ICAEW TAX FACULTY REPRESENTATION

TAXREP 21/11

TREASURY COMMITTEE INQUIRY INTO THE 2011 BUDGET

Memorandum submitted on 25 March 2011 to the Treasury Select Committee by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to the invitation to provide written evidence to its inquiry into the 2011 Budget presented on 23 March 2011.

TREASURY COMMITTEE INQUIRY INTO THE 2011 BUDGET

INTRODUCTION

1 We welcome the opportunity to submit comments to the Treasury Committee (the Committee) on the 2011 Budget presented on 23 March 2011.

WHO WE ARE

2 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. The Tax Faculty is the focus for tax within ICAEW.

EXECUTIVE SUMMARY

3 Principles of good tax policy

- We welcome the Government's principles of tax policy.
- Tax Information and Impact Notes need to assess tax proposals by reference to these principles and need to be based on realistic costings.
- There should be independent oversight of whether government meets the framework year on year.
- HMRC's poor service standards remain a barrier to improving the efficiency of the UK tax system.
- We remain concerned that mandation of electronic filing is being rushed and that HMRC has still not rolled out a suite of electronic services to enable taxpayers and agents to communicate with HMRC.
- Government should commit to minimising sudden policy changes such as the proposed imposition of further charges on the banks and oil companies.
- Government should establish a list of all State Aid approvals and a strategy for its engagement with Europe on tax and regulation matters.

The growth agenda

- We support the Government's growth agenda and welcome the clear strategy set by the Government on corporation tax rates.
- We support the Government's drive to increase R & D and believe there should be a study so see whether R & D tax relief meets the needs of smaller companies.

- We recommend a review of all investment reliefs to see whether they are effective in raising growth capital.

- We recommend a review of the CGT system and particularly entrepreneurs' relief to see whether they meet the needs of the growth agenda,

- We welcome a statutory residence test – it should be simple and based on objective measures that are internationally competitive.

Tax simplification measures

- The UK tax code needs to be shortened and simplified.

- We support the proposed abolition of the tax reliefs set out but suggest there should be a round sum de minimis exemption for small benefits so as to minimise employers' compliance costs

- Merging tax & NICs rules is superficially attractive but rejected in the past as unworkable – before a detailed review is undertaken there is a need to establish what is possible.

- We welcome the proposed administrative improvements to IR 35 but would welcome confirmation of how HMRC will resource these improvements.

Anti avoidance measures

- We support Government measures to counter identified tax avoidance schemes and that the need to step up measures to deal with tax evasion.

- Tax avoidance measures need to be properly targeted and not impose burdens on businesses undertaking ordinary commercial transactions.

- We support the underlying policy purpose behind the disguised remuneration proposals but are concerned that in spite of amendments the proposals are still too widely targeted so that they will increase business burdens, catch ordinary commercial transactions and potentially impose penal tax charges.

PRINCIPLES OF GOOD TAX POLICY

4 We submitted written evidence to the Committee on its recent inquiry into the Principles of Tax Policy. We are pleased to note that in its report published on 15 March 2011, the Committee set out a number of key principles that should underpin tax policy formulation. These principles echo the ten key principles that the ICAEW Tax Faculty formulated in 1999 that we believe should underpin a good tax system – these are attached in Appendix 1.

5 In the Chancellor's Budget speech, he set out the Government's tax principles as:

- taxes should be efficient and support growth;
- they should be certain and predictable;
- they should be simple to understand and easy to comply with; and
- our tax system should be fair, reward work, support aspiration and ask the most from those who can most afford it.

6 We welcome the Government's support for these key principles which are consistent with those set out by the Committee last week and those that we published in 1999. We believe that when evaluating all tax changes from now on, any proposals should be tested against these principles.

Tax Information and Impact Notes (TIINs).

7 As noted above there appears to be broad agreement on the principles that should underpin the tax system in general and specific measures in particular. We therefore recommend that Tax Information and Impact Notes should assess the particular measures by reference to those principles. We remain concerned that the figures and costings used in these Notes are not always realistic and they may underestimate the costs incurred by businesses in implementing changes.

The consultation framework

8 We welcome the Government's approach to formulating tax policy which is broadly in accordance with its paper *A new approach to tax policy making: a response to the consultation* published in December 2010.These are important principles and we believe that there should be some independent oversight of whether government meets the framework year on year.

Efficiency of the tax system

9 We agree that the tax system must be efficient. One important but often neglected part of this is the need for the tax system to be administered efficiently. The Committee has underway another Inquiry into HMRC's efficiency and effectiveness to which we have already submitted written and oral evidence.

10 The oral evidence given by HMRC's senior management on 16 March 2011 did little to alter our view that HMRC's poor service standards is one of the single biggest barriers to improving the efficiency of the UK tax system. Given the further cuts in HMRC's budget following the spending review, there are serious questions about whether HMRC's current efficiencies can be delivered, let alone deliver on the further proposals outlined in the Budget, for example improved administration of IR35 and the move to Real Time Information in PAYE.

11 We are very disappointed that paragraph 3.69 of the Overview of Tax Legislation and Rates published in the Budget pack confirms that the Government is proceeding with its plans to make it compulsory for businesses to use a new online Registration Wizard for corporation tax, income tax self assessment/class 2 NICs, PAYE and VAT as part of the 'One Click' programme which is currently being developed.

12 Although we expect consultation this summer, implementation between August 2012 and 2013 seems to have already been decided. The Tax Faculty is concerned that the mandation aspect of this is being pushed ahead too quickly and, in particular, that not all areas of the UK will have the necessary access to high speed broadband. Mandating online registration by businesses may actually deter new businesses from taking on their first employee or even from starting up, thus hindering the growth agenda.

13 In spite of this rush to mandation, HMRC has yet to roll out robust and reliable methods whereby taxpayers and agents can communicate electronically with HMRC. This has to be addressed as a matter of urgency, and is all the more important given that taxpayers are continuing to experience great difficulty in communicating with HMRC, whether it is by post or the telephone. This is not good enough. In short, we cannot stress enough the need for HMRC to improve its efficiency and offer a proper suite of electronic services.

Stability and certainty

14 The Government has identified that the tax system needs to be certain and predictable. We believe it is important for business confidence that business in general and specific business sectors are not subject to unexpected policy shocks. We note the Chancellor announced extra and unexpected charges on oil companies and banks. While we recognise the policy drivers for these decisions, we remain concerned that the proposals are inconsistent with the principles of certainty and predictability. We think it is important for business confidence that Government should commit to minimising sudden policy changes of this nature.

A strategy for engagement with the EU

15 A number of proposals in the Budget (for example the R & D tax credits and the Enterprise Investment Scheme changes) are subject to clearance under State Aid rules or more generally confirmation that they do not breach EU Treaty rules. In relation to State Aid, the clearance process often appears to take a long time and any discussions appear to be shrouded in secrecy, creating considerable uncertainty about whether such measures will receive State Aid approval, and if so when that might occur.

16 We recommend that the Government should establish a list of all State Aid approvals sought, at what stage they have reached, when State Aid approval is expected and the likely start date. More generally the Government needs to set out a clear strategy for its engagement with Europe on areas such as tax and regulation and also ensure that growth measures across the EU are encouraged.

THE GROWTH AGENDA

Corporation tax rates

17 There appears to be a consensus that the UK tax system needs to be internationally competitive and designed so as to encourage businesses to invest into, and remain in, the UK. The proposed reductions in the main rate of corporation tax set out a clear strategy for making the UK's corporation tax system more competitive and provide businesses with certainty. We welcome the stability and certainty this will bring to business planning.

18 The possibility of a differential rate in Northern Ireland is more controversial. The review of this area will need to consider all the available options for encouraging growth and investment in Northern Ireland, including for example whether it might be better to designate Northern Ireland as one of the new enterprise zones.

R & D tax credits

19 In principle we support the Government's drive to increase R & D spending in the UK. In the Budget the Government proposed to increase R & D tax credit for small and medium sized companies from the current level of 175% to 200% from 1 April 2011 and 225% the following year. We welcome the proposed abolition of the rule limiting the amount of repayable credit to the amount of PAYE and NIC paid and the minimum expenditure requirement. The practical consequences of these changes needs careful consideration.

20 Many smaller companies do not have the financial resources to undertake significant levels of R & D. Further, one of the problems with this area remains the correct identification of the boundary between what does and does not qualify as R & D. In practice, we suspect that much of the activity of smaller firms in this area is in

innovation in its widest sense, for example improving existing products and processes, but these activities are unlikely to satisfy the definition of R & D. We recognise that this area may be constrained by EU law considerations but nevertheless we believe that further work is needed to examine whether R & D tax relief meets the needs of smaller companies which undertake innovative activity.

Enterprise Investment Scheme

21 It is proposed that the current limits that apply to the Enterprise Investment Scheme (EIS) will be increased, subject to State Aid agreement. We welcome these announcements: the EIS was once attractive to equity investors in small and growing companies but, in 2007, the then Government scaled back the reliefs substantially on the grounds that the schemes did not comply with EU State Aid rules. We said at the time that the proposed reductions in the reliefs were likely to kill interest in the schemes and, further, that HM Treasury had not produced compelling evidence that the schemes did breach EU State Aid rules. We raised these points repeatedly during the passage of the 2007 Finance Bill through Parliament but to no avail. Our understanding is that, as we feared, EIS is now rarely used and that a potentially important source of funding for growth businesses has been turned off.

22 It now appears that the Government will be reversing most of the reductions in the qualifying conditions and restore them to levels which appear to be very similar to what they were before the 2007 changes. It appears remarkable that, four years on, the unpublished concerns of HM Treasury about whether these schemes complied with EU rules are no longer considered a problem. It would be helpful for the UK to have a clearer statement from the EU about exactly how EU State Aid rules are applied in practice.

23 Given the Government’s clear focus on the growth agenda, we recommend that there is a complete review of all investment reliefs to identify whether they can be made more effective in raising growth capital for UK companies and the costs and benefits of possible options.

Enterprise zones

24 The Chancellor has announced the creation of 21 enterprise zones. The Chancellor has stated that the zones will benefit from 100% rates relief and superfast broadband and that he will consider the scope for enhanced capital allowances in zones where there is a strong focus on high value manufacturing.

25 Enterprise zones have been tried before – such zones were established in the 1980s to encourage regeneration. The principal tax relief on offer then was 100% allowances on buildings in the zone. Although these were successful in regenerating some areas (for example Canary Wharf), in later years such schemes were often characterised by prepackaged investment schemes often backed by non-recourse loans, but with the downturn in the properlty market many investors still lost money. It appears that for the new enterprise zones to work, local authority support will be essential and this aspect of the proposals needs to clarified and encouraged.

26 The proposed new investment schemes would appear to avoid the less satisfactory aspects of the 1980s schemes and have a clearer focus on manufacturing. However, the rules will increase the complexity of the tax system where the tax treatment will depend upon where the activity is located.

27 In a similar manner to the 1980s schemes, we think it is important that any tax reliefs in the new zones should be time limited, although we recognise that this does not improve stability.

Entrepreneurs' relief

28 Capital gains tax has been subject to numerous policy changes since it was introduced in 1965. The FA 1998 changes to CGT were designed to encourage growing businesses and later changes provided further encouragement to entrepreneurs. However, the FA 2008 changes and the introduction of an 18% flat-rate marked a major reversal of earlier policy. The move to the flat-rate also saw the introduction of entrepreneurs' relief (ER), which was modelled on retirement relief, a valuable relief that had been a feature of the UK tax system from the introduction of CGT in 1965 until 1998, when it was phased out in favour of taper relief.

29 This complicated set of events and policy changes has been further exacerbated by the increase in the CGT flat-rate to 28% on 22 June 2010 and an increase in the limit for ER from £2m to £5m. In this Budget, the ER limit was raised again, from £5m to £10m. This increase is likely to encourage entrepreneurs to start and continue to grow businesses, although ER itself has reintroduced many of the uncertainties that surrounded the availability of retirement relief.

30 In order to encourage growth, entrepreneurs need to be encouraged to grow, sell and reinvest in businesses. The history of changes to the CGT rules highlighted above show that in this key area the UK tax system lacks stability and certainty: entrepreneurs do not often know at the outset whether they will be eligible for ER and even if they do qualify they do not know whether the tax rules will have changed by the time they realise their investment.

31 As part of the growth agenda, the Government should undertake a review of the CGT system and particularly ER to see whether they meet the needs of the growth agenda and whether any further changes are needed to encourage entrepreneurs. Once decided, then the Government should commit to making no further changes for the life of this Parliament.

Statutory residence test

32 We welcome the Government's proposal to consult on a statutory residence test which is something we have advocated for some years and have contributed to the working party that has been examining this.

33 We believe that it is essential to have a statutory residence test so that taxpayers have certainty as to their tax position. The recent court cases on residence have highlighted just how uncertain are the UK rules and this uncertainty does little to encourage investment and growth in the UK.

34 In accordance with the principles identified by the Chancellor, it is essential that any residence rule is simple and clear and is based on objective measures that are framed to encourage growth. Any such measure should be internationally competitive and therefore framed in similar terms to the residence rules of territories that are our principal trading partners.

TAX SIMPLIFICATION MEASURES

35 As part of the UK's growth agenda, we believe that the tax code should be shortened and simplified. It cannot be right that the UK has a tax code that is one of the longest in the world. This adds to complexity and damages the UK's reputation as a place to invest and do business. We welcomed the establishment of the Office for Tax Simplification (OTS) and have contributed to the two reviews that the OTS has published so far, namely the review of tax reliefs and SME business taxation.

Review of tax reliefs

36 The OTS review has identified a number of reliefs for abolition and the Government has set out a programme for abolition of the reliefs that were identified by the OTS. In our comments to the OTS, we noted that many of the original list of reliefs identified were part of the fundamental structure of the tax concerned and that any abolition of them had to be considered as part of a wider review of the structure of the tax.

37 We support the proposed abolition of the reliefs some of which (eg millennium gift aid) should have been repealed in any event as the relief is spent. The OTS report has highlighted one of our key principles, namely that measures introduced should be subject to regular review and that consideration given to including within them 'sunset' clauses – this would help to ensure that spent measures are not left to clutter up the tax system and that time is then wasted having to identify them as candidates for repeal – this type of exercise should be undertaken by HM Treasury/HMRC under existing care and management powers.

38 Paradoxically, the abolition of tax reliefs may increase compliance costs. For example, where once employers did not have to worry about tax charges arising because they were covered by a specific relief, if that relief is now abolished tax (and national insurance) charges will arise. For example, the abolition of the exemption for late night taxis may simplify the system but will create practical administrative difficulties for many employers. We have suggested previously that there may be merit in introducing a round sum de minimis exemption for small benefits so that provided any benefits were below that figure they would not have to be reported and there would be no tax charge on the employee. Such an exemption would simplify the tax system and help minimise the burdens on business.

SME business taxation report

39 The interim report of the OTS into SME business taxation has highlighted some of the problem areas and highlighted once again that many of the barriers to tax simplification arise due to structural problems in the UK's tax system. Two of the particularly contentious areas that were identified in the report were the problems caused by having to operate income tax and national insurance and by the IR35 rules introduced in 2000.

40 In relation to the former, the OTS suggested that there should be a review of a possible merger between the two. In his Budget Speech, the Chancellor announced a consultation on merging the operation of National Insurance and Income Tax but at the same time stated that the contributory principle would not be abolished and that National Insurance would not be extended to pensioners or to other forms of income.

41 The idea of intergrating income tax & NICs rules to simplify administration for HMRC and employers is superficially attractive. However, the idea has been considered in some detail several times in the past and rejected as unworkable. It is important to remember that the two regimes were created for different purposes, and fundamentally the policy behind NICs was to fund the provision of benefits not to provide government revenue. A 1986 Green Paper concluded that the 'benefits of a combined charge would be unlikely to justify the ensuing upheaval'. A similar conclusion was reached by a dedicated DSS study in 1993, although this led to some useful steps towards harmonisation.

42 Without fundamental changes to underlying policy, we are not convinced that major simplification can be achieved by way of further operational integration. Closer alignment of the PAYE and NIC collection rules would help, as will collection of self employed NIC and income tax. We think that there is a need to establish at an early stage exactly what could feasibily be done in this area, both to manage expectations

and also to ensure that time is not wasted on exploring possible areas for simplification that will not be taken forward, when the time spent might be better targeted at more fruitful areas for simplification.

IR35

43 The Government has decided to retain IR35 but make some administrative improvements listed in paragraph 3.66. While we have a number of concerns with IR 35 and in particular the uncertainty it can create, in principle we think this is the right decision. With a top rate of income tax of 50% and corporation tax for smaller companies being reduced to 20% and no national insurance on dividends, we are likely to see a further growth in the number of businesses seeking to incorporate to reduce the total tax /NIC charges, so abolishing IR 35 would merely have made this problem worse and put further government revenues at risk.

44 We note the proposed administrative improvements which will be welcome. However, given our comments above concerning HMRC's efficiency and that its budget will be cut further, we question whether HMRC will have the manpower and resources to implement these proposed improvements rather than opening up expectations that will not be realised or lead to deteriorations in HMRC's services elsewhere. It would be helpful if HMRC sets out a plan for how it will implement these improvements and how they will be resourced.

ANTI AVOIDANCE MEASURES

45 It is entirely right that the Government should take steps to counter identified tax avoidance schemes and that it steps up attempts to identify and deal with tax evasion.

46 In our ten tenets, we said that 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, ie it should be properly targeted. We have also been supportive of the previous Government's proposals for promoters of tax avoidance schemes to disclose them to HMRC and since the rules were introduced in 2004 we have worked closely with government and the authorities to ensure that the rules work as intended.

47 Most of the specific proposals have already been published. Our particular concerns relate to the measures on 'disguised remuneration'. We do not have a problem with the underlying policy: namely to stop arrangements whereby what is in substance employment income being passed out to employees in ways that are not subject to income tax and national insurance – for example by way of an interest free loan that it is not intended to repay.

48 Our concern is to ensure that such a measure is properly targeted, does not catch ordinary commercial transactions where there was no intention to avoid tax and does not cause administrative burdens for ordinary businesses. In other words, that the measure tackles the problem that has been identified but does so in a way that does not harm UK growth where there was no intention to avoid tax.

49 The draft legislation published on 9 December 2011 was defective in that it was far too widely drafted and would have caught many entirely innocent and commercial transactions which could have resulted in unfair and penal tax charges. Following consultation, a number of changes have now been made to the rules to obviate the worst effects but the revised legislation still contains many problems that are likely to hinder UK business.

50 We recommend that this legislation is subject to detailed review at the Finance Bill Committee Stage and tested against a number of detailed examples so as to ensure that the final legislation is properly targeted, proportionate and does not impose undue burdens on businesses.

FH 25 March 2011

Appendix 1

THE ICAEW 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.com/index.cfm?route=118111