ICAEW TAX FACULTY REPRESENTATION

TAXREP 5/11

DRAFT FINANCE BILL 2011

Memorandum on draft Finance Bill 2011 clauses and Finance Bill Tax Information and Impact Notes (TIINs) submitted on 9 February 2011 to the Exchequer Secretary at HM Treasury and the Permanent Secretary for Tax at HM Revenue & Customs (HMRC) by the Tax Faculty of the Institute of Chartered Accountants in England and Wales

The detailed comments on the Bill were also submitted separately to the HMRC officials responsible for that particular area of the Finance Bill

Contents	**Paragraph**

DRAFT FINANCE BILL 2011

INTRODUCTION

1. We are writing to provide our comments on the draft Finance Bill 2011 clauses published for comment on 9 December 2010.

2. We welcome the Government's commitment to provide greater time for scrutiny of draft tax legislation following a period of prior consultation.

3. The provisions contained in the current draft Finance Bill will be published, after appropriate amendment, as part of the Finance Bill 2011, on 31 March 2011.

4. The Budget will take place on 23 March 2011 in advance of publication of Finance Bill 2011. Amongst other announcements we understand that the Chancellor will set out the taxation measures on which the government will be consulting over the ensuing months prior to publication of draft Finance Bill 2012 in November or December 2011.

5. Our Ten Tenets for a Better Tax System which we use as a benchmark to evaluate tax legislation and the tax system are summarised in Appendix 1.

WHO WE ARE

6. The Institute of Chartered Accountants in England and Wales (ICAEW) operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, ICAEW provides leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

7. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

8. The Tax Faculty is the focus for tax within ICAEW. It is responsible for technical tax submissions 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 Institute who pay an additional subscription, and a free weekly newswire.

EXECUTIVE SUMMARY

9. In this section we summarise the key points made in this paper and highlight our main concerns about the measures contained in draft Finance Bill 2011.

Employer supported childcare: changes to tax relief

10. We are concerned that the way in which it is proposed to restrict employer-supported childcare to the basic rate, through the PAYE system, will prove not to be practicable and will create very considerable burdens for business. We recommended in our paper submitted in March 2010 that the policy objective would be best achieved by requiring employers to return the excess benefit on forms P11D so that the benefit-in-kind is processed by HMRC in exactly the same way as any other benefit-in-kind.

11. We urge the government to reconsider the mechanism by which the policy objective is to be achieved.

Furnished Holiday Lettings

12. We make a number of further suggestions as to how the proposals could be improved. We have recommended an averaging arrangement in the first three years of a new letting business. We also believe that there should be an opt-out election for those businesses who do not want the administrative burden of day counting when they would otherwise be in the system some years but outside in others.

Tainted Charity Donations

13. We welcome the change from the existing Substantial Donor rules which are very burdensome to operate. However we are concerned that the new proposals, as currently set out in the draft legislation, pose a number of problems. We suggest that consideration is given to deferring the introduction of the new regime if it is not possible to redraft the legislation to address the concerns of the Charity sector.

Pensions annuitisation

14. We are concerned that there are annuities, such as partnership and some life annuities, which may not rank towards the minimum income requirement. In addition transfers to another pension provider may affect the maximum income drawdown.

Disguised Remuneration Employment Income through third parties

15. We welcome the decision to publish anti-avoidance legislation in advance for consultation.

16. However, we believe the legislation is too widely drafted and will catch too many innocent transactions. It will also create considerable uncertainty and compliance problems. All in all it will hinder the UK's competitiveness and stifle growth.

17. We have set out our detailed concerns about the legislation but overall we believe that the current structure and fundamental principles underlying this draft legislation are wrong.

18. We will be happy to work with HMRC to identify a set of rules that will be fit for purpose.

CFC Interim improvements

19. We note that the current provisions are a stopgap and will be replaced by a new permanent regime which is to be enacted in Finance Act 2012. We have made a number of detailed recommendations as to how we believe the interim improvements can be further improved.

Taxation of Foreign Branches

20. We are concerned that some of the provisions are in breach of the EC Treaty or contravene EU State Aid rules. We recommend the government reconsiders the legislation so as to address these concerns.

21. We do not believe it is realistic to make the opt-in election irrevocably and we have suggested a practical solution which we believe will retain a sufficient degree of permanence to the election.

22. We recommend that consideration is given to backdating the effective date for the new election to 1 January 2011.

Corporate Gains Tax: De-grouping Charges

23. We are concerned that the new rules will not protect intangible assets from the de-grouping charges.

Small profits rate: associated companies

24. We have a number of concerns as to how the new rules will apply in practice and have set out examples on which we would welcome comment.

VAT: Academies

25. We believe the current legislation gives too much discretion to HMRC and that the extent of this discretion should be more closely defined so that Parliament can scrutinise the proposals to determine whether they are reasonable. We believe Academies should be put on the same footing as local authorities in relation to the recovery of input tax relating to exempt income.

VAT zero-rating: splitting of supplies

26. We recommend changes to the legislation so that zero-rated supplies of printed material are only treated as standard rated in appropriate circumstances. Under our suggestion standard rating would only apply if both suppliers are connected and the value of the supply is artificial and not at arm's length.

Security for payment of PAYE

27. We have made a separate response to the consultation document. Our concern in relation to the Finance Bill clauses is that a criminal offence will arise under the provisions in secondary legislation without any safeguards in the primary legislation. This means that Parliament will not have adequate opportunity to scrutinise the nature of the offence in detail. We are also concerned that the new security regime could be used against businesses that cannot pay whereas it should be targeted at businesses that want to evade their obligations.

Data gathering powers

28. Our key comments on this consultation which are also relevant to the draft Finance Bill 2011 clauses are as follows:

    (a) **A consolidated Act:** There is now a clear need for a new consolidated Taxes Management Act, ad we strongly recommend that one be drafted. It would consolidate and integrate the taxes management legislation, and bring together in one place all the new legislation arising from the HMRC Powers Review.

    (b) **Compliance burden:** We are concerned that providing information to HMRC should not impose a disproportionate or unreasonable compliance burden on data-holders. We should like to see a specific requirement in primary legislation for HMRC to have regard to the likely cost for the data-holder of complying with the notice. HMRC's guidance must also contain safeguards to minimise compliance burdens, and we list some recommendations in paragraph 15.

(c) **Time to comply with a notice:** The legislation should specify a minimum time for complying with a data-holder notice, preferably 90 days but certainly no less than 30 days. As drafted, no limit is specified.

(d) **Retention of documents:** Para 7 should differentiate between documents which are returns of data in the required format and any original documents of the data-holder. The data-holder should have a right to have any original documents returned.

(e) **Charities:** Para 27, which defines charities as data-holders, is too widely drawn. It should be more specific, and relate to donations to charity.

(f) **Appeal rights:** We feel strongly that there should be a right of appeal on the grounds that a data-holder notice is onerous, even if the information relates to statutory records. At present the appeal right in para 28 is excluded in this situation.

(g) **Foreign tax:** We would welcome detailed confirmation about HMRC's approach to requests from overseas tax authorities and what tests will be applied to ensure that any requests meet the required guidelines.

(h) **Statutory records:** The definition of statutory records needs to be clearer, to distinguish between the data a person is required to hold and the records themselves.

(i) **Section 76, TMA 1970:** This section should be retained, though not in the data-gathering legislation, as it provides a necessary protection for trustees where income is mandated directly to the beneficiary.

TAX INFORMATION AND IMPACT NOTES (TIINs)

29. We fully support the approach of the Government to provide greater deliberation before deciding on tax policy changes and ensuring that there is adequate time for appropriate consultation.

30. We also welcome in principle the introduction of TIINs which we believe should assist in creating greater transparency on the objectives and anticipated impacts of particular policy measures. We believe that they require further work to ensure that they become an essential tool in evaluating tax policy and we would welcome the opportunity to work with officials to develop them further.

DETAILED COMMENTS ON THE BILL

Employer supported childcare: changes to tax relief

31. From April 2011 employer-supported childcare (ESC) will be restricted to the basic rate. We are concerned about the practicality of this proposal. In order to restrict the relief, employers will be required to estimate the marginal tax rates of

their employees. Previous experience in a related area, namely seeking to limit the benefit of married persons' allowance to the basic rate, was abandoned because it was impractical to implement this via the PAYE system.

32. We commented on 22 March 2010 (published as TAXREP 20/10) on HMRC's Technical Note published on 19 February 2010. At that time we recommended that employers simply return the excess benefit on forms P11D so that the benefit-in-kind is processed by HMRC in exactly the same way as any other benefit-in-kind. We still consider that that would be the least burdensome approach and in practical terms is likely to be the only sensible way of achieving the desired policy objective of limiting tax relief to basic rate.

33. We welcome the fact that the burden on employers has been reduced in the draft legislation published on 9 December because employers will no longer be expected to both undertake an estimate and complete forms P11D. But employers will still have to make the estimate which will be burdensome and open to error, manipulation and abuse, and in the case of employees whose other income takes them into a marginal rate of tax which is higher than that applied to the earnings of the employment in which the ESC is provided, the employer estimates will give an answer which is at variance with the policy objective of giving less relief to those whose marginal tax rates are above basic rate.

34. In addition, the number of different types of income that have to be included will involve the payroll department having to undertake a number of time consuming and burdensome calculations. Furthermore, it is not clear the extent to which bonuses, which may not have been fixed, should be taken into account, or even confidential future plans that are being considered for execution in the forthcoming tax year, for example, to close a division, and which will impact on the affected employees' taxable pay. We should welcome confirmation that in cases such as this the previous year's income can be taken as a reasonable estimate.

35. We note the attempt to make the estimates more accurate by requiring the adjustment for 'coded-in personal allowances' but, as defined in new s 318AA (4), this is a figure which it is impossible for any employer to ascertain without involving his employee because the coding notifications provided to employers by HMRC consist of an overall figure – or may even be a K code or a code which does not cite a figure, like BR or 0T. Having to obtain information from employees will increase the time and hence the cost of compliance.

36. If the estimate process is to be retained, with all the inherent risks of a breakdown in employer/employee relations, we recommend that the personal allowance that is applied should be based on the estimated income on the assumption that that income is total income for the year so that the employers do not have to refer elsewhere.

37. We should also welcome clarification, preferably by way of a ministerial statement, of the steps that employers will have to take to satisfy HMRC (eg in a PAYE compliance audit) and employees (eg who object to the estimated rate of tax arrived at by the employer) that they have done all that is necessary – ie taken reasonable care – to comply with the law in making the estimate, and whether penalties for an incorrect end of year return P35 will arise owing to an estimate that is found to be wrong.

Furnished Holiday Lettings (FHL)

Implementation date

38. We welcome the additional time being given before the proposed changes are to take effect, 1 (or 6) April 2012. This will allow taxpayers to implement whatever changes are needed to their business models.

39. Of the proposed changes, the one which has caused most concern to our members is the increase in the number of days a property must actually be let from 70 to 105. This is particularly difficult for businesses whose letting season is very short. One side effect of increasing the number of days when a property is required to be let is that more properties will become marginal.

40. The old test of 70 days was roughly equal to the UK holiday letting season. 105 days will be more difficult to achieve. Many business models are based on charging higher rents for a shorter period. This may be because of local weather patterns, or may be due to local letting restraints imposed by planning authorities. It will be easier for a property owned and let in southern European states than in the north of England or Scotland.

41. We welcome the proposed averaging tests although we will be interested to see how this is to be implemented in the self assessment system. Presumably free standing claims will be necessary.

42. In relation to new s 326A (1) (d), the phrase 'there was a genuine intention to meet the letting condition' leaves scope for uncertainty. The same issue arises for a company in new s 268A (1) (d).

43. To avoid businesses which are at the margin falling in and out of the rules from year to year, we recommend a further change to the legislation. An opt-out election where those businesses which do not want the administrative burden of day counting, can choose to be simple property businesses rather than FHLs.

44. FHL treatment is not an optional tax treatment. Losses arising in a void period, for example from carrying out a major refurbishment, may lead to a property needing to be kept outside the FHL scheme in order to utilise the losses.

45. We would be pleased to discuss further how this could be applied.

Existing averaging rules

46. Section 326, ITTOIA 2005 contains averaging rules which can be used for under-utilised holiday accommodation. We presume these rules will be retained in the new regime. The existing rules require this relief to be given by way of a formal claim. We suggest that the administration associated with this relief would be reduced if it could be self assessed and just used by taxpayers whose lettings qualify.

New businesses

47. Achieving 105 days during the first 12 months of a new business will be very challenging. This will be particularly difficult in those areas of the UK where the letting season is more seasonal. It could cause a barrier to entry and reduce competition in the sector.

48. When a taxpayer first sets out to let holiday property they often have fewer lettings. These build up over time.

49. We suggest that there should be a three year period of averaging of days for new businesses, subject to the ‘opt out election’ described above. There could be a presumption that the business will qualify as a FHL, with clawback if it fails the test at the end of three years. This could be taken as three tax years for an unincorporated business or 36 months for a company.

Tainted Charity Donations

50. We welcome in principle the Government’s commitment to amend the existing Substantial Donor rules which we understand from the charity sector are very burdensome to operate. However, we are concerned that these new proposals also pose a number of problems that need to be addressed if the policy objectives are to be achieved in a way that is not too burdensome. We are concerned that the detailed proposals are also very wide ranging in nature in particular the way in which Conditions A and B could bring many arrangements within the new provisions, when these are not the intended target of this new legislation.

51. We believe that HMRC has accepted that if it is not likely that suitable amendments can be made in time for inclusion in the Finance Bill to be published on 31 March 2011, then the current proposals should be the subject of further detailed discussions. Revised draft legislation could then be published in Finance Bill 2012. In the meantime the current Substantial Donor provisions would remain in place.

52. We believe it is important that the current draft legislation should not be included in a formal Finance Bill until HMRC is satisfied that it achieves its intended purpose and has adequately addressed the concerns of the Charity sector.

Pensions annuitisation

Unsecured and alternatively secured pension to be replaced by drawdown pension

Paragraph 13, inserting new paragraph 14A(3) of Schedule 28 FA 2004: Minimum income requirement and non-surrenderable partnership retirement annuities

53. We are concerned that partnership annuities such as those covered in paragraph 8 of Statement of Practice D12 are not covered within the categories cited in new para 14A(3) of Sch 28 FA 2004 where the annuity is payable for life. We recognise Government’s wish to ensure that those who draw down their pension pots do not subsequently become a burden on the state, but we think that those who have partnership retirement annuities of amounts that would, if they were relevant income as currently defined, enable them to meet the minimum income requirements are unlikely to have any need to fall back on state assistance, and where the payments represent payments in reasonable recognition of the past contribution of work and effort by the partner the former partner is unlikely of his own volition to forego these.

54. Similarly, where a life annuity is purchased in a non-surrender policy then that means that the contract cannot be reopened to amend the duration or amount of

payment which means that it will be a guaranteed, life-long, income. We suspect that purchased life annuities are not included in the draft legislation as qualifying for the minimum income requirement because they operate under a tax regime different from that governing annuities purchased using pension fund monies but given that purchased life annuities in a non-surrender policy are payable for life and cannot be changed, we see no reason for excluding them.

55. We therefore consider that an additional category to cover annuities paid as in reasonable recognition of the past contribution of work and effort by a former partner and non-surrenderable purchased life annuities should be inserted into new para 14A(3).

Drawdown pension year and basis amount for drawdown pension year

Paragraph 86

56. We are concerned that the provisions of draft paragraph 86(4)(b) of Schedule 1 will prejudice a member of a pension scheme in drawdown who is currently receiving income of between 100% and 120% of the Government Actuaries' Department (GAD) limit and effects a transfer to another pension provider after 5 April 2011. This will trigger a new reference period which means that the drawdown income from the new provider will be limited to 100% of GAD whereas if that person had remained with the original pension provider the current reference period would just continue for the original 5 year term.

57. This effectively amounts to a penalty for transferring to a new provider from the existing provider. This is unfair, particularly as at present a transfer to a new SIPP provider does not trigger any requirement for a new reference period. We should welcome clarification as to why the draft legislation should impose this change penalizing individuals who move their pension 'pot' from one provider to another.

58. In addition to the unfairness it is very concerning from an administrative burden. It is very difficult to determine in practice the precise date of the transfer of a pension arrangement from one provider to another. Some providers regard the effective date as the date they receive confirmation of what the current level of benefits are. Others do not regard the transfer as complete until all the investments of the fund have been transferred into their name, which, particularly if there are any foreign investments, can take months. The exact date of the completion of the transfer of a client's pension arrangement has never been critical before; but under the proposed legislation it is now. It will make it very difficult, if not impossible, for SIPP administrators over the next two months to cope with transfers that are in progress. How can anyone know whether they will be completed before 6 April? If they are not, and the level of pension is critical to the client, the process will somehow have to be unravelled which may not be possible if some of the pension fund assets have already been reregistered in the name of the new scheme provider.

59. We therefore recommend that paragraph 4(b) should:

- be framed by reference to when the transfer process is started (which in practical terms will simply be when the client first instructs the pension provider to transfer his pension scheme); and
- include an exception for those already in drawdown who transfer to another SIPP provider where the transfer process had been started on the

date that the draft legislation comes into force, i.e. 6 April 2011, to enable drawdown to continue for the remaining part of the five years at the same rate with the new SIPP provider as under the previous SIPP provider.

‘Disguised Remuneration’ Employment Income through third parties

60. We commend the decision to publish anti-avoidance legislation for advance consultation.

61. We appreciate that HMRC consider legislation necessary to stop what they perceive as the abuse of Employee Benefit Trusts (EBT) and Employer Funded Retirement Benefit Schemes (EFRBS). It is entirely right that the government should seek to counter tax avoidance but any anti avoidance legislation should be properly targeted.

62. We believe that this legislation is far too widely targeted. It catches far too many innocent transactions. It will also create considerable uncertainty and compliance problems that will hinder the UK’s competitiveness and stifle growth. Our particular concerns with the principles underlying this draft legislation are set out below:

- As drafted tax liabilities will arise in circumstances where the employee in question may receive no value from the arrangement, either when the taxable ‘step’ is taken or at any later time. The legislation applies to many forms of *‘disguised’* and/or *deferred* and/or *conditional* remuneration. All that is required is that there is a ‘step’ that may or may not lead to some form of advantage for the employee later.

- There is no scope for tax/NIC to be refunded if the employee ultimately receives less or no benefit. This contrasts sharply with the current anti avoidance provision for loans to participators in close companies, under which the tax payable (at generally far lower rates) is refunded when the loan is repaid (s 455 CTA 2010).

- The tax charge is not confined to circumstances which are motivated by tax avoidance. A wide range of innocent and normal commercial transactions and arrangements will be caught, forcing employers and employees to pay tax/NIC in circumstances where, as a matter of policy, it is not right that they do so.

- A large body of statute law and centuries of case law have led to a complex but reasonably well understood basis for charging tax on ‘earnings’ and deemed earnings, with extensive and detailed exemptions and deductions. All of that is now largely overridden by the vague, but clearly wider terms ‘recognition’ and ‘reward’ which are not subject to the exemptions and deductions applying to earnings. This can result in disproportionate tax charges arising which bear little or no relation to the actual benefit that may be received by the employee.

63. As noted above the draft legislation is far too widely targeted. To take one example, an employer might arrange for a group company to make a bridging loan to an employee moving house on relocating for the purpose of employment. The loan might be for, say £1 million. It may be repaid with interest at a commercial rate within two weeks. Nevertheless under the new law, PAYE and

NIC must be paid, without any prospect of a refund, on £1 million when the loan is advanced.

64. Other examples are referred to below but many others are likely to arise in practice. These unfair and unreasonable charging provisions will inevitably distort commercial practice and impose disproportionate tax costs on the unwary. There is a danger that these changes will bring the UK tax system into disrepute and will damage the attractiveness of the UK's competitiveness and growth prospects.

65. Set out below are our comments on particular provisions.

'Wholly or partly' reward payments are fully taxable

66. Section 554A (1)(b) and (c) (as inserted by para 1 of draft Sch 1) provide that a step is caught if it is 'wholly or partly' a means of rewarding the employee. Suppose an employer needs an employee to relocate quickly to another part of the country and offers, through its relocation agency or a parent company, to pay the employee the highest of 3 independent valuations for his existing home, in order to facilitate an early move. The payment arguably includes an element of reward or recognition and the employee is prima facie now taxable. The problem is that the employee is not taxed (as previously and correctly) on any **excess** over its market value but instead on the **whole** of the payment made to buy his house (s 554K(1)).

67. Similarly, if an employee sells shares in a private company to an employee benefit trust for what the parties believe to be the market value, there is now a risk that if HMRC consider after the event that the market value is even £0.01 (one penny) less in total than the price paid, then the **whole** of the purchase price is liable to PAYE/NIC. Valuation is inevitably a matter of opinion and the position is made worse by the fact that HMRC will not comment on a valuation in advance in these circumstances. Private companies that have limited markers in the company's shares will now be faced with greater uncertainty about the tax treatment of substantial transactions.

Reward or recognition

68. Section 554A (1)(c) introduces tax on 'rewards or recognition'. This is obviously different from and wider than 'general earnings' and 'specific earnings' as defined in ITEPA 2003. The extension of the scope of the employment income tax charging provisions in this way is potentially very far reaching and requires further consideration. Case law has developed considerable clarification of the meaning of 'emoluments' and 'earnings' and the deeming rules associated with them, and of the exemptions and deductions available in respect of earnings.

69. Simply overriding this large body of legislation and case law with these terms will create uncertainty in a very wide range of circumstances (e.g. compensation payments awarded by the courts, tips, training, many aspects of international assignments and tax equalisation policies, welfare and entertainment in various forms, etc) and is potentially damaging to the UK competitiveness.

70. The structure of Part 7A results in a limitation of the application of the exemptions in Part 4 of ITEPA. Some of those exemptions (e.g. the Christmas party exemption and long service awards) prevent liability from arising under any enactment and so would prevent liability arising under Part 7A. However, other exemptions remove liability only under Part 2 (s 228 ITEPA). Therefore they

would not prevent a liability arising under Part 7A. These include mileage allowances, passenger payments, parking facilities, incidental overnight expenses, work related training, relocation expenses, and so on. If any of these ‘exempt’ payments involve any element of ‘reward or recognition’ they are wholly taxable (s 554K(1)).

71. Similarly, the deductions allowed in Part 5 of ITEPA are deductible only in calculating taxable earnings for the purpose of Part 2 (s 327(1)). Thus if an employee who works hard is ‘rewarded’ or ‘recognised’ by being allocated a task that involves an overseas business assignment that might happen to be in an attractive location, his expense reimbursements may be deductible from earnings under Part 2, but they may be wholly taxable under Part 7A.

When is an employer a third party?

72. Section 554A(7) and (8) provide that an employer may himself be a third party for these purposes if he ‘holds any sum of money or asset’, or ‘is responsible for the management of any sum of money or asset’ held under an ‘arrangement’. An ‘arrangement’ also includes simply an ‘understanding’. These words are potentially of very wide application.

73. Given that HMRC’s guidance on ‘arrangements’ in other contexts indicates that an arrangement can include a decision taken at a meeting or a ‘common practice’ (see SP 13/91), virtually any ‘step’ taken by an employer himself may be caught. If the board of directors of a company minute a decision in their meeting to make a loan to an employee, they arguably at that point create an ‘understanding’ and become ‘third parties’ and they either ‘earmark’ their own funds within Part 7A at the point of making the decision, or they pay a sum within s 554C when they subsequently advance the loan. When shareholders approve new share plans and awards involving treasury shares or shares held in trust, they are arguably ‘third parties’ who are ‘earmarking’ shares under ‘arrangements’ etc. We do not think it is sufficient that HMRC may publish guidance to clarify this aspect as employers will be left in doubt as to the meaning that may be ascribed by the courts in due course.

The earmarking charge

74. Section 554B introduces the earmarking charge. This is far too widely drafted, as will be seen from the examples below.

Share plans

75. A very large number of employers, including many of the largest listed companies, have some form of ‘deferred’ bonus and/or long term incentive share plan that involves ‘earmarking’ cash or shares on an award date but delivering the cash or shares only after a vesting period, typically a period of three to five years. FSA guidelines published in December 2010 will of course increase the pressure on employers in the financial sector to provide deferred and conditional remuneration.

76. Employers and employees will not wish to pay tax at the outset in respect of awards that will vest only if conditions are met over a number of following years. The upheaval that will be caused in restructuring employment remuneration packages throughout business in order to avoid the ‘earmarking’ charges from April 2011 will be disproportionate to the mischief at which this legislation is aimed. In the event that this legislation is enacted in this form, the legitimate expectations of taxpayers need to be preserved. There is insufficient time

between now and the proposed start date of 5 April 2011 for those affected to consider the necessary policy changes and take action.

Pension plans

77. Many multinational employers have globally mobile workforces. Some employees are simply seconded from a home country to a host country for a period and then return to spend the remainder of their career in the home country. Other employees may be assigned to a series of countries in succession. It is common for such multinational groups either to allow employees to continue to participate in their home country pension plan, or to establish one or more international pension plans in which employees participate only when they are assigned away from their home country. Such plans may be administered and funded centrally and may or may not involve recharging funding costs to host country subsidiaries. Few such plans qualify for migrant member relief, double taxation relief or 'grandfathered' corresponding acceptance (the burden placed on overseas administrators to report benefit crystallisation events is in practice too great). Further, in many instances, no income tax will have been paid on employer contributions in the past, either because such contributions were exempted from 6 April 2006 or because before then, the contributions were not paid by the employer and were not chargeable under the predecessor legislation (s 595 ICTA 1988).

78. Any such employer with assignees to the UK who have participated in such plans must now consider not only those currently here on assignment but also every individual who has at any time in the past been assigned to the UK and who is still alive. Such individuals will have accrued investments in the home country/international plan while on secondment to the UK and those investments may increase in value (by the receipt of investment income or gains or simply from currency movements) from one month to the next. Each increase in value appears to represents an 'earmarking' which triggers a PAYE/NIC liability. Even those who have retired and are now receiving a pension are not necessarily excluded. In some cases the pension income itself will be exempt by virtue of a double tax treaty. In others it will not and proportionate charges will be made. In some cases the individual will receive a lump sum on retirement and that may not be pension income for the purpose of a double tax treaty. Thus far no guidance has been issued on whether ESC A10 may apply to any lump sum caught by Part 7A. If, following the principle that no employee should enjoy any tax advantage beyond those available in registered plans, it is not to apply, taxable lump sums which would previously have been exempted must now be identified and taxed.

79. In any event, the 'earmarking' charge arising from the investment returns is prima facie not itself 'pension' income and so is not exempt. Therefore the past records covering potentially many thousands of individuals worldwide will need to be consulted, taxable values calculated and PAYE/NIC charges paid with effect from 6 April 2011.

80. Where an employee has at any time in the past contributed to such an international pension plan, the trustees of the scheme will be 'connected' to the employee (s 554I(9)(a)) and therefore a 'relevant linked person'. Employer contributions made to the plan since 9 December 2010 will therefore be caught (para 48 of Sch 1). If the employee wishes to avoid the PAYE charge arising from the deemed payment on 6 April 2012 he will normally have to find the cash to reimburse the employer from his own resources because the pension plan in

question is likely to preclude any distribution or application of its funds in this way before retirement.

81. Paragraph 33 of Sch 1 provides a limit on amounts of relevant benefits taxable under Part 7A. Paragraph 33(4) has the effect of eliminating any express deduction for employee contributions. The result appears to be that if an employee receives a lump sum that comprises a refund of his own contributions and any combination of investment returns on those contributions (that may or may not be considered a commercial return), a lump sum benefit derived from employer contributions, and so on, the payment will represent ‘wholly or partly’ reward or recognition and will be wholly taxable.

Group employers and advance funding and budgeting

82. In many large businesses, and in government, employees may be contractually employed by one entity but their salaries, bonuses, benefits, etc may be budgeted for, funded, administered and paid by other entities (parent companies, payroll agencies and so on). There are potentially many complex permutations that may give rise to salaries or other components of remuneration packages being ‘earmarked’ by a third party before they are paid.

83. The task of simply researching the facts in a large organisation may be considerable. Has any research been undertaken within government to establish the extent to which any part of the pay or benefits of, for example, NHS staff, the military, the police et al is affected by this legislation?

Exemptions in Part 7A

Tax approved plans

84. Section 554E provides exemptions for steps taken ‘under’ various tax approved plans. This does not go far enough to be effective. Steps taken in order to enable a plan to be adopted and approved are not exempt. If trustees buy shares from an existing shareholder in order to grant CSOP options to particular employees, that purchase is a ‘step’ and it is not taken ‘under’ the CSOP. The shares may be taxed under the earmarking charge.

85. Similarly, s 554E(1)(d) provides exemption for a step if it ‘for the sole purpose’ of granting an EMI option. It is common in practice for employee benefit trusts to buy shares from retiring founder shareholders with a view to granting EMI options to new management. Since the transaction results in shareholders receiving cash originating from the company subject to capital gains tax, a clearance procedure is available, and is often used, under the transactions in securities legislation. Even where such clearances are obtained, the employer will have no certainty. The purchase is a ‘step’ which is partly to enable the retiring shareholder to leave and sell his shares and partly to grant the EMI option. As it is not ‘solely’ to grant an EMI option, it is not exempt from a charge under Part 7A.

Loans

86. The exemption for loans is not broad enough. Loans are of course caught even if they are not in the nature of ‘reward or recognition’ (s 554A(1)(c)). If the lender (normally a group company separate from the employer which is set up to qualify to make loans under the consumer credit legislation) charges a commercial rate of interest but does not make similar loans to the public, the exemption is not available. This is despite the fact that the employee will have received no more benefit than if he had obtained the loan from a high street bank.

87. Loans are given to employees for a variety of perfectly good commercial reasons: to relocate to be near their work, to obtain season tickets to get to work, to relieve hardship when an employee is in a temporary financial crisis, 'cashless exercises' of share options, tax loans to international assignees, and so on. These loans are often administered by third parties and are generally repaid. As a matter of policy it is not right to impose a PAYE/NIC charge on the amount advanced in these and a variety of other circumstances.

Employee benefit packages

88. The exemption for employee benefit packages is too restrictive. It is commonplace for employers to provide benefits of various kinds only to higher paid or senior employees. Company cars are normally confined to management grades, for example. Administration of benefit schemes are often outsourced to leasing companies, 'flexible benefit' providers and so on. If the employer has an arrangement with a leasing company to provide say company cars only to employees above a certain grade, the allocation of a car will give rise to an immediate PAYE/NIC liability on the value of the car (s 554G(5) and (6)) even though the employee may actually enjoy only the use of a car for a period.

89. We understand that it was not intended that the employee benefit package exemption should be capable of applying to any form of retirement benefit plan. This is on the basis that the basic principle for pensions is that HMRC do not wish to permit any employee from receiving any greater tax advantage in relation to pensions than is possible under the registered pension plan regime. The legislation does not appear to achieve that as the payment of a pension is clearly a 'transaction' with the employee within s 554G(1)(a) and all funding of the pension will be 'steps' taken for the purpose of that transaction. Even if the exemption does apply, as the exemption stands it will be of limited value to employers with pension plans caught by Part 7A (as international plans will often not be available to most of the contractual employees of the employer, or will be confined to higher paid employees).

90. The exemptions in respect of employment related securities are too narrow. Section 554H provides an exemption for an acquisition by an employee of forfeitable securities, or of an option, but it does not exempt an acquisition by an employee benefit trust for the purpose of making the award. The trustees will almost inevitably 'earmark' the shares before making the award. Also, s 554H takes no account of the reduced value to be attributed to convertible securities under Part 7, and will thus again accelerate a tax charge in many innocent circumstances.

The value of the 'step'

91. Section 554K provides that if the step involves a sum of money or an asset the taxable value is the sum or the market value (or, in the case of an asset, the cost if higher). However, for this purpose the cost may be apportioned between the provision of the benefit and other matters. The sum of money and the market value of the asset are not capable of apportionment in this way.

92. Thus suppose a holiday company charters a passenger aircraft with a market value of £20m for two weeks to take fee paying customers on holiday, but permits an employee to take an otherwise unused seat on the aircraft for his holiday. The airline is a third party and takes the 'step' of providing use of the aircraft to the employee. The employee is to be taxed on £20m.

Dividends

93. Section 554J(2) provides that dividends paid to employees which are capable of being taxed under Part 7A will be so charged in priority to the normal dividend rules in ITTOIA 2005. Prima facie all dividends paid on shares which are provided to employees under any form of share plan (including any form of tax approved plan) will be caught by this rule, since the plans in question are clearly a form of 'recognition or reward' and the rights of share ownership, including the potential to receive dividends, is part of the offer made under the share plan.

94. Given the extremely wide ranging language of s 554A and all of the things that 'do not matter', and that dividends will always be voted on by shareholders (ie, third parties), and that the voting on resolutions at shareholder meetings are prima facie 'arrangements' it is arguable that any dividend paid to any employee shareholder will be liable to PAYE/NIC. Again, the doubt in this area will be very damaging to business even if HMRC attempt to limit the damage through publishing guidance.

Consideration given by employee

95. Section 554O permits payments made by the employee to be deducted from amounts otherwise taxable under Part 7A. Again this is far too narrow:-

    - The requirement that the employee's consideration must be in cash is wrong in principle. If an employee gives consideration in another form (for example on a share for share exchange on a reorganisation or takeover, or an exchange of an interest in shares for another interest of equal value), that should be equally deductible.

    - Similarly the requirement that the cash must be paid before the asset is transferred to the employee is wrong in principle. Many contracts involve simultaneous provision of consideration in both directions and it will be impossible to demonstrate that the employee's payment is made 'before' the transfer. Even if the employee's payment is made after the transfer (for example, in accordance with the rules for settlement on a market, or by means of deduction through the payroll in the following payroll run), he should not be penalised by a tax charge which allows no credit for his payment.

    - The deduction is permissible only from a charge arising under s 554C(1)(b). An employee's payment for any 'step' in Part 7A should be creditable against that step.

Imposition of s 222 ITEPA

96. The extension of s 222 ITEPA, itself a tax charge in the nature of a penalty, to the penal charges made under Part 7A, further compounds the problem. The recent appeal in *Chilcott and others v Commissioners for HM Revenue and Customs* [2010] EWCA Civ 1538 demonstrates that s 222 itself is unfair and in need of reform. The policy in defence of s 222 is that it is there to encourage compliance. There is no policy reason why share option gains, etc should be subject to such intense 'encouragement' measures compared with, say, cash remuneration which is not taxed at the correct time and attracts a penalty at a lower level. Given that Part 7A will itself create far greater injustices for the unwary, the addition of s 222 to those injustices will serve to exacerbate the problem,

discourage business from operating in the UK, and bring the tax system into disrepute.

Conclusion

97. We believe that the current structure and fundamental principles underlying Part 7A are wrong. While we understand the wish not to leave scope for abuse, and we would be happy to work with HMRC to identify a set of rules that will be fit for purpose, we do not accept that it can be right to impose severely penal tax charges on a wide range of very common commercial remuneration arrangements.

98. In general the tax that will be collected under this legislation will be paid mainly by employers and employees who do not take advice before taking the step in question. These will comprise mainly small employers who are not advised in this area or foreign based employers whose remuneration policies are designed without regard to the tax legislation of any particular country and who will seek advice only after assignments have commenced.

99. No matter how many such employers and employees are caught in practice, and no matter how much sympathy HMRC may have for their circumstances, they will be obliged to pay. It is clear from the recent appeals in *Chilcott* that neither HMRC nor the Courts would have the power to offer any relief from any disproportionate tax charges that will arise under these provisions.

100. More importantly, if employers can no longer offer deferred or conditional incentive plans without incurring an immediate tax charge, and if all forms of loan are effectively now prohibited, and if the potential for innocent transactions to trigger penal tax costs that are not recognised until too late is to be so increased, these measures will damage the UK's competitiveness.

101. We believe that the basic principle underlying these provisions that all 'steps' are caught, whether motivated by tax avoidance or not, is wrong. It is not realistic to expect to cater for all of the potential variety of innocent transactions that will arise in practice, by making specific provision for each example that is identified by this consultation. Commercial practices develop constantly and new circumstances and new questions arise every day.

102. We suggest that in view of the far reaching and potentially damaging consequences of the legislation as drafted, the proposals should be substantially withdrawn. We suggest more serious consideration be given to the fundamental principles underlying this legislation and further consultation undertaken on a more workable and realistic structure, which clearly targets the abuses that HMRC wishes to stop but which does not impose additional burdens and cost on UK businesses.

CFC Interim Improvements

General comments

103. The CFC Interim Improvements are a stopgap and will be replaced by the new permanent regime which is currently under discussion and will result in new provisions for enactment in Finance Act 2012. Our comments on the Interim Improvements should be seen in that light.

104. Overall we welcome the government's efforts to introduce temporary easing measures to the CFC regime prior to the new regime to be put in place in 2012.

105. We welcome the introduction of the statutory exemption 'grace period' of three years for foreign subsidiaries that, as a consequence of a reorganisation or change of UK ownership, come within the scope of the CFC regime for the first time.

106. We do not believe that cash and finance income that is derived from previous 'good' overseas income should potentially come within the CFC regime. It would be possible to pay this income up to the UK parent by way of dividend and then reinvest as equity to the potential CFC subject to any possible Fat Cap provisions. But we do not see why there should be a need to do that and it could also be expensive if the local jurisdiction operates a withholding regime.

107. We welcome the 'other improvements' set out in paragraphs 2.29 to 2.35 in Part 111A of the Corporate Tax Reform document but suggest in the comments below some alternative to the proposed monetary increase in the de minimis limit.

Revisions to s 748 ICTA 1988

108. There is a proposal for new s 748 (3)(da) to increase the de minimis limit from £50,000 to £200,000. The limit for small and medium sized enterprises would remain at £50,000. We suggest that, as an alternative, there should also be a de minimis based on group turnover.

New s 751AB ICTA 1988

109. We found it extremely difficult to read and understand the provisions in this new section. We understand that new s 751AB is intended to allow partial CFC relief claims similar to s 751A/AA/B, where the provisions of new s 748(3)(ba) or (bb) are failed. Section 751AB(2)(a)(i) then addresses the situation where the new s 748(3)(ab)/Part 2A trading company relief is not applicable by virtue of UK-related gross income or expense being > 10% but </= 50%, and s 751AB(2)(b) addressing the situation where > 5% of the CFC's gross income for the new s 748(3)(bb)/Part 2B. Section 751AB(2)(a)(ii) then appears to allow partial trading company relief where > 5% of a CFC's gross income is either finance income or relevant intellectual property income, but the relevant intellectual property income itself is </=5% of the CFC's gross income. Is this right? If so, we recommend that this is redrafted to make this clearer.

110. We recommend that the limit on intellectual property income below which no apportionment will apply should be 10% rather than 5% (s 751AB(2)(a)(ii)) for consistency/accessibility of the new exemption.

111. Our general concern is that if these exemptions are made too complicated then business will revert to, and rely on, the existing motive test.

Amendments to Schedule 25 ICTA 1988

112. We are concerned by the provision in para 12D which requires the CFC company not to have 'to a substantial extent' non-exempt activities. Without a more precise definition of substantial we are concerned by the uncertainty that this particular provision may create. We understand that this is to be based on the substantial shareholding exemption practice of interpreting substantial as 20% or more, but would be grateful for confirmation of this. However, we believe that it should be statutorily defined.

113. We welcome the provisions in new para 12E which are no longer an all or nothing test. However we do have a concern with the definition in sub-para (5) where ‘UK-related gross income’ is defined to include income derived from persons within the charge to UK tax and also UK-related business expenditure with third parties. This would include income from unrelated i.e. non-group persons in charge to UK tax. If such income is greater than 10% of total gross income then the exemption is reduced pro-rata and if such income is greater than 50% exemption is totally denied. We suggest that the 10% limit should only operate with regard to UK-related gross income from connected or related UK persons as per para 12D(3). This would also mirror the provisions in paragraph 12F(4)(b) and para 12K(2). It should also be noted that existing para 10 of Sch 25 already exempts goods delivered into the CFC’s territory. A final concern with sub-para (5) and the proposed definition of ‘UK-related gross income’ is that it could include the income from transactions with the foreign permanent establishment of a UK related company.

114. The measures in new paragraph 12 G et seq are more demanding than the proposed 1:2 Fat Cap ratio considered for the new, post 2012, CFC regime and outlined in paragraphs 3.17 and 3.18 of Chapter 3 of part IIA of the Corporate Tax Reform document. There is some lack of clarity here as the Fat Cap concept is applied to situations where the intellectual property is held as an offshore investment. Is there to be a distinction between passive and active intellectual property? If this is the intention, why should passive intellectual property be easier to deal with by way of a simple ratio concept?

115. In para 12I (2)(a) there is a requirement that the intellectual property has not been held by a person resident in the UK within the previous 10 years. If there is to be such a provision we believe that the period specified should be reduced to say 6 years, which is in line with the provisions in s 179 TCGA 1992. However, even with this reduced period, we are concerned that the basic provision may be in breach of the EU/EEA law where the CFC is an EU or EEA non-UK company. It may also be the case that the original intellectual property may have moved from the UK and an exit charge paid in which case any future income would have been captured in that exit charge and shouldn’t be subject to a further CFC charge. It may also be difficult to determine what constitutes intellectual property previously held in the UK, which is a similar problem to that faced by the FA 2002 intellectual property provisions: see CIRD para 11678 of HMRC’s Corporate Intangibles Research and Development Manual for a discussion of the problem in that earlier context.

116. Also in para 12I(2) intellectual property has a UK connection if it has been held within the previous ten years by any person resident in the UK whereas if the intellectual property has been created, maintained etc this is only caught if it has been carried out by a person related to the overseas subsidiary and where the creator etc is within the charge to UK tax. The first condition would have the effect of catching an innocent case where a foreign subsidiary has acquired IP from a completely unconnected UK person and we believe this provision needs to be amended to take account of this.

117. In para 12K(2)(a) the indirect equity funding of the CFC’s business could present a significant problem because, in theory, all CFCs, however remotely held from the UK, could arguably have been indirectly funded from the UK parent.

118. We believe that in para 12K(2)(b) IP income from unrelated persons should be specifically excluded.

Interaction with exempt dividends

119. There will be cases where a CFC that might otherwise qualify as an exempt trading or intellectual property company will be disqualified from such status because it receives dividend income that would constitute an exempt distribution under Part 9A CTA 2009 if it was apportioned.

120. For example, the relevant shareholding could fall within paras 12D(2)(a) and 12J(1) even though the consequent dividends would constitute exempt distributions. It is noted that an exclusion from exempt distributions has already been applied in para 12F(3).

Taxation of Foreign Branches

121. There would appear to be no potential relief for investment companies. In our view this will cause the provision to be in breach of EU State Aid rules.

122. Para A2 of the Technical Note indicates that there will be an irrevocable election for every UK resident company under which all of its foreign branches will be exempt from UK corporation tax.

123. We do not believe it is realistic to expect a company to be able to commit itself irrevocably. It would seem more appropriate for the initial election to be for a minimum period of say four years and for there to be a facility to bring the election to an end by giving a minimum period of advance notice of say one or two years' such notice not to be effective before the end of the initial four year period.

124. There would appear to be no potential relief for terminal losses for which relief would need to be given to keep the UK legislation EC Treaty compliant on the principles established by the Marks & Spencer ECJ judgment. Equally, if on the closure of the foreign branch there was a foreign exchange loss on the branch 'investment' then not to give loss relief to the UK 'parent' would be contrary to the ECJ judgment in the case *Deutsche Shell GmbH v. Finanzamt für Grobunternehmen in Hamburg* (C-293/06).

125. We are also concerned by new s 18B (1) (b) CTA 2009 under which the election to exclude certain profits and losses will apply 'to all accounting periods of the company following that in which it is made.' This would mean that for companies with a calendar year end, the election could not be validly made until after Royal Assent in July 2011 and so branch exemption would only apply for the accounting period beginning on 1 January 2012. Companies with a June year end would be even worse off and would only be able to elect into the new system for accounting periods beginning on 1 July 2012. We believe that the election should commence at the very least with effect from 1 April 2011, as was the original intention, with split accounting periods. We recommend that consideration is given to backdating the effective date of the new election to 1 January 2011 as was done in Finance Act 2004 on the introduction of the Interest and Royalty Directive (see now ss 757 – 767 ITTOIA 2005).

Corporate Gains Tax: De-grouping Charges

126. The Substantial Shareholders Exemption protection which effectively allows an exemption on the de-grouping charge on trading divisions moving into new companies which are then sold does not extend to intangible assets.

127. It would be helpful to understand why this is the case because it can lead to a number of anomalies. These include:

- The CGT and intellectual property rules were meant to be largely aligned.

- Discrimination appears to exist between pre 2002 divisions whose goodwill is fungible and treated as a CGT asset and a business division formed on say 1 May 2002 which, if it had distinct goodwill, would still experience a de-grouping charge in respect of that goodwill under the intellectual property rules.

- The difficulty that will be caused for assets like hotels/public houses where it is difficult to determine between free goodwill and the associated property values.

- This means that newer divisions may stand at a disadvantage where intellectual property is involved and therefore for them there is no simplification.

Small profits rate: associated companies

128. We welcome the simplification of the associated companies' legislation but we do have various observations.

129. The draft legislation applies to accounting periods which have already commenced. Although this ensures early adoption of simplification, there is no guarantee that the legislation will be enacted as drafted. This leaves companies with uncertainty in matters such as the requirement to pay tax by quarterly instalments or the extent that they should undertake reorganisations in their current accounting period to ensure that they are not caught by the proposed substantial interdependence tests.

130. Present legislation makes two companies associated throughout their accounting period if they are associated at any point during the accounting period. Companies may choose to reorganise in their current accounting period to remove association. It would be helpful to confirm HMRC's views as to the extent that a reorganisation during a current accounting period could remove association. For example, X and Y are married. X's company has a 31 October year end and borrowed money from Y's company. Based on the proposals recently issued, X's company repays the loan in December 2010. This was with the stated intention of removing any interdependence between the two companies. Would the fact that the loan was repaid very soon after the issue of the draft legislation and the loan existed for less than two months of the year to 31 October 2011 mean that any commercial independence is not substantial?

131. It is noted that the factors which should be taken into account when determining whether substantial commercial interdependence exists is determined by secondary legislation. If there are to be changes to these factors then we would

anticipate a minimum of three months' advance notice in order to permit companies to consider their structuring before revisions are made.

132. The example of economic interdependence involving Mr Q and Mrs Q should be revisited. The final sentence notes that there is no link between their company and their companies have been trading before they met. It is not clear from the example if the existence of the trade before the couple met is a determining factor. We recommend that this is clarified.

133. The example of organisational independence involving Mr Z and companies P & Q is complex with numerous determinants of association. This makes it more difficult to identify the weight applying to those determinants. We recommend that the example is simplified.

134. The following are common business scenarios and therefore examples based upon them may be appropriate.

- Company A is owned 50% by Mr X and 50% by Mr Y. Mr X has numerous other business interests. Company A has a long term loan from the SIPP of Mr X. Although the company could obtain financing from a third party bank it has chosen to use Mr X's pension fund as the pension fund was willing to accept a slightly lower rate of interest than what would be charged by a third party bank. Is the company associated with the other business interest of Mr X?

- The X family trust owns the entire share capital of two entirely independent and separate businesses. The proposals imply that the businesses are no longer associated. Is our interpretation correct?

VAT: Academies

135. We are concerned that the draft legislation gives HMRC too much discretion to make changes.

136. There is no definition of the format or frequency of the claims. The legislation merely states that claims shall be made 'at such time and in such form and manner as the Commissioners may determine'.

137. In addition subs (1)(3) states that claims should be submitted within four years of the supply being made but subs (1)(4) then gives HMRC the right to determine a shorter period.

138. We consider that in the interests of certainty the legislation should specify what HMRC is permitted to determine so that parliament can scrutinise its reasonableness.

139. It seems that if an Academy is not VAT registered and makes a claim under s 33B, then it cannot recover any input VAT relating to exempt business activities, whereas s 33 does allow local authorities to recover input Vat relating to exempt income in certain situations. We believe that the legislation should be amended so that Academies can benefit from the same VAT treatment as local authorities.

VAT zero-rating: splitting of supplies

140. The legislation regarding the proposed VAT treatment of the splitting of supplies in relation to printed matter is drafted too widely. As it stands, it would require many zero-rated supplies to be standard rated where the supplier had no way of knowing that this should be done.

141. We do not believe that it is the intention of this clause to remove zero-rating from a wide range of books and other printed matter and instead subject them to 20% VAT or convert them into exempt supplies. But it risks starting that effect unless the draft is amended to make it more targeted.

142. The Tax Information and Impact Note (TIIN) in relation to this clause states

> **'Policy objective**
> This measure supports the Government's objective of making the tax system fairer by closing a VAT avoidance scheme that is being used to reduce the amount of VAT due where a business supplies a service together with printed matter that is ancillary to that service.
>
> **Proposed revisions**
> This measure covers, for example, the following situations:
> • where the consumer is contractually obliged to purchase the printed matter from one company in order to obtain the service from another; and
> • where the price of the printed matter is discounted against the price of the service but if the customer chooses not to take the printed matter they are charged the undiscounted price for the service."
>
> **Summary of impacts**
> This measure will only impact on the small number of businesses taking part in this VAT avoidance scheme.'

143. We can understand why HMRC decided to change the law, but the draft legislation amending the zero-rating provisions in Group 3, Sch 8 VAT Act 1994 goes far wider than HMRC's stated intentions. It states:

> "…(2) Items 1 to 6 do not include goods in circumstances where.
> (a) the supply of the goods is connected with a supply of services, and
> (b) those connected supplies are made by different suppliers.
>
> (3) For the purposes of Note (2) a supply of goods is connected with a supply of services if, had those two supplies been made by a single supplier.
> (a) they would have been treated as a single supply of services,
> and
> (b) that single supply would have been a taxable supply (other than a zero-rated supply) or an exempt supply.."

144. There is no requirement for the two suppliers to be connected (in the sense of under common ownership), nor that they are even aware of the other's existence. There is not even a requirement on HMRC to demonstrate that there has been any tax advantage or that there has been any artificial value-shifting.

145. Supplies that would be caught by the draft legislation include the following.

- A newspaper promotional coupon offering a 10% reduction on a restaurant meal.

- Someone hiring an electrical item from one supplier decides to purchase a book on how to use it from an independent retailer.

- Someone having their car serviced decides to buy a servicing manual to check that the job has been done properly.

- A tutor gives a reading list to a group of fee-paying students, who then buy the books from various independent booksellers. The booksellers would not necessarily know that the purchase was linked to an exempt supply of education.

- Educational course books being purchased by students from a third party distributor. This is a common arrangement which applies to, for example, the supply of ACA and other ICAEW course materials. These are commercial and practical arrangements to make it easier for the distribution of reference material to students. There is no requirement for students to purchase the materials available.

146. In each case the retailer of the zero-rated printing matter would not know, nor have any means of knowing, that there had been a supply of services by a third party to the same customer. It is even difficult to see how HMRC could discover this without identifying and speaking with the purchaser.

147. It would not be acceptable for government and/or HMRC to say that the law would not be applied in such cases. There would still be considerable uncertainty. Taxation by law and relief by concession is not a satisfactory tax policy.

148. If a retailer were assessed, then it would be difficult for him to contest the assessment properly unless HMRC were to provide him with the information on the third party supplier of services. HMRC would presumably not be prepared to do this because of taxpayer confidentiality. But without that information, how could the third party retailer know to what supplies of services his sales of books etc HMRC considered were connected?

149. We consider that the draft legislation should be amended to require, in each case that

- both suppliers are connected (in the sense of common ownership); and

- that the values for each supply are artificial and not at arm's length.

150. There is also the question of whether the UK would need a derogation under Art 395 of Directive 2006/112/EC before it could introduce the clause.

Security for payment of PAYE

151. A separate response has been made to the consultation document published on 9 December which contains draft Finance Bill and secondary legislation. The primary legislation in the Finance Bill is enabling legislation with the detailed provisions in the PAYE Regulations. HMRC has assured us that it will continue to

consult on the form of the regime and the content of the secondary legislation and will be exposing draft guidance for comment. In the light of the above we have only one point to make on the draft Finance Bill legislation.

152. We are concerned that a criminal offence, which is not defined in the primary legislation, will be contained in secondary legislation without any safeguards in the primary legislation. This means that Parliament will not have an opportunity to scrutinise the nature of the offence in detail. Another concern is that the new security regime could be used against business which cannot pay, for example because those businesses have taken on too much risk or overstretched themselves, rather than won't pay, because the business wants to evade their obligations.

153. We accept that much of the PAYE regime is governed by secondary legislation and the regime will not come into effect until at least April 2012. This will allow time for HMRC to consult on the form of the regime, the regulations and guidance, and, as noted above, this is what HMRC has promised to do. Nevertheless, given that the draft Finance Bill legislation is enabling legislation and does not specify the conditions that must be met for security to be demanded, the primary legislation should include an important safeguard, namely that a member of the Board of HMRC should take responsibility for issuing a demand for security.

154. We therefore recommend that in new item 4B in subs (2) after the word 'required' should be added the words 'by a Commissioner of HMRC'.

Data gathering powers

General Comments

The need for a consolidated Act

155. We concur with the approach of moving the data-gathering powers and some specialist third-party powers into a single schedule. However, there does need to be clarity about these powers and how they interact with Sch 36, FA 2008.

156. This leads us to the more general recommendation for a new Taxes Management Act. The legislation arising from the HMRC Powers Review is currently spread across four years' Finance Acts – 2007 to 2010 – and this will become five years once Finance Act 2011 is in place. Further, each year's Finance Act has made additions or amendments to previous Powers legislation. We think this is an unsatisfactory situation. It means that taxpayers and advisers have difficulty firstly in finding the legislation, and secondly in understanding how the new administrative and compliance powers fit together. It is also not clear how the new legislation fits with the provisions that remain in Taxes Management Act 1970. No doubt HMRC would also find it much more efficient to have the legislation consolidated and in one place.

157. We participated in discussions when a New Management Act was mooted in 2006; we did not support that project at the time, as it was unworkable to re-write the administrative rules before the Powers Review had produced the new framework for compliance matters. However, now that the Powers Review is drawing to a close and we have most of the new legislation, now is absolutely the right time to consolidate and integrate the taxes management legislation.

Compliance burden

158. We are concerned that providing information to HMRC should not impose a disproportionate or unreasonable compliance burden on data-holders. We and others raised this issue in response to the previous consultation; as noted in the December 2009 summary of responses (para 2.4): 'Many respondents felt that HMRC underestimates the work that has to go into collating and checking the accuracy of information that is often only held incidentally to the data-holder's main business.' We strongly agree with this statement.

159. The Bulk and specialist information powers consultation discussed the administrative burdens on data-providers and ways to mitigate them in some detail – for example, if HMRC could give advance warning of what data should be collected and offer alternative formats for providing it, what time limit should be allowed for providing data.

160. However, there is very little about this in the current Condoc or in the legislation. We assume that the way HMRC uses the data-gathering powers will be specified in guidance, and this must contain safeguards to minimise the compliance burden on data-holders.

161. We should like to review the guidance before it is published. We highlight below some principles which it should cover:

- HMRC must first ensure that it does not hold or could not extract the information from its own records before it issues any information notice.
- Information requests need to be given in good time, be proportionate and not be overly burdensome.
- Data-holders should be given advance warning of what data HMRC will require. Warning should be as far in advance as possible and certainly well before the start of tax or accounting year so that data-holders can adapt their system to provide it.
- HMRC should be flexible about the form in which data is provided, especially if there has been no advance warning of the requirement.
- The time limit for providing the data must be reasonable (this is discussed further at paras 20–23 below).

162. We also think that it is best for safeguards to be in legislation rather than just in non-statutory guidance. Para 4, Sch 1 says that the format and time-frame for complying must be 'reasonably specified'. In addition to this safeguard, we should like to see a specific requirement for HMRC to have regard to the likely cost for the data-holder of complying with the notice.

Bulk data and overpaid tax

163. We were pleased to note in the Bulk and specialist information powers (para 1.7) that one of the uses of bulk information is for HMRC to target publicity and support where there is a risk tax has been overpaid. In our response we asked for HMRC to set out the details of its current and proposed campaigns to assist those who have overpaid. The issue was noted in the summary of responses (para 2.7) but is not mentioned in the current Condoc.

164. We include this point here as we do not want it to be forgotten while the emphasis is on finding undeclared or underpaid tax. It is HMRC's duty is to make sure that taxpayers pay the right amount of tax, which includes ensuring that those who have overpaid get refunded.

Specific Comments

165. We set out below our comments on specific aspects of the Condoc and the legislation. Our comments broadly follow the order of paragraphs in the legislation.

Time to comply with the data-holder notice

166. There is nothing in the draft schedule specifying the period allowed for compliance with a notice, other than it must be 'reasonably specified in the notice' (para 4(1)) . The Condoc notes that: 'There is no intention to shorten the periods currently allowed, although this is a matter which may be discussed with specific data-holders.'

167. In our response the earlier consultation we supported a 90-day time limit (which, as HMRC said, applies to many of the current bulk information powers). We note from the summary of responses that: 'Most respondents were opposed to any reduction in the 90-day period usually allowed to provide data, saying that accuracy may be compromised if its collection were rushed.'

168. We do not think it is acceptable that despite these comments, the primary legislation does not specify a time limit. Even though HMRC says it does not intend to shorten the periods currently allowed, we think it likely that in a few years' time the superseded time limit will be forgotten and HMRC might start imposing shorter deadlines. A time limit specified in guidance alone is not an adequate safeguard.

169. We recommend that the legislation should specify a minimum time for complying, preferably 90 days but certainly no less than 30 days.

Approval by the tribunal

170. Para 5, Sch 1 provides for an un-appealable pre-approval by the Tax Tribunal. We are concerned that this gives insufficient or poor protection to ordinary taxpayers and does not strike a fair balance. There is also concern that the un-appealable pre-approval route might be over-used or incorrectly applied by HMRC.

171. In particular when HMRC applies the very wide opt-out in para 5(5), where notice allegedly might prejudice any purpose, then the limited test left to be applied by the Tribunal in paras 4(a) and 4(b) is very weak.

Power to retain documents

172. We welcome the safeguards in para 7 that if HMRC retains any document, the retention must be on reasonable grounds, and that the data-holder can ask for a copy.

173. However, there does not seem to be anything preventing HMRC retaining data-holder's documents indefinitely. It is difficult to see why a data-holder might send original documents rather than the specific return of data required by the notice, but if this happens, the data-holder should be able to get the documents back.

174. We think this safeguard would be clearer if it differentiated between documents which are returns of data in the required format – which presumably HMRC would wish to keep permanently – and any original documents of the data-holder.

Charities as data-holders

175. The way in which charities have been included as data-holders (para 27, Sch 1) is very broad. The rest of Part 2, Sch 1 sets out specific categories (activities or types of data) and then defines the data-holders. Para 27 simply has the heading 'Charities' and then says that a charity is a relevant data-holder – thus it is open to HMRC to ask a charity about pretty much anything.

176. We understand that HMRC would only exercise this power where the charity appears to be a party to activities that relate to tax avoidance. However, this safeguard is not in the legislation and we are concerned that smaller charities in particular might find themselves subject to onerous information requests.

177. We note that a charity can already be a data-holder under the specific headings (eg where it is an employer) and that the regulations anticipate that data requests will relate to donations to a charity. Therefore we do not think a widely-drawn further category is necessary. We suggest that para 27, Sch 1 be made more specific so that it relates to donations to charity, and then lists charities as data-holders.

Appeals

178. The right of appeal against a data-holder notice in para 28(1)(a), Sch 1 on the grounds that the requirement is unduly onerous does not apply if the information requested is part of the data-holder's statutory records. Statutory records are defined in para 46.

179. We accept that a data-holder should have the statutory records required of it but we do not think that it is adequate to remove the right of appeal on those grounds. It might be that the format in which HMRC requires the data or the time-frame in which it is required is too onerous. It may not be a simple matter to extract the data from statutory records and present it in the way HMRC has requested. We think that there should be a right of appeal on the grounds that a notice is onerous, even if the information relates to statutory records.

180. We also have some more general concerns about what is meant by statutory records, see paragraph 36 below.

Foreign tax

181. Para 45, Sch 1 provides that for the purposes of the data-gathering powers tax includes 'relevant foreign tax' (para 45(1)(m)). We understand that any requests either by or to overseas tax authorities would be by reference to the OECD guidelines on the subject. We understand that in using the power HMRC would also consider reciprocity – ie if HMRC made a similar request to the overseas authority, would that overseas authority have the power to obtain such data and would they actually do so?

182. We would welcome detailed confirmation about HMRC's approach to requests from overseas tax authorities and what tests will be applied to ensure that any requests meet the required guidelines. In particular, in what circumstances might HMRC decline a request, for example because of concerns about confidentiality in the overseas tax authority?

Statutory records

183. We do not think that the definition of statutory records in para 46 is sufficiently clear. This is relevant in the context of appeal rights under para 28(2) as mentioned above.

184. We note that para 46(1) defines statutory records as ‘data the data-holder is required to keep and preserve under or by virtue of any enactment relating to tax’. We presume from this that the legislation is intended to target the data rather than the records or underlying documents themselves. This is different from the usual concept of statutory records, which would include (for example) original invoices. We do not think the legislation is sufficiently clear on the point and that it should be clarified.

Repeal of section 76, TMA 1970

185. The Condoc proposes (at para 2.36) repealing s 76, TMA 1970 and this is achieved by para 51(2)(q), Sch 1. We think this should be retained. It is not in fact a data-gathering power but is designed to protect trustees of an interest in possession trust where income is mandated directly to the beneficiary. As such it should be retained in the Taxes Acts though not with the data-gathering powers.

186. The background to this section, which explains the reason for it, is as follows:

187. Section 76 deals with the situation where the trustees of an interest in possession trust mandate income direct to the beneficiary. It provides the vires for ensuring that the trustees cannot be taxed on such income.

188. It derives from s 103(3), ITA 1918. That gave the exemption to the trustees. In 1918 the Inland Revenue did not have power to require a return of total income from a taxpayer; nor did they have power to require information returns. Both of these powers were introduced by FA 1927 in a single section, ie it gave HMRC power to require a return of total income and such other returns as they felt appropriate. FA 1927 made the s 103(3) exemption dependent on complying with the return requirement.

189. In the 1952 consolidation these two powers were separated out. Unfortunately it does not seem to have been done well. Section 76 was s 367, ITA 1952. The reference to s 13 (which was introduced in the 1952 Act) is not appropriate. This deals with returns where a person receives income belonging to someone else, whereas s 76 deals with the situation where someone else (the life tenant) receives income that technically belongs to the trustees on its receipt but on trust for them to pay it over to the life tenant. We think the reference to s 13 should have been to s 9 (ie that the trustees needed to complete their own income tax return in order to secure the exemption).

190. Be that as it may, if the section is scrapped the protection against being asked for tax on sums which technically were earned by the trustees but which they have never received is both fair and important.

191. It may be that HMRC says it is no longer needed because the trust tax return does not ask for details of such income. If so that misses the point. The section was not designed to elicit information; it was designed to protect the trustees from being assessed on income that is technically theirs but never comes into their hands. They still need such an exemption.

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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/index.cfm?route=128518.