to remain with the lessor and benefit from reduced rentals. We accept that this may not be a major problem in practice but request that the impact of this measure on small business start ups be kept under review.

129 The proposal may inhibit cross-border trade where lessees do not receive the tax depreciation (eg UK lessor, French lessee – in France the lessee will not receive the benefit of tax depreciation in such circumstances).

130 We remain concerned that long funding lease provisions are still contrary to the EC Treaty in that in the case of a cross border lease with France there will be no allowances available to the UK lessor and there are no allowances available in France to the lessee. This is in contrast to an equivalent UK – UK lease where the UK lessee would be able to claim the allowances.

131 New section 70YJ of the CAA 2001 gives power to HM Treasury to amend for tax purposes the meaning of 'plant or machinery lease'. This power is far too wide and we do not see why it is necessary. We think that it should be withdrawn.

Settlements

Clause 88 and Schedule 12 – Settlements, etc: chargeable gains

Paragraph 1 of Schedule 12

132 We welcome the principles behind the new definition of settlor set out in section 68A but are concerned that sub-section (6) of the new section 68A may not work properly. Suppose that A has settled assets on a trust but is not the only settlor; the trustees have sold a property and now have cash from this disposal as well as other cash from other transactions; the trustees advance cash to a beneficiary. We would welcome clarification that A has ceased to be a settlor in relation to this settlement.

133 A similar point arises in sub-paragraph (3) of new section 68B where we would be grateful for clarification on how the property disposed of by the settlor is to be identified.

134 In new section 68C, please confirm our understanding of the effect of sub-para (5) as set out in the following example. Under his will A leaves property on an interest in possession trust for B; B creates a trust for his minor children and enters into a variation of A's will whereby the property that would have gone onto life interest trust for A is varied into the trust created by B. We understand that A, rather than B, will be treated as the settlor of the settlement.

Paragraph 2 of Schedule 12

135 There is no provision to assist UK trustees equivalent to the present section 69(2) TCGA 1992? We understand that this is in relation to concerns that such a provision would amount to State Aid. Given that similar concerns have been expressed in relation to the new relief for a film qualifying as a British film under clause 40 and that an application has been made to the EU for the measure to be accepted even though it may be qualified as State Aid, we suggest that a similar request is made for a provision equivalent to section 69(2).

Paragraph 3 of Schedule 12

136 Given that the gains of trusts are in general now taxed at 40%, we see no need for this paragraph,. It adds unnecessary complication simply for the purpose of a possible reduction in CGT since the settlor may have an annual exemption or losses available.

137 It would be consistent with normal practice to provide that the changes in paragraph 3 should apply only to settlements created on or after the 22 March 2006 or for property added to an existing settlement after that date. It is wrong in principle to change retrospectively the treatment of settlements already existing from which a settlor is excluded.

Paragraph 4 of Schedule 12

138 We see no case for now denying hold over relief where an individual transfers property to a settlement for his dependent children. This produces a complete anomaly in that a transfer of the same property to be held by trustees as bare trustees for a child under the age 18 would be eligible for hold over relief as would a transfer to a trust for the benefit of children over 18. There seems no purpose in creating this bizarre discontinuity and we request that it is removed from the Bill.

139 Since this change is particularly unwelcome and illogical, we think it is even more appropriate that it should apply only to settlements created on or after 22 March 2006 or property added to an existing settlement on or after that date.

140 Under Schedule 20 there will now be an IHT charge on all transfers by a settlor to a trust for his minor children after 21 March 2006. The normal CGT hold-over relief should therefore apply to such transfers.

Paragraph 6 of Schedule 12

141 Paragraph 6 introduces nearly four and a half pages of legislation to provide for sub-funds to be able to be treated as a separate settlement. Whilst we welcome the principle that trustees may elect that sub-funds are treated separately for tax purposes, in practice this will not happen because the effect of such an election is to create a potential charge to CGT. There seems no reason why such an election cannot be accompanied by a provision that deems the property to pass for CGT at a no gain no loss basis so that there is no step-up in base cost and thus no loss of CGT. Without such a provision, this welcome approach will be of virtually no effect.

142 Sub-section 8 introduces an unnecessary condition. There seems no avoidance in such a situation and it is in practice quite likely that those who are beneficiaries of the principal settlement may be reversionary beneficiaries under the sub-fund in the event that all the sub-fund beneficiaries fail.

143 The information requirement in sub-section 12 (c) needs to be narrowed and limited to information relevant to the sub-fund election. There is a growing tendency to make information provisions much wider than are strictly necessary. There is no reason at all to know about property no longer in the settlement or anything about the settlor or the beneficiaries as these are not relevant factors.

144 Similar comments apply to those made above in relation to sub-section 16. There seems no reason at all why HMRC should have any ability to make enquiries of anybody who is or has been a beneficiary or anyone who is or has been a settlor as their circumstances cannot be relevant to the sub-fund election.

Clause 89 and Schedule 13 - Settlements, etc: income

Paragraph 1 of Schedule 13

145 The new section 685(A) introduced by paragraph 1 of Schedule 13 will have the effect that some trusts will become bare for income tax with the result that the beneficiaries, rather than the trustees, will be liable to pay the tax. As this would be a significant change for those trusts, it would be helpful if this change could take effect only from 6 April 2007 to allow trustees time to prepare for the change and inform the beneficiaries.

146 Paragraph 6 of new section 685(B) and sub-section 5 of the new section 685(D) need to deal with the same issue that was noted for CGT in relation to paragraph 1 of schedule 12 above.

147 We note that the new section 685(F) follows the starting date of 15 June 1989 used on the introduction of section 110 FA 1989 but are not clear why the same starting date is retained in relation to this change. The start date should be amended to apply in relation to income payable or benefits received from 6 April 2006.

Paragraph 4 of Schedule 13

148 It is not realistic to suppose that anyone will set up multiple settlements where the yearly benefit that can be obtained is limited to £800 at 20% = £160 per settlement. The initial costs and annual costs will be at least equal to that. We recommend that this paragraph is removed.

Paragraph 6 of Schedule 13

149 Please confirm that new section 685(A) treats a discretionary beneficiary as having received a payment which has suffered tax at 40% in a case where the settlor of the relevant settlement is not domiciled in the UK and the income arising within the settlement is not UK source and not remitted to the UK.

Paragraph 36 of Schedule 13

150 We understand the purpose of this provision but in sub-section (2)c) it refers to “a relevant child within the meaning given by section 629 of ITTOIA”. We cannot see that the term “relevant child” is defined in that section.

Clause 90 - Special trust tax rates not to apply to social landlords’ service charge income

151 We welcome this clause which goes some way to solving a problem that has been identified for many years. However, many service charges will arise in respect of housing/residents associations that will not meet the conditions necessary in new section 6ZA to qualify as a ‘relevant housing body’. Therefore, we remain concerned that residents’ associations which set up sinking funds rather than service charges are actually setting up discretionary trusts without appreciating the consequences. We see no reason in principle why the special trust rate should apply in these circumstances and request that consideration is given to extending this clause so that such associations are included.

Investment reliefs

Clause 91 – Venture capital schemes

152 We do not understand why the gross assets limits for companies using the EIS, VCT or corporate venturing schemes have been halved. We believe that this may be counter-productive as the costs of raising finance using these schemes may be disproportionate in a smaller company, making the schemes unattractive. The

increased risk inherent in a smaller company is in any event likely to deter investors. If the Government is concerned that companies of this size find the cost of raising capital prohibitive, we doubt that the measures introduced will improve matters.

Employment related securities

Clause 92 – Avoidance using options etc

153 It is perfectly reasonable for the government to counter tax avoidance through the introduction of specifically targeted legislation. However, as we said in previous submissions concerning avoidance of income tax and NIC on remuneration, we remain opposed in principle to retrospective taxation. This change makes a change to UK law with retrospective effect, namely from 2 December 2004. Whilst we appreciate that on 2 December 2004 the Paymaster General warned that future counter measures may be back-dated to that date, given the uncertainty about the precise scope of these new rules we think this these proposed measures should apply only from 22 March 2006.

154 The new provision means that all options which are not ‘securities options’ will henceforth, and backdated to 2 December 2004, rank as ‘securities’ and be taxed on the grant of the option, not the exercise, and generally be subject to the extensive anti-avoidance provisions in Chapters 2 to 4 of Part 7 ITEPA 2003. This would mean that the new provisions will potentially extend to a whole range of mainstream employee rewards including, for example, ‘put’ options over employer share rights (rights to dispose of such shares, rather than acquire them) share appreciation rights and rights under phantom share option schemes and other forms of option arrangement regardless of whether or not there is a tax avoidance motive.

155 We understand HMRC have indicated a change of practice in relation to phantom share option schemes and have concluded that they are not in fact ‘options’ and so will not generally be caught by clause 92. Nevertheless the extremely wide-ranging nature of the proposals, dating back to 2 December 2004, does give real cause for concern about the practical implications of recourse to retrospective legislation.

PAYE

Clause 94 - PAYE retrospective notional payments

156 If reimbursement is not made within 90 days, an employer could be severely disadvantaged in cases where the employee has left the employment.

Accounting practice

Clause 102 – Accountancy change: spreading of adjustment

157 We welcome the spreading relief provisions which although not as generous as we had asked for will provide valuable assistance to those businesses that face an adjustment income charge as a result of the adoption of UITF Abstract 40.

158 We are also pleased that the form of the relief should provide assistance to retired partners who may not have participated in any accrued income arising.

159 We remain concerned about the position of those businesses that either adopted UITF 40 before 22 June 2005 or made similar adjustments as a result of applying Application Note G. We appreciate that backdating of a relieving provision causes practical difficulties, but we remain of the view that this provision should apply from the date that UITF Abstract 40 was published, namely 10 March 2005.

160 We believe that there is lack of clarity in Part 1 of Schedule 15 concerning the effect of the spreading rules on cessation of a business within the scope of income tax.

161 The main rules in paragraph 2 set out the amount chargeable in each tax year. This appears to be clear. Paragraph 3 then states:

> "If before the whole of the adjustment income has been charged to tax the person permanently ceases to carry on the business in question, paragraph 2 continues to apply but with the omission of the alternative limit … referring to the profits of the business".

162 This seems to provide a clear result for tax years before and after cessation, but is unclear in relation to the actual tax year of cessation. The main rules in paragraph 2 charge adjustment income according to tax years. A cessation will, however, normally occur part way through a tax year. The unclear wording in paragraph 3 might be read as excluding the business profits test in the year of cessation, or alternatively as only referring to years after that of cessation.

163 It is unclear how long is the final period. If it is, say, a full twelve months then there appears to be no reason why the business profits test should not apply. On the other hand, the business might only trade for (say) one month during the final tax year, in which case the business profits limit could provide an unreasonably low figure for that year. The rules should be clarified.

164 A similar difficulty, although the wording is different, arises on a partnership cessation, where it is unclear how the profit sharing rules apply in the tax year of cessation.

PART 4

REAL ESTATE INVESTMENT TRUSTS

General comments on Clauses 103 to 146

165 Much of the legislation is subject to interpretation using Regulations which have not been published. We believe that draft Regulations should be available before the relevant clauses are debated in Standing Committee.

166 It is not clear how Jersey Property Unit Trusts (JPUT) will be treated under the new regime. JPUTs are 'Baker Trusts', taxable in accordance with the decision in Baker v Archer-Shee [1927] 11 TC 749. JPUTs are treated as transparent with the investor entitled to the underlying income of the JPUT. Will the income of JPUTs be qualifying rental income? The sale of the REIT shares and the units of a JPUT would appear to be taxable while the underlying qualifying activities are not – we would welcome clarification.

Introduction

Clause 104 and Schedule 16 – Property rental business

167 Whilst we can see the reason for the exclusions in Part 2 of Schedule 16, we think it would be sensible for them not to apply where the income is incidental to the income of the Schedule A business. For example if a UK REIT owns an office block and, in addition to the rent for the offices, also receives rent for allowing a mobile phone mast to be sited on top, we think it unreasonable to expect that small amount of rent to be separated out and subjected to tax. We suggest that rent should be excluded from Part 2 if it is incidental to the ownership of a building and does not exceed five per cent of the rent from the building.

168 There is also a need to understand what will be included in the qualifying income of a property rental business. Schedule 16 deals with the exclusions but what about, for instance, car park income or income from an ATM machine?

169 Dividend income received by one REIT from another is not qualifying income but is treated as residual income (paragraph 16 of Schedule 16). We should welcome clarification as to the policy reason behind this provision.

Clause 106 – Conditions for company

170 Condition 1 which restricts the special treatment to a company that is resident in the UK appears to us likely to conflict with the principle of freedom of establishment under EU law. We would expect, for example, EU law to require a Schedule A business carried on by a French company to be treated in the same way as the same business carried on by a UK company, particularly one listed on the Paris Stock Exchange.

171 A REIT cannot be a close company. In determining whether a company is close the standard definition in ICTA 1988 has been extended by excluding the let outs in

sections 414(5) and 415(4)(a). We are not clear as to the policy reasons behind this extension of the close company regime and would welcome clarification.

172 A REIT cannot be funded by a non-commercial loan (sub-clause 8). However we believe that this particular provision is drawn too widely.

Clause 107 – Conditions for tax-exempt business

173 It seems to us unreasonable that a company which has three properties, sells one and reinvests the proceeds in another should fail the REIT conditions for the accounting period in which the sale takes place merely because there is a short gap between the sale of the old property and the purchase of the new, so that it does not hold three properties 'throughout' the accounting period. We suggest that in such circumstances Condition 1 should be treated as continuing to be met if it would have been met had the old property been retained for the entire accounting period and the new one is bought within six months of the sale of the old (or within such longer period as HMRC may in a particular case allow).

174 We think it would be sensible to define profits for the purposes of Condition 4. In the context of a tax exempt vehicle, most people would assume that it means accounting profits but the Explanatory Notes indicate that it means profits calculated using normal tax rules.

175 We also think that it would be more sensible to apply the test by reference to accounting profits, particularly bearing in mind that a UK REIT is a listed company, subject not only to audit but also to review by the Financial Reporting Review Panel. It seems a waste of time to require a body that is exempt from tax in incur the costs of computing profits using tax principles solely to measure the distribution test, when such a calculation is not needed for corporation tax purposes. In particular, the calculation of capital allowances in a building, and the apportionment of refurbishment costs between repairs and improvements, can be very burdensome.

Clause 108 – Conditions for balance of business

176 In relation to Condition 1 it is particularly burdensome to require a UK REIT to calculate capital allowances on its buildings. Many taxable businesses do not incur the costs of calculating such allowances, which frequently require valuations and protracted negotiations with HMRC, where their net rental income is likely to be insufficient to utilise the allowances. It seems odd to require a tax-exempt business to incur heavy costs that a taxable business might think twice about incurring.

177 The requirement for the 75 per cent test to be met in each individual accounting period seems unduly restrictive. It ought to be sufficient for the test to be met taking one year with another. In the year a UK REIT buys a property, capital allowances will depress its tax exempt profits particularly when it is eligible for first year allowances, in the year a property is sold the loss of rent will depress exempt profit and temporary investment of the proceeds will enhance taxable profits, and in a year in which a refurbishment takes place rents will be temporarily depressed because the building being refurbished is likely to be not let for a period. It seems wrong for these

normal commercial activities to cause a UK REIT to become taxable on its rental income for a single year.

Assets etc

Clause 113 – Ring-fencing of tax-exempt business

178 Please confirm whether a loss incurred by C (pre-entry) can be set against income of C (residual) (subject of course to the normal limitations on the use of losses) or of C (post-cessation). On the face of it, as clause 111(1) treats the property rental business as ceasing for corporation tax purposes, section 391A ICTA 1988 would prevent any carry forward of a loss of C (pre-entry) unless C (residual) includes an investment business, when it would permit a carry forward. However it would be logical to permit a loss of C (pre-entry) to be carried forward and utilised against a loss of C (post-cessation) where the Schedule A business has in fact continued throughout, albeit that it is deemed to cease under clause 111(1). It certainly does not seem logical for the right to carry forward to depend on what the company does outside its exempt business.

179 It is also unclear whether C (tax-exempt) is deemed to claim all loss relief that it is possible for it to claim, so reducing the quantum of the distribution that it is required to make. In particular the Explanatory Notes state that there will be no restriction on the offset of losses and profits between any parts of the tax exempt business, but we cannot see any legislative authority to permit this. We would have expected the property rental business to need to be deemed to be a Schedule A business in order to permit such offset.

Clause 115 – Profit: financing-cost ratio

180 We are unclear how this can work in practice, particularly as exchange gains and losses cannot be quantified in advance. The restriction on borrowings and the maximum 10 per cent shareholding are likely to mean that most sophisticated investors will prefer to use other vehicles, such as a limited partnership, rather than a UK REIT for investment in UK properties. Accordingly the main investors are likely to be the general public. It seems unreasonable for an investment vehicle designed to encourage small investors to be subject to unpredictable market fluctuations merely because the market is unable to forecast to what extent the UK REIT might attract tax due to circumstances beyond its control.

181 We are also concerned that the legislation does not contain the details of this tax charge but leaves it to be filled in by Regulations. We do not consider this a proper subject to be left to Regulations.

Clause 116 – Minor or inadvertent breach

182 The Regulations dealing with minor or inadvertent breaches seem fundamental to the system. Some of our concerns might well be allayed by them. We accordingly feel that it would be sensible to publish draft Regulations as soon as possible and certainly prior to the enactment of the legislation, as these could have an impact on the extent to which concerns in other areas are justified.

183 We are also concerned by the indication in the Explanatory Notes that a UK REIT will be allowed to suffer only two inadvertent breaches (which we assume includes those arising from factors entirely outside the control of the UK REIT) of the rules in a five-year period. We would stress that the rules seem to us to ensure that a UK REIT is most likely to be a retail investment for small, unsophisticated investors, who are ill-equipped to appreciate the likely effect on the share price of the risk of a loss of the exempt status.

Clause 117 – Cancellation of tax advantage

184 We are concerned by the very wide powers reserved to the Commissioners under this provision. If the Commissioners 'think' that someone is seeking to avoid tax then they have extensive powers to cancel, recompute, assess etc to prevent any advantage occurring. The provision requires the Commissioners to give notice, against which there is an appeal procedure but we are concerned that the wide powers available to the Commissioner are akin to a 'back door' GAAR.

Clause 118 – Funds awaiting re-investment

185 We cannot see justification for funds held temporarily between the sale of one property and the purchase of the next being treated as part of the taxable trade. Apart from the fact that it is much cleaner for the assets of a tax-exempt business to remain within that business whilst it subsists, it means that a pure UK REIT (i.e. one with no residual business) will have a residual business, normally with a comparatively small amount of income, for such brief periods and will therefore move in and out of the tax net. The administrative burdens of this, both on HMRC and on the company, could well exceed the modest tax on the interest.

Profits

Clause 121 – Distributions: liability to tax

186 We are unclear why clause 121(6) provides that a distribution from a UK REIT cannot be included in the profits of an actual UK property business carried on by an individual shareholder (or a Schedule A business of a corporate shareholder). It seems to us cumbersome to deem a person to have two separate property businesses. We can see no logic in treating the income from a direct property investment any different from that in an indirect investment through a UK REIT.

Clause 122 – Distributions: deduction of tax

187 We think it would be sensible to publish draft Regulations so that the proposed exceptions are clear.

Capital gains

Clause 124 – Corporation tax

188 We do not think that the words in brackets towards the end are helpful. They seem to require reasonableness to be assessed primarily by reference to periods of use, whereas one would not normally expect what is reasonable to be determined by reference to all relevant factors that exist in a particular case. If the primary determinant is intended to be the periods of use it would be sensible for the legislation

to specifically say so, rather than specifying a reasonable attribution subject to such a major caveat.

Clause 125 – Movement of assets out of ring fence

187 We are concerned by the provisions in sub-clause 6. What happens where an established UK REIT wishes to develop and sell a building which it holds as an investment? It is arguable that the development and sale is by its nature a trading transaction, and is thus a transaction of the non-tax exempt business. It seems unreasonable in such circumstances that the entire gain during the tax-exempt period should be subjected to tax. Outside the UK REIT regime there would be a deemed appropriation from investment to trading at the time the development commences. We cannot see why such treatment should not apply equally in this case. Clause 125(6) virtually forces the UK REIT to sell the property and allow someone else to develop it.

188 Clause 125(7) treats a REIT as carrying on a trading business when 30 per cent or more of the value at the time a property is acquired by a REIT (or a company achieves REIT status) is spent on development and the property is sold within 3 years of practical completion. We are not clear why this specific provision should be included when the normal rules of trading versus investment could be applied?

Clause 126 – Movement of assets into ring-fence

189 It is unclear whether the deemed disposal is intended to trigger the normal charge to tax on the resultant capital gain or whether the entry charge will apply on a transfer into the tax-exempt business subsequent to the company joining the UK REIT regime.

Clause 129 – Termination by notice: Commissioners

190 We are concerned about HMRC's wide discretion to withdraw the exempt status. We cannot see any real scope for a UK REIT to be used as a tax avoidance vehicle (we doubt that even the most avid tax avoider would regard such action as worthwhile if he is forced to give 90 per cent of the resultant tax benefit to other shareholders) and we doubt that it is sensible for the Government to encourage small investors to go into a vehicle whose tax status is vulnerable to be adversely changed at any time by HMRC.

191 In view of the very serious consequences of a notice under clause 129 we think that the legislation, in sub-clause 6, needs to make clear that on an appeal the Special Commissioners have power to determine whether or not the UK REIT has in fact entered into arrangements designed to obtain a tax advantage. The right of appeal is largely illusory if the Special Commissioners have to decide only if HMRC genuinely 'think' that the company has entered into such arrangements. In addition, the Special Commissioners ought to be able to substitute their own view as to whether the notice should be given. Clause 129(2) gives HMRC a discretion as to whether or not to give a notice. Commissioners cannot normally question the exercise of a discretion by HMRC.

Leaving Real Estate Investment Trust Regime

Clause 132 – Early exit by notice

192 We believe that the strict conditions that must be met by a UK REIT preclude it being used as a tax avoidance vehicle. We are therefore disappointed at the inclusion of anti-avoidance rules, for which we can see no obvious necessity.

193 We are particularly concerned why these rules should apply if the UK REIT regime has not applied to the company for at least ten years rather than the six-year period that normally applies for tax purposes (including for other anti-avoidance rules).

Clause 133 – Early exit

194 We think this power inappropriate for a listed company, particularly as a direction could significantly adversely affect the share price. Indeed, the directors could trigger a direction in order to pick up the shares of the company cheaply from the innocent private investors, who are likely to disinvest on the drop in the share price generated by HMRC.

Miscellaneous

Clause 143 – Section 139 TCGA 1992

195 We are concerned that demerger relief is to be withdrawn if arrangements exist for a company to join or leave the REIT regime.

Clause 144 – Housing investment trusts: repeal

196 We are unclear why there should be a five-month gap during which there are no tax incentives to encourage investment in housing.

PART 6

INHERITANCE TAX

Trusts

Clause 157 and Schedule 20 - Rules for trusts etc

General points

197 We are very concerned about the impact of this legislation. The proposed legislation is extremely complex and unclear and it is not possible for any definitive advice to be given to the beneficiaries of those who have died on or after Budget Day. Accordingly, we recommend that the new provisions should apply only for deaths on or after 6 April 2007 to allow time for those involved to reconsider their wills. By definition, a provision based on death cannot give rise to unacceptable avoidance.

198 It is wrong in principle that the most significant change to the IHT treatment of trusts for over 25 years should be introduced without any consultation. The issues raised are very complex and there has been considerable unhelpful debate about how many individuals they affect. This could have been much better managed if there had been a proper consultation process as there has been in relation to the income tax and CGT treatment of trusts.

199 It is not clear what is the main purpose of the provisions since the expected revenue is estimated at only £15 million for the first full year and Ministers have said it applies only to a small minority. If the target is what is considered to be avoidance in the operation of certain trusts, then that should be tackled on its own to achieve the necessary result.

200 In our view millions of people are potentially affected, either because they will need to change their wills or because they have life insurance policies settled in trust. We attach in Appendix 3 some examples of unexpected tax charges which we think will arise.

201 There seems no policy reason to deny the spouse exemption in what is a very common form of will under which an individual leaves his or her assets on trust for his spouse and then on trust for his children with capital passing to them at age 25. We understand that under Shari'a Law, it is necessary to provide certain requirements for succession which are likely to mean that spouse exemption will never be available. This seems unfair and discriminates against the many British residents who apply Shari'a Law for religious reasons. The rules need to be amended to remove this discrimination.

202 It is wrong in principle to introduce legislation which affects existing A&M trusts with inadequate transitional provisions. We see no case for introducing a requirement for capital to vest absolutely at 18 rather than 25. We made a similar point in the consultation on Trust Modernisation. There is a huge difference in maturity between an individual at the age of 18 and one at the age of 25 who is likely to have completed further education and started work. Existing trusts should have been left alone.

203 We would welcome clarification of whether death-in-service benefits written in trust will give rise to an IHT charge.

Schedule 20

204 Our comments on specific parts of Schedule 20 are as follows:

Paragraph 1

205 In sub-section (3)(a) of new section 71A, what does "absolutely entitled" mean? In a case where land is held on trust for minors as and when they reach 18, it is our understanding that the property will remain settled until the youngest reaches age 18. Please confirm whether such a trust meet the requirements of paragraph 1?

Paragraph 3

206 In sub-paragraph 2, we think it is crucial that this change should not apply to A&M trusts in existence at 22 March 2006 and that such trusts should be left within the present regime. This is the policy that has been applied to existing trusts on previous occasions of change (see for example section 66 IHTA 1984) and it is very important for the credibility of the UK fiscal regime that such long lasting entities should not be subject to retrospective changes.

207 If that is not accepted, we recommend that an existing A&M trust should remain within the existing regime if the trustees appoint an interest in possession before 6 April 2008.

208 If property within A&M trusts is deemed to be relevant property it will fall within the chargeable provisions including section 66 IHTA 1984. This requires the trustees to know the history of chargeable transfers in the seven years before the settlement commenced. In some cases these will not be available and we therefore recommend that a transfer made before 22 March 2006 should not be required to be taken into account for the purposes of section 66(5). An example of the impossible situations that the legislation creates is as follows. A created a discretionary trust in 1986 which involved a chargeable transfer on creation. The trust was subsequently wound up in 1995 and no longer exists. He also created an A&M settlement in 1992 which therefore became an exempt transfer in 1999. There was no reason at all for A to

have kept records of the history of the discretionary trust in 2006 and since the A&M will now be put into the new regime he is required to recreate its history in 1992 which will no longer be available to him.

Paragraph 4

209 Please confirm that where an individual or an existing life interest trust for an individual adds property to a separate life interest trust for another individual, that will continue to be a PET from 22 March 2006.

210 In our experience, it is quite common for those who are elderly to settle property on an interest in possession trust for themselves to ensure that their assets can be managed for them in the event that they become incapable of dealing fully with such assets. Under paragraph 4, such a self settlement will now create an IHT charge which seems anomalous and unnecessary. We recommend that such a transfer should continue to have no IHT consequences.

211 Please explain what the treatment is after 22 March 2006 if property passes from existing Trust 1, which is a life interest for A into existing Trust 2, which is a life interest for B? We assume that this will be treated as a potentially exempt transfer but the legislation is not clear.

212 The Q&A issued by HMRC on 7 April 2006 says that a life insurance policy written into a flexible trust before Budget Day will continue to benefit from its pre-Budget treatment. Please confirm which part of the legislation achieves this and that our Example 1 (in Appendix 3) is thus incorrect.

Paragraph 5

213 We find it difficult to understand in what circumstances the spouse exemption will be available where a trust is created by will for the surviving spouse. We believe that this provision should be read such that the exemption is to be applied on the basis of waiting to see if any powers are exercised in an unacceptable manner, but we would welcome confirmation. If that is right, then presumably there will be a charge as and when the relevant interest ceases to satisfy the relevant conditions but it is not clear how this arises.

214 Please confirm in the following case whether condition 4 in section 49(A) will be satisfied so that the spouse exemption is available. A leaves his house on trust for his wife C for life and then absolutely to his children D&E. At the time of the death of C, D is over 18 and E is not. Under the doctrine of Crowe v Appleby [1975] STC 502, D will not become absolutely entitled to his share of the house which will remain settled property until E reaches 18.

215 There has been considerable discussion of how the statutory trust that arises on intestacy in England and Wales appears not to allow the spouse exemption. Please confirm whether you consider that sections 49(A) and 49(B) disallow the spouse exemption in the case of an intestate estate in England and Wales.

216 Under intestacy rules there can be successive life interests. The assets of such trusts will now be relevant property under the new rules. We would welcome clarification of whether changes will be made to either the rules of intestacy or Schedule 20 to cater for unexpected tax liabilities arising on intestacies, which will by no means have been planned, as in the following example.

217 Mr D, lives with his wife and three children in the South East in a house that he inherited from his parents. He dies intestate on 1 August 2006. The value of his estate, which comprises his house and contents and little else, is £500,000. After Mrs D receives the personal chattels plus the statutory legacy of £125,000 plus a life interest in one half of the residue, the children will receive one half of residue on statutory trusts plus upon the eventual death of Mrs D the other half of residue on statutory trusts.

218 As Mr D died on or after 22 March 2006, Mrs D's life interest in one half of residue (£225,000) may be relevant property, in which case a charge to IHT will arise on the excess value of the estate over the nil rate band of £285,000, ie £165,000. The tax due will be £165,000 @ 40% = £66,000. The house will probably have to be sold to pay the tax. Prior to 22 March 2006, the charge to IHT would have been 40% of the excess over the nil rate band of the value of the amount passing to the children under statutory trusts, ie £nil. There are in addition potential charges to IHT every 10 years on the value of the assets in the trusts and exit charges. We do not think that this is what is intended but as drafted currently this appears to be the result of these provisions. They need to be amended so that this situation does not occur.

219 We understand that under Shari'a Law, a husband may leave his estate on trust for his wife. Shari'a requires that the trustees dispose of the property without the consent of the spouse so section 49(B) will not apply. This is unfair.

220 It is common in divorce for property to be left in trust for the surviving spouse until she remarries and then to children of the first marriage. This appears to deny the spouse exemption because the spouse will not be required to consent to property passing from her on remarriage.

Paragraph 6

221 At present an individual who wants to make provision for a relative of his who, while not disabled as defined in section 89, is vulnerable in some way, perhaps because of long term illness which has started to progress or because the individual is prone to bouts of addiction to alcohol or drugs, can create a trust with no tax charge as this is a potentially exempt transfer. This will not now be possible. We suggest that the definition of "disabled" should be expanded to remedy this.

Paragraph 9

222 Please confirm that if an individual adds property to an interest in possession settlement in existence on 22 March 2006 that this will continue to be treated as a PET.

Paragraph 19

223 Please confirm that the changes do not prevent existing or future employee benefit trusts qualifying for relief under section 58. It seems possible that the new provisions mean that no property can ever qualify.

Paragraph 23

224 The amendment to section 80 seems to operate unfairly as regards section 62. At present if A leaves part of his estate on a life interest trust for his spouse B and part in trust for his children C&D, when the interest of the spouse ends assuming that the property then becomes relevant property, B is treated as the settlor of that settlement. This would mean that the life interest trust for the spouse and the trust for the children are not related settlements for the purposes of section 62. We think that this should continue to be the case where after 21 March 2006 the settlement for the spouse qualifies as an interest in possession within new section 49(A) but since section 80 no longer applies that is not at present the case.

225 We are not sure how section 82 applies following the amendment to section 80. It is clear that section 82 can never apply to property settled in the future since there will be no property to which section 80 applies. But it is less clear how it applies to existing settlements. Suppose that A, a non-domiciliary, has created a trust the terms of which are for his spouse B (also non- domiciled) for life and then life interest trust for their children C&D for life. At present, section 80 would not apply at all. If A dies after 5 April 2008 and has by that time become deemed domiciled in the UK, then we think the correct interpretation is that section 80 applies, A is treated as having made the settlement at the time of his death with the result that the property in it is not excluded property. Section 82 does not appear to be relevant. However, if A dies before 6 April 2008 and B dies afterwards when B is at that time not deemed domiciled, the effect of section 80 appears to be that B is now treated as having made the settlement. Section 82(3) is now relevant but A was not domiciled in the UK at the time he made the settlement and so the property is excluded property.

Paragraph 27

226 We do not believe that this amendment works technically because it requires something to happen before an interest in possession exists. Interest in possession is now defined to be an immediate post death interest and if an interest is an immediate post death interest, then the conditions of section 144 can never be satisfied. It is expected that beneficiaries of existing wills will need to rely on sections 142 and 144

to make changes. There will undoubtedly be cases where existing testators no longer have the capacity to change their wills which will make sections 142 and 144 all the more crucial.

227 There needs to be a clear commitment that sections 142 and 144 will continue to avoid prejudicing those who cannot change their wills, perhaps because of incapacity.

PART 7

PENSIONS

Clause 161 and Schedule 22 - Inheritance tax

Paragraph 2 of Schedule 22

228 The drafting of this paragraph is confusing as it is not clear to us at what point a test is to be made. It should be redrafted to make its meaning clear.

229 Paragraph 2A provides that sub-section (2B) applies in a case where section 10 IHTA 1984 would prevent any charge arising. This does not make sense because if section 10 above applies so that there is no charge, then there is nothing on which the IHT legislation can bite. The provision needs to be clarified.

230 We oppose the provisions in new paragraph 2(C). This puts an intolerable imposition upon the executors and relatives of the deceased who are required to establish what he knew about his life expectancy in the period of two years before his death. This is not a suitable provision to introduce since it is likely to involve harrowing enquiries having to be made by the executors and relatives of the deceased, which is not an acceptable proposition in a civilised society. In addition, the burden of proof is unreasonable since it is very likely that there will be no evidence available to show what the deceased's actual understanding was of his life expectancy. It would be helpful to understand precisely what HMRC think individuals should keep by way of records about their understanding of their medical position. If they do not keep them, then does that mean that there will automatically be an IHT charge because it will not be possible to show a reason for relief? We recommend that the whole issue is reconsidered and if there is not to be a complete exemption, then the burden of showing what were the motives of the deceased should fall upon HMRC.

231 Even after applying the tortuous language and the unreasonable provisions of paragraph 2C, paragraph 2D then appears to exempt such an occasion from being a transfer of value to the extent that it results in the provision of a lump sum death benefit to a relevant dependant (as defined). In other words, after seeking to apply these complicated, confusing and possibly unreasonable provisions, most cases are likely to be exempt.

232 The legislation in paragraphs 2C and 2E for someone who has reached age 75 refers to "an actual pensions disposition". However, the term is not defined. We think it should be defined in schedule 22.

233 Paragraph 2E provides that a disposition by someone who has reached age 75 is not a transfer of value if it includes omitting to exercise pension rights under the pension scheme. We recommend that this provision should apply also to those under 75.

234 Please explain whether there is a 35% income tax charge under section 206 FA 2004 where there is an IHT charge under paragraph 2 and, if there is, how the two interact?

It appears to give an effective rate of tax of 61%. We see no need for an IHT charge where there is a 35% income tax charge since any benefits that are actually received by a spouse or dependants will themselves give rise to taxable income.

Paragraph 4

235 We have similar comments to those made above on the arrangements for alternatively secured pensions in paragraph 4. We believe that it is intended that there should be both an income tax charge at 35% and an IHT charge and we think that this is wrong in principle.

PART 8

STAMP TAXES

Stamp duty land tax

Clause 164 - Partnerships

236 We welcome the removal of a charge to stamp duty land tax where there is a transfer of an interest in a partnership if the partnership property includes land for all partnerships whose main activity is the carrying on of a trade (other than a trade of dealing in or developing land) or a profession and the provisions that allow a double charge (the charge on 'actual consideration' in paragraph 10 of Schedule 15 and the interaction between paragraphs 14, 17 and 17A of Schedule 15). Given the enormous complexity of the new SDLT regime, which was officially acknowledged by delaying implementation and HMRC agreeing that a light touch would initially be operated, many will have not have applied the rules correctly to transactions during the period up to when the Finance Bill provisions will come into effect. We would welcome confirmation that HMRC will treat with a light touch cases where the rules have not been followed correctly.

Clause 168 – Demutualisation of insurance companies

237 We welcome this clause which removes an anomaly whereby SDLT group relief might be denied where intra group transfers are effected in preparation for a demutualisation transfer where the demutualisation transfer is itself exempt from stamp taxes.

238 Stamp duty "associated companies" relief (section 42 FA 1930) and the similar SDLT "group relief" (Schedule 7 of FA 2003) are denied where the intra group transfer is effected as part of "arrangements" whereby someone is to obtain control over the transferee but not the transferor (section 42(2) FA 1930 and paragraph 2(1) of Schedule 7 of FA 2003); or the intra group transfer is effected as part of arrangements whereby the transferee is to be degrouped (section 27(3)(c) FA 1967 and paragraph 2(b) of Schedule 7 of FA 2003).

239 If relief is allowed, but the transferee company is subsequently degrouped within three years of the intra group transfer, the SDLT group relief is clawed back (paragraph 3 of Schedule 7 of FA 2003) (there is no claw back of stamp duty associated companies relief).

240 It has been recognised that, where the degrouping event is itself exempted, these three anti avoidance provisions should be disapplied. This is the case where the degrouping event is the demutualisation of an insurance company.

241 Similar disapplication of the anti avoidance provisions exists where the degrouping vent is a reconstruction which qualifies for exemption under section 75 FA 1986 but this relief is not complete. The "change of control" provisions are disapplied (paragraph 2(1) of Schedule 7 of FA 2003) and the clawback of relief is disapplied (paragraph 4(6) of Schedule 7 of FA 2003). But the legislation as drafted continues to

deny exemption if the intra group transfer is part of "arrangements" whereby the transferee is to be degrouped.

242 This provision should be extended to the more common scenario involving intra group transfers which are part of a scheme of reconstruction where the reconstruction is exempted under section 75 FA 1986. In these circumstances the anti avoidance provisions in the equivalent stamp duty legislation were not applied, by concession. This should be extended to SDLT group relief.

PART 9

MISCELLANEOUS PROVISIONS

International tax arrangements

Clause 174 – International tax enforcement arrangements

243 It is not clear from this clause exactly what are the 'variety of existing provisions' that are being replaced and the extent to which these powers have been extended. Please clarify exactly what provisions this clause replaces and how the provisions are extended.

244 We are concerned that the consequence of the UK signing up to the OECD/Council of Europe Convention on Mutual Assistance in Tax Matters could be that the UK would be asked to enforce tax collection on behalf of overseas jurisdictions, party to the multilateral convention, which do not have the same high standards of 'due process' as the UK to ensure that tax was properly payable by the person against whom the enforcement was being required. This would breach the Human Rights of the person against whom the enforcement was being required. This is compounded by the fact that HMRC officers have a unilateral power to disclose and the taxpayer has no rights of appeal, nor to know that it has even happened. We think that this provision should be amended so that requests for disclosure of information have to be approved by a High Court Judge.

245 Clause 174(5) indicates that the provision will not be applicable if the overseas jurisdiction does not have appropriate rules of confidentiality but we do not believe this provision overcomes our objection as the rules of confidentiality do not prevent abuses of human rights.

FH
15 May 2006

APPENDIX 1

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/taxfac/index.cfm?AUB=TB2I_43160,MNXI_43160.

APPENDIX 2

ICAEW AND THE TAX FACULTY: WHO WE ARE

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.

The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. 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.

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 11,000 members of the ICAEW who pay an additional subscription.

APPENDIX 3

FINANCE BILL 2006 SCHEDULE 20: EXAMPLES

1. A earns £35,000 a year as a teacher. He has taken out a 20 year term insurance policy on his life for £800,000 to provide replacement income for his family in the event of his death. He has two children, C born on 7 July 1996 and D born on 8 July 1998. He transferred the policy into trust on 6 July 2000 immediately after issue. The terms of the trust are standard since the policy is held on a life interest for Mrs A if she is alive at the date of A's death and then on life interest for C and D equally with capital to them at age 25 if not appointed earlier.

   A and Mrs A are involved in a car accident in June 2008. Mrs A dies immediately and Mr A is very ill and dies on 15 July 2010 when the nil rate band for IHT is £325,000. The trustees of C and D, who are A's brother and sister, decide to advance the funds to C and D when each reaches 25. They are astonished to be told that there is IHT of around £12,000 to pay as a result of A's death. The life policy has considerable value on 6 July 2010.

   Previous position

   Before Budget 2006 there would be no charge to IHT on the policy. There is no charge when A transfers it into trust as it has no value. There is no IHT charge when A dies because the policy is already in the estate of C and D. There is no IHT charge when C and D receive capital since as life tenants they are treated for IHT as owning it already.

   Position under Finance Bill

   There is no IHT charge on the transfer into trust as before. The trust is treated as a discretionary trust from 6 April 2008. There is therefore a charge on 6 July 2010. Assume that the value of the policy then is £800,000. The charge is on £800,000 and is £6,332 under section 66 IHTA 1984. There are further charges of £1,407 in 2011 on appointment of £400,000 to C and of £4,221 in 2013 on appointment of £400,000 to D. It is assumed that the nil rate band remains at £325,000. The calculations are attached.

   There will be compliance costs in calculating the tax and filing the necessary returns which will be more expensive than income tax returns because they are less common.

2. B is aged 45 and is a policeman earning £40,000 per year. He has two children from his first marriage born in 1991 and 1993. B has now married again and has two more children with Mrs B. They were born in 2003 and 2005. Mr & Mrs B live in a semi-detached house in Leyton which is worth £300,000 in April 2006.

   When he married Mrs B, B drew up a will which provides that his home passes to Mrs B for her life or until she remarries and then is held in trust until the younger of his two children from his first marriage reaches 25 when it is to be sold and divided equally between them.

   Previous position

   Before Finance Bill 2006, on B's death there would be no IHT charge as there would be a complete spouse exemption between B and Mrs B.

   Position under Finance Bill

   Under the Finance Bill proposals, there will be no such exemption and thus an IHT charge. B dies in January 2010. Because of the 2012 Olympics the value of his house has increased to £450,000, but the IHT nil rate band is £325,000. As the IHT due is £50,000, the trustees have to sell the family home to pay the tax.

   B's will cannot be varied as the two families cannot agree.

3. F, a senior fireman earning £40,000 a year, aged 58, has a daughter, D aged 30, who is subject to periods of severe depression. During these, she spends any money she has on drugs or gambling. When F reaches retirement he is advised that to give her an annual income of £10,000 requires a capital sum of £350,000. In order to fund this, he sells his modest house in Brent, moves to a small cottage in Wales and uses most of the proceeds from the house sale and his pension lump sum and life savings to provide for D in the future. As it is not sensible to give funds outright to D, he sets up a trust for her with his brother and sister as trustees to provide D with income but not capital and transfers £350,000 into the trust.

Previous position

Even though D is not within the definition of disabled for IHT, F could transfer funds into the trust with no immediate IHT charge if he survives 7 years. During D's life there would be no IHT charge on the funds.

Position under Finance Bill

F will face an immediate charge of 20% on the transfer of funds into the trust for D. This is £11,800.

There will be further charges every 10 years on funds in the trust.

F does not understand why he is penalised because of D's unfortunate condition.

Example 1

Calculations

1. Charge on 6 July 2010 under Section 66 IHTA				
Deemed chargeable transfer	800,000			
Previous chargeable transfer	Nil			
Tax due at lifetime rates			800,000	
less nil rate band		325,000		
2 x annual exemption		6,000	331,000	
			469,000	
Tax due @ 20%				93,800
Effective rate	93,800 800,000	= 11.725		
3/10 of this is 3.5175				
Assume that this is reduced to reflect the fact that relevant property regime applies only for 9 of 40 quarters.				
Tax due at 6 July 2010 is 800,000 x 3.175 x 9 40		= £6,332		
2. Charge on appointment to C in July 2011				
Tax due is 3.5175 x 4 x 400,000 40		= £1,407		
3. Charge on appointment to D in July 2013				
Tax due is 3.5175 x 12 x 400,000 40		= £4,221		