

Tax Representation



TAXREP 94/08

PRE-BUDGET REPORT 2008: PROSPECTIVE CHANGES TO PERSONAL ALLOWANCES AND TRUST TAX RATES

Text of a letter sent on 22 December 2008 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to HMRC

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The Tax Faculty of the Institute of Chartered Accountants in England and Wales
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Pre-Budget Report 2008:
Prospective changes to personal allowances and trust tax rates

PRE-BUDGET REPORT 2008: PROSPECTIVE CHANGES TO PERSONAL ALLOWANCES AND TRUST TAX RATES

FOREWORD

This memorandum contains the text of a letter sent on 22 December by the ICAEW Tax Faculty to HMRC following the Pre-Budget Report on 24 November 2008 in which it was announced (see the detailed notes in [PBRN01](#)) that:

- from 2010/11 personal allowances will be tapered for incomes above £100,000 and £140,000 by £1 for every £2 of additional income, and
- from 2011/12 the trust rate of tax will be 45% and the dividend trust rate will be 37½%.

Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

PCB
22.12.08

PRE-BUDGET REPORT 2008: PROSPECTIVE CHANGES TO PERSONAL ALLOWANCES AND TRUST TAX RATES

TEXT OF LETTER

It was announced on 24 November in PBR08 that, inter alia:

- (i) from 2010/11 personal allowances will be tapered for incomes above £100,000 and £140,000 by £1 for every £2 of additional income, and
- (ii) from 2011/12 the trust rate of tax will be 45% and the dividend trust rate will be 37½%.

In the detailed notes in PBRN01, you are cited as the contact point and we are, as I alerted you this morning, therefore writing to you with our concerns about the implications of the proposed changes and our proposed solutions.

Compliance costs of proposals

In addition to the added complexity which will result, an inevitable consequence of the proposals is considerable extra work for HMRC which will need to issue more estimated PAYE codings and process more repayment claims. This will increase compliance costs for taxpayers, employers and HMRC. We should therefore be grateful to see any impact assessment in respect of the proposals. It is usual for these to be prepared to quantify the effect on affected parties, in this case HMRC, taxpayers and employers, before a decision is made to announce changes.

Tapered personal allowances

The object of the PAYE system is to collect as nearly as possible the right amount of tax in-year. Tapered personal allowances do not allow this as the amount of income and therefore the personal allowance available is not known until after the taxpayer's return has been submitted and processed.

There seems no case in principle to deny any personal allowance to a small group of taxpayers. In addition, the effect is to introduce unnecessarily high marginal rates of income tax, of 60% over the relevant band excluding NIC. It is for Government to decide the rates of tax, but it would be much simpler and less damaging in economic terms to raise the same revenues by a straightforward increase in the rate of income tax above a certain level.

As regards the tapered personal allowances, HMRC will have to estimate income and issue estimated PAYE codes for individuals subject to PAYE with income of just over £100,000 and £140,000, as they currently do for individuals entitled to age allowance with income around £20,000. Adjustments will then be required to subsequent years' codings for under-payments which are small enough to be coded out or the underpayments or overpayments will be dealt with through SA. This means that, as with those entitled to age allowance, the PAYE system will be unable to ensure that the right amount of tax is paid in year by those who will have personal allowances tapered.

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Furthermore, we are concerned about the position of those with total annual incomes which are normally under £100,000 who, as a result of bonuses or pay rises during a tax year, have income above £100,000 for one tax year. Their tax codes will not take into account the tapering of the personal allowances so they will be given the benefit of full personal allowances to which they are not entitled in that year, resulting in significant and unexpected underpayments of tax and a strong likelihood of the tax code in the following years being incorrect as well, as corrections are likely to compound the error.

Trust tax rates

The 45%/37½% proposal for trust rates of tax is likely to result in the majority of trust beneficiaries needing to file repayment claims which will create more work for HMRC as well as the beneficiaries. We understand that the 45%/37½% follows the Government's decision in 2004 that there should be no incentive to accumulate income within trusts but instead trustees should be encouraged to distribute income to beneficiaries, to which end trust rates of tax would henceforth be harmonised with the highest rates of personal tax. However, whereas a trust rate of 40% reflects the marginal rate of tax paid by a large number of wealthy people, the PBR proposal of a trust rate of 45% will equal the rate of tax paid by only a relatively small number of trust beneficiaries (only 2% of taxpayers are in the £100,000-plus income bracket, according to PBR para 2.48, so significantly fewer will be in the 45% marginal rate, and it is questionable how many of those will be beneficiaries of discretionary trusts) when one takes into account minor children, vulnerable beneficiaries and all those not liable at the new 45% higher rate.

It also appears to us that increasing the trust tax rates of tax will actually exacerbate the present cash flow disadvantage to the Exchequer arising from the increasing difference between the average rate of tax payable by beneficiaries and the rate paid by trusts. Taking a typical example, a beneficiary who is a non-taxpayer or a basic rate taxpayer will receive distributions in-year, net of trust tax rates, and be given a form R185. In the following April/May, a refund claim will be submitted for that beneficiary - tax will normally be repaid fairly promptly. In the following January, the trustees will pay the tax due from the trust. If the income of the trust and the beneficiary are predictable, then the distribution might even be made at the start of the tax year and the refund claim submitted in-year, maybe 18 months before the trustees actually pay the tax. Increasing the trust tax rates will increase the value of the refunds made in advance of the tax being paid. We question whether the extra tax collected from higher rate beneficiaries will in fact outweigh the cash flow cost to the Exchequer of refunds to a great number of non-taxable and basic beneficiaries and trust that this has been considered in any impact assessment.

HMRC's own Research Report 25 on Trusts does record that, for the majority of settlors, trusts are set up not for tax reasons but for the ability to look after assets for the benefit of those, including minors, less able to manage assets. Only "on occasion" did settlors in that research acknowledge "that the sole reason for setting up the trusts was to reduce tax liability" (page 63). It is regrettable, therefore, that there is a continuing anti-avoidance drive on trusts over time, of which the proposal to increase trust rate to 45%/37½% is just one example. The proposed change to the rate applicable to trusts will not increase the tax take significantly, but it will inevitably increase compliance costs disproportionately for HMRC.

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We strongly recommend that the trust tax rates remain at 40% and 32½% for reasons of both equity and simplicity.

Added costs and complexity

Given present resource constraints, it seems strange to introduce tapered personal allowances that necessitate additional time to be spent by HMRC in estimating income and issuing more coding notices and also a rate for trusts that is likely to be higher than the rates payable by almost all beneficiaries, resulting in more repayment claims being submitted and HMRC having to process them.

We also question whether the proposals accord with our Ten Tenets for a Better Tax System by which we benchmark tax changes (summarised in the Annex (B)), as they make the tax system more complicated (contrary to Tenet 3) and the right amount of tax less easy to collect (contrary to Tenet 4), thereby making the UK tax regime less competitive by discouraging investment in or movement to the UK (contrary to Tenet 10).

Conclusion/proposed solutions

In summary, for reasons of certainty, equity and simplicity we recommend:

- withdrawal of the proposal for tapered personal allowances for those whose incomes are over £100,000 and £140,000. The least complex and most equitable way to collect more tax from those whose income is more than £100,000 or £140,000 is to introduce some graduated higher rates, and
- that the current 40%/32½% tax rates for trusts should be retained.

We look forward to your comments and to receiving the regulatory impact assessment.

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. 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.
2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. 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.
3. 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 10,000 members of the ICAEW who pay an additional subscription.
4. To find out more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

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>.