



HIGH-RISK AREAS OF THE TAX CODE: RELIEF FOR INCOME TAX LOSSES

Comments submitted in September 2011 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales (ICAEW) to HMRC in response to the consultation on income tax losses issued in June 2011

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper High-risk areas of the tax code: Relief for income tax losses, published by HMRC in June 2011 at http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?nfpb=true&pageLabel=pageVAT_RatesCodesTools&propertyType=document&id=HMCE_PROD1_031_409
2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.
3. Information about the Tax Faculty and ICAEW is given below. We have also set out, in the Appendix, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

4. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
5. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
6. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

MAJOR POINTS

7. We are pleased that the Treasury is consulting on this issue at an early stage and welcome the opportunity to contribute to discussions.
8. The Tax Faculty supports the Government's desire to counter tax avoidance. However, one of the Tax Faculty's key principles is that tax avoidance should be addressed through the use of properly targeted anti-avoidance legislation. This is important in order to ensure that the overall policy purpose is achieved, namely that loss relief is not denied in cases where taxpayers make commercial losses.
9. Therefore, if changes are to be made as a result of this consultation then they need to be properly targeted and should not restrict either the amount or the timing of sideways loss relief given for commercial losses.
10. We would be happy to have discussions about whether the existing commercial rules for targeting sideways loss relief could be better targeted although we do not think it would be easy.

11. We appreciate that sideways loss relief, in common with other reliefs where tax repayments are available, will be a target for avoidance schemes and it is right for the Government to try to counter such schemes. However, and as recognised in the consultation document, the existing tax legislation already has rules that we would have thought should prevent the type of tax avoidance schemes described by HMRC from succeeding. The starting point should therefore be to see whether the existing rules are being applied effectively.
12. The comments in paragraph 2.10 et seq of the document suggest that some of these schemes rely on misrepresentation or concealment: if so then these are not tax avoidance but tax evasion and should be dealt with as such. It would seem to us that HMRC would have a prima facie case for reporting any professional adviser involved in such activity to their professional body because (as the Engaging with tax agents consultation document states) there is no place in the tax system for dishonest tax agents.
13. While we accept that HMRC may be experiencing a problem dealing with the volume of tax avoidance, as noted above we consider that HMRC already has sufficient power within the existing legal framework (for example s 66, Income Tax Act 2007 which imposes a clear commerciality test – see paragraph 21 below) to prevent invalid (but not illegal – see our comments above) claims to sideways loss relief from succeeding. The remedy for tackling schemes which HMRC see contrary to the underlying policy purpose must first be to pursue such cases through the courts rather than necessarily resorting to yet more legislation.
14. If there is a cash flow benefit being exploited, then that issue in those specific cases should be tackled specifically rather than changing the law in a manner which is detrimental to all genuine businesses. Delaying a tax repayment to a vulnerable business could cause a potentially viable venture to fail. This is contrary to the Government's strategy for growth.
15. We consider that sideways loss relief for commercial losses should continue to be allowed without restriction. As for the proposed options set out in the paper, option 2, which would limit sideways loss relief to just £25,000, should definitely not be followed as it would penalise genuine businesses. Option 1 would work, but only if it could be made sufficiently objective to apply in practice – we are not convinced that it could be but we are happy to discuss further. Option 3 would need a major resource commitment by HMRC in order to ensure that claims are processed very quickly: this looks unlikely given HMRC's budget cuts which have resulted in major problems with HMRC's service delivery across a wide range of its operations.
16. In relation to employment and office holder losses, relief could be limited to the amounts actually paid rather than those merely accrued. The suggestion in the consultation appears to be that relief for employee losses should be restricted to the level of earnings in the year. It would be more reasonable to supplement this by allowing additional relief where it is just and reasonable to do so.

GENERAL POINTS

17. We are concerned that the proposals in this consultation are actually dealing with two separate policy matters.
18. The first is the policy objective of restricting sideways loss relief in cases where the rules are used for tax avoidance. The consultation is aimed at addressing this specific policy objective and we support the policy in principle, subject to the rules being properly targeted.
19. However, we are concerned that the paper appears to have a second, albeit unstated, policy objective, namely to cut the cost to the Exchequer of the general loss relief currently available to genuine commercial businesses. Although this is not a stated aim of the consultation, two of the proposed options would have that policy effect. This would be by capping the amount of

sideways loss relief to £25,000 as in option 2 or in option 3, in cases of larger claims, by slowing down the cash repayment.

20. This is a much wider policy question that would require consultation with business more generally. We will be very concerned if as a result of a consultation, changes are made to the general loss relief rules, which are in place for sound policy reasons, in order to address specific tax avoidance in this area. Therefore, we do not think any changes should be made which restrict either the amount of sideways loss relief given for commercial losses, or the timing of that relief.
21. If there is a cash flow benefit being exploited, then that issue in those specific cases should be tackled specifically, for example using the approach suggested in the tackling tax avoidance consultation paper, rather than changing the law in a manner which is detrimental to all genuine businesses. Delaying a tax repayment to a vulnerable business that may be temporarily suffering losses could cause a potentially viable venture to fail. Such a policy appears at odds with the Government's strategy for growth and the need to support businesses in the current challenging economic climate.

RESPONSES TO SPECIFIC QUESTIONS

Q1 HMRC would welcome comments on ways to deter the making of invalid claims to "sideways loss relief".

22. While we accept that there may be a problem, we consider that HMRC already has sufficient power within the existing legal framework to prevent invalid claims to sideways loss relief from succeeding. Section 66 (1) Income Tax Act 2007 states:

'Trade loss relief against general income for a loss made in a trade in a tax year is not available unless the trade is commercial.'

In order for a trade to pass the commercial test it must be carried on:

- throughout the basis period; and
- on a commercial basis with a view to the realisation of profits.

We believe that properly applied this is a well-targeted definition that should prevent non-commercial claims from succeeding before a Tribunal.

23. If there is a cash flow benefit being exploited through schemes which are taking advantage of the self assessment system, then those cases should be tackled specifically rather than changing the law in a manner which is detrimental to all genuine businesses.
24. Where a loss claim relies upon misrepresentation or concealment of the facts, in our view this amounts to evasion. Relief will always be denied and HMRC should consider prosecuting those involved.

Q2 HMRC would welcome comments on ways to deter the making of invalid claims to property loss relief against general income.

25. As above, we consider that HMRC already has sufficient power within the existing legal framework to prevent invalid claims to sideways loss relief from succeeding.
26. The property income pages of the self assessment tax return (SA105) says specifically at Box 40 'Loss set off against 2010-11 total income - this will be unusual for these losses to be offsetable against general income, this relief could be claimed

on a separate page or schedule rather than on the main return pages. Taxpayers would then be less likely to claim relief by accident.

27. Additional questions could be asked on this schedule in relation to such losses as required. As Box 40 is at the moment, the represented taxpayer is likely to make a correct return while the unrepresented taxpayer is most likely to make an error.

Q3 HMRC would welcome information on the types of employment and office holder losses that arise and how the relief could be better targeted to these.

28. Uninsured loss claims against directors are not unusual. We do not see why tax relief for genuine overall losses suffered in these situations should be denied.
29. Loss relief could be limited to amounts actually paid rather than merely accrued.
30. The suggestion appears to be that relief for employee losses should be restricted to the level of earnings in the year. It would be more reasonable to supplement this by allowing additional relief where it is just and reasonable to do so. Guidance for this would speed up the claim process.

Q4 Would restricting loss relief to the amount of the economic loss irrevocably suffered be effective in deterring tax avoidance and provide sufficient certainty? How could it be expressed clearly? Are there alternative principle-based options which should be considered?

31. Provided that 'economic loss' can be defined in a satisfactory manner, this option would achieve HMRC's stated aim of preventing misuse while preserving relief for those for whom it is intended to benefit. The existing restriction for non-commercial trading losses could be used as a basis for this.
32. A mini general anti avoidance rule could be used to ensure that the relief remains targeted, although such an approach should probably await the outcome of the report due later this year from the GAAR study group.

Q5 What would be the advantages and disadvantages of applying a £25,000 cap for a tax year on total losses that can be relieved against general income or capital gains as "sideways loss relief", property loss relief against general income, post-cessation trade relief, post-cessation property relief and employment loss relief? Are there alternative mechanistic options which should be considered?

33. We strongly disagree with this option.
34. As noted above there are already safeguards to prevent tax avoidance through sideways loss relief, although we recognise that HMRC needs to invest time and resources in ensuring that they operate as Parliament intended. Removing relief from the compliant majority because of the actions of the small minority would be bad for business and contrary to the Government's strategy of supporting small businesses, particularly in these challenging economic times.
35. The existing £25,000 sideways loss relief cap for finance provided by business angels is proving a hindrance in enabling fledgling businesses to obtain finance and should itself be reviewed.
36. It is unclear from the consultation document whether the £25,000 cap would be an annual limit per entrepreneur. Care would be needed to prevent business fragmentation to secure larger amounts of loss relief, which could easily become quite complicated legislation.

Q6 What would be the advantages and disadvantages of a check first repay later approach being applied where total losses claimed in a tax year as “sideways loss relief”, property loss relief against general income, post-cessation trade relief, post-cessation property relief and employment loss relief exceed £25,000? Are there alternative operational options which should be considered?

37. This option is contrary to the principles of self assessment. It would penalise those claiming relief for genuine losses at a time when relief is most needed.

38. We are also concerned that HMRC would be unable to move quickly enough to agree a claim for larger amounts, causing cash flow problems for business owners who would by definition already be struggling to survive.

Q7 HMRC would welcome comments or evidence to support the assessment of the impacts of the changes under consultation.

39. The graphs show only numbers of taxpayers who have claimed, as opposed to tax lost following incorrect claims. We cannot see what the figure is for tax lost through incorrect claims, which is crucial to support any proposed changes to the existing rules. Rather, the implication seems to be that reducing the tax relief overall, whether correctly given or not, is the ultimate policy goal.

40. On the basis that valid loss claims should be allowed as now, option 2 should definitely not be followed. Option 1 would work if it could be made sufficiently objective to apply in practice, and option 3 would need a major resource commitment by HMRC to process claims very quickly.

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APPENDIX

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.com/~media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide/towards-a-better-tax-system.ashx>)