THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Tax Faculty

Tax Representation

TAXREP 23/05

FINANCE ACT 2005

Memorandum submitted on 13 May 2005 to the Treasury by the Tax Faculty of the Institute of Chartered Accountants in England and Wales commenting on Finance Act 2005

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FINANCE ACT 2005

INTRODUCTION

1. We are writing to provide our comments on the provisions contained in the Finance Act 2005. In addition we are writing to repeat our concerns, expressed in several letters to the Paymaster General, in relation to the manner in which Finance Act 2005 was enacted.

2. We have judged the Finance Act 2005 by reference to our 'ten tenets'. These are the ten key principles that we believe should underpin a good tax system and they are set out in Appendix 1.

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

KEY POINT SUMMARY

4. More than 200 pages of legislation were enacted in Finance Act 2005. There was a single Committee session, before the whole House of Commons, which lasted for only four hours on the afternoon of Wednesday 6 April 2005.

5. We are grateful that the original Finance Bill was truncated as we requested in our letter to the Paymaster General dated 31 March 2005, but we are disappointed that many of the clauses in the original Bill were retained. Tenet One of our Ten Tenets states that *tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.* We are concerned that the Finance Act was not subject to the usual detailed parliamentary scrutiny.

6. We appreciate why the Government was anxious to keep many of the provisions in the Bill, particularly those in relation to anti-avoidance. We also understand that with an impending election it is very difficult to balance the difficulties of reviewing legislation with the need to finalise matters before the dissolution of Parliament.

7. Nevertheless we disagree profoundly with the approach that was adopted. The result is that the Finance Act 2005 has not been subject to detailed Parliamentary scrutiny. In addition it contains a number of problems that need to be remedied, for example:

   - some of the drafting is poor (see for example paragraph 26 below):
   - many of the provisions are not properly targeted and will not work as they should do (see for example paragraph 32 et seq); and
   - taxpayers engaged in ordinary commercial activities will be penalised (see for example paragraph 52 et seq).

   The Finance Act needs to be amended to take account of these issues in the same way that it would have been amended on its passage through its Committee stages. Any amendments should also be backdated to the start date of the Finance Act.

8. We trust that if a new Finance Bill is now published, there will be a Finance Bill Open Day as there have been in previous years and that this will include discussion of those provisions now included in the Finance Act 2005.

9. We have included our comments on the detailed provisions in the Specific Comments section below.

GENERAL COMMENTS

The lack of Parliamentary scrutiny and the need for this Bill to be amended

10. The original Finance Bill was published on 24 March 2005 and contained 172 clauses and 20 Schedules. It was 341 pages in length.

11. At the time it was widely anticipated that the Government would call a General Election for early May and that Parliament would be dissolved in early April.

12. The Chairman of the Tax Faculty's Technical Committee wrote to the Paymaster General on 31 March 2005 expressing concern about the prospect that the whole of the Finance Bill would be rushed through Parliament without adequate scrutiny. We published that letter as TAXREP 15/05.

13. In that letter we indicated that our major concern was that there were:

> 'a number of provisions in [the] Bill which need to be subject to proper Parliamentary scrutiny and debate.'

14. We then went on to note that:

> 'Whilst we accept that quite a number of provisions in the Bill relate to anti-avoidance, many of them are highly controversial and need to be subject to proper parliamentary scrutiny, because they:
>
> - are potentially in breach of the EU treaty;
> - are not properly targeted;
> - are highly complex; and
> - may damage UK competitiveness.'

In the remainder of the letter we set out some examples of the provisions which illustrated the issues listed above. We requested that the Finance Act only included rates, allowances and other non-controversial measures effective from 6 April 2005 and that the other measures should be dropped from the Bill.

15. We are grateful that the Government took note of our concern and that a number of measures were removed from the Bill. Nevertheless over 200 pages of legislation were still included in the Finance (No. 2) Bill 2005 and it was debated by a

Committee of the whole House for only four hours on that same afternoon before becoming the Finance Act 2005 the next day.

16. The following quote from our 31 March 2005 letter appears in the Hansard record of that debate:

> 'We are strongly of the view that if the provisions in the Finance Bill are not subject to appropriate Parliamentary scrutiny then this will be to the detriment of UK business and will undermine confidence and trust in the Parliamentary process.'

17. We are disappointed that Parliament pushed through over 200 pages of detailed legislation without proper scrutiny and no time for consultation with interested parties. There are many aspects of the Bill that are both complicated and controversial and they need to be subject to proper Parliamentary scrutiny. In normal circumstances we would have presented our detailed comments on the draft Finance Bill in advance of the Standing Committee debates. However, this was not possible.

18. Moreover, there are other measures, such as the rules for trusts with vulnerable beneficiaries, which need proper consultation.

19. As a result of this lack of Parliamentary scrutiny and consultation, this Finance Act is flawed. This Act now needs to be given proper scrutiny and extensive amendments made to it to ensure that it is certain, properly targeted, fair and proportionate and does not put the UK at a competitive disadvantage. Our comments below are designed to assist that process and we would be happy to meet to discuss them.

20. We also request that any amendments are backdated to the start of the legislation included in the Finance Act.

The legislation in Finance Act 2005

21. Set out below are our comments on the provisions that were retained from the original Finance Bill, published on 24 March 2005, and which were enacted in Finance Act 2005.

Finance (No. 3) Bill Open Day

22. Due to the election, there was no Open Day, as there have been in previous years, to discuss the first two Finance Bills. The Open Day provides a very useful opportunity for the professions to discuss the detailed provisions with the relevant technical specialists. If a third Finance Bill is published, we request that there is a Finance Bill Open Day. We would welcome confirmation that there will be an Open Day and that it will also cover legislation that is now included in the 2005 Finance Act.

SPECIFIC COMMENTS

Section 13 Non-corporate distribution rate for financial year 2005

23. We note the perpetuation of the non-corporate distribution rate of corporation tax without any discernible attempt to date to review how far this measure has been successful in meeting the Government's objectives. We believe that these provisions are unnecessarily complex and place unreasonable burdens on the smallest businesses, and on the advisers to such businesses. We recommend that an urgent review be carried out as to whether the compliance costs of these rules exceed the benefit from retaining them.

Section 14 Special trust rates not to apply to first slice of trust income

24. The legislation should provide for the limit to increase automatically in line with inflation. The easiest way to achieve this objective would be for the allowance for trusts to be set as a proportion of the allowance for individuals.

25. We are concerned that the drafting of this section appears to have been carried out in haste and that the full implications of the provisions have not been considered. For example, it is not clear whether the £500 is per fund or per trust. This needs to be clarified.

Section 15 Childcare vouchers: exempt amount

26. The rules for the tax exemption for help with childcare costs are extremely complex. The fact that change is needed to the original legislation before the rules have even come into effect is a further illustration of the haste with which tax changes are being introduced. When these rules were first put out for consultation two years ago, we suggested that this whole area should be dealt with in its entirety, rather than through piecemeal change

> 'We would suggest that there is a need to take a step back and look at the overall aims and strategy behind Government assistance in relation to childcare to ensure that all aspects of the system operate from the same starting point and that no one group of individuals are disadvantaged.'
>
> (Paragraph 4, TAXREP 15/03)

We remain concerned that the piecemeal approach has resulted in legislation that is poorly drafted. It is far too complicated to the ordinary taxpayer to understand and can easily penalise those on low incomes. It needs a detailed review and redrafting aimed at simplification and removing some of the anomalies that cause unfairness.

27. We would also like to stress once more the unequal treatment of the self employed who are not able to obtain tax relief for childcare costs. We think that this is unfair and causes needless complication. We have commented several times during the recent past on our concern that the Government is leading people to incorporate their small businesses in order to benefit from the tax reliefs. This results in additional administration, with attendant costs, and distracts businesses from their primary activity of making profits. We see no policy reason as to why the self employed should be treated differently and we think that the law should be changed so that they are able to claim relief.

Section 18 Extension of outplacement services etc exemption: part-time employees

28. We welcome the extension of this exemption to part-time employees

Section 19 Armed forces pensions and compensation schemes

29. We welcome the extension of this exemption to armed forces pensions and compensation schemes.

Section 20 Research institution spin-out companies

30. New section 451(2), ITEPA 2003, states that the 'Chapter does not apply if the avoidance of tax or national insurance is the main purpose (or one of the main purposes) of the arrangements under which the right or opportunity to acquire the shares (or interest in shares) is made available'. We understand the policy purpose but the result is that it creates uncertainty. In order to reduce uncertainty, we think that there should be an advance clearance mechanism.

31. The 14 day time period permitted by new section 454(3)(b) seems to be unreasonably short. This may be particularly problematic for those universities starting their academic years later in October in relation to the definition set out in new section 460(7).We think that the time period should be a minimum of 30 days.

Sections 23 - 45 Trusts with vulnerable beneficiary

32. We are concerned that this legislation was not properly reviewed before it was enacted. The purpose of these rules is to benefit a particularly vulnerable group of taxpayers. This is a highly sensitive area and the views of trustees of such trusts, and those of their advisers, should have been sought in the proper manner.

33. The rules for these trusts are extremely complex and necessitate a considerable amount of technical expertise for those with relatively little income. At the very least the new provisions should have followed the Tax Law Rewrite style.

34. The basis for calculating the tax deduction for the trust is too complicated. An easier way would have been to make the trust tax-transparent and allow the normal trust expenses. We would welcome the opportunity to discuss with HMRC officials how the existing law can be improved.

Section 37 Vulnerable person election

35. We note these provisions apply from 2004/05 so the first election has to be submitted by 31 January 2007. It appears that the election must also be signed by the vulnerable beneficiary, which will not be possible if the person is disabled. Someone with a general power of attorney would have to sign on behalf of the vulnerable person. How elections can be made in these circumstances needs to be clarified.

36. There is a further problem in that trustees will need to know all of the circumstances of the 'vulnerable person' when deciding whether or not to make the election. This information is unlikely to be easily and readily available, adding considerably to the costs of compliance.

Section 39 Meaning of 'relevant minor'

37. We believe that the definition of a vulnerable person is too narrow. A disabled person has to be in receipt of the medium or higher rate of attendance allowance or disability living allowance to qualify, which is very difficult to achieve for a child living at home.

38. The definition of a 'relevant minor' is a child under 18 where one parent has died. However a child of a single-parent family, where the other parent has left, but is still living, (or not proved to have died) will not be a vulnerable person, as defined. Furthermore, to require the death of at least one parent does not recognise situations where a minor may be equally vulnerable due to the incapacity of a parent. We believe that the definition of 'relevant minor' needs to be expanded to include the types of person described above.

39. The definition should state the date for determining the status of the vulnerable person and, if possible, should be defined to minimise the circumstances in which split year treatment will apply.

Section 72 Removal of restrictions on interest relief

40. We would welcome confirmation that this rule affects only those partnerships involved in the film industry and not other partnerships.

Section 85 Dividends by reference to which a deduction is allowed: no underlying tax

41. We believe that section 85 FA 2005 should be repealed since it will act as a disincentive to investment in developing countries, such as Brazil, which allows companies a tax deduction for interest on shareholders' funds. It is understood that this particular investment incentive was introduced in Brazil in the mid 1990s as a method of compensating the shareholder for the consistently high rate of inflation (previously, a system of 'monetary correction' was operated whereby the financial statements of Brazilian companies were regularly restated to take account of inflation).

42. From a computational viewpoint, prior to the introduction of section 85, the payment of a dividend that was deducted for tax purposes in the territory of the payer was not deductible in arriving at the relevant profits for double tax relief purposes. As a result, it would often have the effect of decreasing the underlying tax rate significantly below 30 per cent, so that there would be UK tax payable on the dividend. Given that the underlying tax rate on such dividends is generally low, we consider that the complete restriction of underlying tax imposed by section 85 is unduly harsh. In addition, it is not clear how underlying tax will now be attributed to the relevant profits of the foreign company other than these extracted as a tax-deductible 'dividend'. Specifically, effective double taxation will arise if it is not now possible to allocate all of the underlying tax of the foreign company to its profits which may be distributed to the UK as a non-deductible dividend. We would therefore be grateful for clarification of this point.

Sections 86 and 87 Double Taxation Relief: restrictions

43. Insofar as either section 86 (Limits on credit re trading profits) or section 87 (schemes designed to increase relief) inhibit the credit of EU (non-UK) foreign tax paid, then we believe they are contrary to the EU treaty. We are also concerned that the effect of the change will be that some foreign tax will not be relieved by set off against UK tax and this will lead to double taxation.

44. Finally we believe that the need to identify each (or even each class) of foreign income and allocate direct and indirect expenses to it is imposing a significant (massive in some cases) additional compliance burden on business particularly in the financial and entertainment sectors.

45. The additional complications imposed by this measure will make the UK internationally uncompetitive. We think that this measure needs to be withdrawn with retrospective effect.

Background (to sections 86 and 87)

46. These issues have been the subject of a Technical Notes issued on 2 December 2004 at the time of the Pre-Budget Report. Comments were requested by 31 January 2005. However the Revenue issued a Press Release on 10 February indicating that they were going to take action along the lines of the provisions now contained in sections 86 and 86.

47. We believe that the issue of the 10 February Press Release was prompted by the victory of the taxpayer before the Special Commissioners in the case of Legal & General Assurance Society Ltd v David Thomas (Inspector of Taxes) SpC 461. The release date for the Special Commissioners decision was 28 January 2005, although the decision was not published until a few days later. The first issue considered in this case covers the matter which is the subject of the Technical Note i.e. the amount of credit for foreign tax paid on trade receipts.

48. One of the taxpayer's arguments before the Special Commissioners was that if the view put forward on behalf of the Revenue was correct it would represent a restriction on investment abroad which is contrary to European law (contention 7 of behalf of the Appellant – see paragraph 12 of the Commissioners' decision).

49. In the light of the Gerritse judgment paragraphs 47 & 52-54 (C-234/01) and the High Court's referral to the European Court of Justice (ECJ) in the Test Claimants in Class IV of the ACT Group Litigation (C374-04), which includes the point as to whether the UK's taxation of foreign (EU) dividend income with Double Taxation Relief is contrary to the free movement of capital, having regard to the UK-UK inter corporate dividend exemption, any measure to limit the recovery of foreign (EU) withholding tax would in our view amount to a further breach of the EU Treaty.

50. We also believe that regard should be had to the decisions in Fokus Bank ASA v Staten v/Skattedirektoratet (E1/04) (EFTA case re withholding tax only on cross border dividends), Gerritse (C234/01) (ECJ case re German flat rate non-refundable non-resident entertainer's tax) and the forthcoming cases of Scorpio Konzertproduktionen GmbH v FA- Hamburg-Eimsbüttel (C-294/04) and Test

Claimants in the F II Group Litigation v Commissioners of Inland Revenue (C-446/04).

51. Following the Press Release of 10 February 2005 we sent in a Representation (TAXREP 6/05) to the Inland Revenue indicating our concern that the Government seemed to be undermining confidence in the Consultation Process by 10 days after the close of the consultation period announcing legislation to overturn the decision of the Special Commissioners. We think that this legislation needs to be amended radically so as to ensure that it is EU compliant and does not put the UK at a competitive disadvantage. There needs to be proper consultation on the measure and any changes need to be backdated to the start of the legislation.

Section 91 Tax avoidance involving annual payments and double taxation relief

52. We understand that section 91 is specifically aimed at financing structures designed to allow the UK borrower a tax deduction for annual payments where the borrower received a loan in the form of a dividend sheltered by deemed underlying tax credits.

53. However, the scope of the new rules is much wider since it restricts underlying tax relief in the case of investments in UK companies that have not been structured for tax planning purposes. In particular, section 91 withdraws completely relief for deemed UK underlying tax by repealing section 801(4A)-(4D) ICTA 1988. This measure has the damaging side effect of restricting underlying tax relief available to many UK multinational groups which hold UK companies through offshore holding companies for normal commercial reasons. For example, this type of group structure may be inherited on an acquisition or utilised where it reflects the operational divisions into which the group's business is organised.

54. Such groups will now be put at a serious disadvantage where the underlying tax rate on the relevant profits of the UK subsidiary is less than 30 per cent e.g. due to normal mismatches between tax and accounting profits. We request that section 801(4A)-(4D) is reinstated but amended in such a way that it applies only in cases that do not involve annual payment financing structures.

Section 92 and Schedule 6 Capital allowances: renovation of business premises in disadvantaged areas

55. The definition of a disadvantaged area has been strongly criticised in relation to SDLT, and yet for the purposes of introducing this relief, the same definition is to be used in the first instance.

56. A Consultation Document was issued on 2 December 2004, in preparation for this legislation, and we submitted our response, TAXREP 11/05, in early March 2005.

57. We welcomed the overall objective of the proposed Business Premises Renovation Scheme which is to increase the availability and use of business premises. However, we were concerned then, and we remain concerned, as to whether the relief is properly targeted and whether it is sufficiently simple to provide the necessary incentives.

Section 96 Removal of disadvantaged areas relief for non-residential property

58. This relief was introduced only two years ago, by Finance Act 2003, as one of the core tools designed to use the tax system to help disadvantaged areas.

59. Withdrawing a relief so quickly after its introduction, particularly in relation to property transactions which tend to be long term projects, destabilises business and undermines confidence in those companies wishing to invest in the UK. Projects in progress may be left unfinished. We believe the rules should be amended to allow tax relief to continue in cases where a planning application has already been approved.

AM/IKY
13 May 2005

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.