

**TAXREP 58/08**

## **2008 PRE BUDGET REPORT: THE KEY TAX ISSUES**

*Memorandum submitted in September 2008 by the ICAEW Tax Faculty  
to the Chancellor of the Exchequer*

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## **2008 PRE BUDGET REPORT: THE KEY TAX ISSUES**

### **1. Ensuring certainty in the UK tax system – improving tax policy formulation**

The ICAEW would like to work with the Government and policy makers to improve the tax policy formulation process. We believe that the UK needs to embrace a change of approach, in which tax policy is formulated in collaboration with the experts who will ultimately have to deal with its implementation. This collaboration should start at an earlier stage than is currently the case, preferably when policy options and the technical delivery mechanisms of these options are still being considered.

Key consultees should include those with relevant experience, such as professional bodies like the ICAEW. These bodies are willing to put the expertise of their members at the service of the Government. They are able to draw on the experience of their highly trained members who work in all fields of taxation, in all sectors of the economy and have both a national and global reach. The aim would be to help the Government, as the public interest guardians of the tax system, to avoid any unintended or damaging consequences.

We accept that there are times when the Government may need to act swiftly and that consultation is not always advisable, for example where measures need to be announced to counter known tax avoidance schemes. Subject to this, however, we believe that there should be a presumption that there should be meaningful consultation on all major changes of tax policy.

We believe that this change is needed in order to restore confidence in the UK's tax policy, which has been damaged by recent events. The tax reforms that were announced in the 2007 PBR, including the reform of capital gains tax (CGT) and residence and domicile changes, led to a prolonged period of uncertainty, poor communication and confusion for both business and individual taxpayers.

#### ***Avoiding unintended consequences***

We recognise and, of course, accept that the Government will want to make tax policy changes. We want to work with Government to ensure that Ministerial policy objectives are delivered with a full appreciation of all the consequences so that they can be minimised where necessary.

The current system of tax policy formulation does not include a formal process to ensure a shared understanding of how tax policy changes will work in practice. What are the 'elephant traps'? Has the impact of the proposed change on all taxpayers been fully appreciated? Where are the unexpected, adverse and unintended consequences? Is there a better technical way to deliver the overall policy aim? What transitional arrangements might be needed?

We believe that a more formal relationship with the professional bodies at an earlier stage in the tax policy formulation process will address these issues and lead to better tax legislation.

#### ***The principles that should underpin tax policy formulation***

When formulating tax policy, we believe that a number of principles need to be followed. We have in the past identified ten principles, or tenets, that should underpin a good tax system (Annex 1).

Key principles should be:

- Tax changes should not act retrospectively. We believe that the UK tax system should respect the tax treatment of transactions entered into under one set of provisions and that changes to the tax rules that have a retrospective or retroactive effect should not be made.
- Where tax rules are changed there should be reasonable transitional provisions. In addition to the principle of fairness, we believe there is a risk of challenge under the EU law doctrine of legitimate expectation if changes are introduced too quickly and without proper transitional periods.
- Given that most taxes are either self assessed (e.g. income tax, corporation tax, capital gains tax, IHT) or collected on behalf of Government by business and employers (e.g. VAT, PAYE, NIC, SDLT, IPT), regard should be paid to the ease of implementation and consequent costs of compliance by those who have to pay the tax and those who have to collect the tax on behalf of Government. Having formulated policy, there should then be consultation on the operational and practical considerations. We think that HMRC should work more closely with the professions when preparing operational impact assessments, so as to ensure that any assumptions underlying the assessments are reasonable and that the conclusions are robust and provide a sound platform for policy implementation.

***A live example – the 2007 PBR changes to the residence and domicile rules***

The Government had been in conversation with the profession about reforming the residence and domicile rules for over twenty years. However, the 2007 PBR announcement had no link to recent consideration of the relevant issues, which stemmed from an announcement in Budget 2002 and the publication of a Background Paper in April 2003. More worryingly the subsequent incomplete draft legislation announced in January 2008, which was later amended, would have made the UK highly uncompetitive in attracting high net worth individuals, and linked business, to this country.

The absence of transitional rules and the misunderstanding of the related compliance costs caused great controversy. There was considerable concern in the non-domicile community and we know of many who chose not to undertake transactions here because of the uncertainty. We also argued at the time and continue to be concerned that the impact on low earning non domiciles has not been assessed.

Following these announcements we worked closely with Government, HM Treasury and HMRC to improve the proposals. We welcomed the positive approach of the Government departments to addressing the concerns we raised and we believe that the final products are much better as a result of this dialogue. Nevertheless, we think that this willingness to engage with external stakeholders came too late in the process and there will be considerable improvements if bodies like ourselves work with policy makers at a much earlier stage.

***Moving forwards***

If the improved approach we are suggesting had been in place in 2007, we believe that tax policies could have been formulated for announcement in the 2007 PBR which would not only have met the Government's needs but would have enjoyed the wider support of stakeholders.

We note that our proposed approach has been endorsed by the House of Lords economic committee report on the 2008 Finance Bill, published on 12 June 2008. They stated:

*We see no reason why there could not have been earlier, better and more open consultation on both CGT and residence and domicile. We are particularly disappointed that the progress on consultation, which we welcomed in last year's report, has not been maintained.*

We urge the Government to publicly commit to early consultation on proposed tax changes and that the House of Lords recommendations (set out in paras 285 et seq of their report) are adopted.

### **Recommendations**

- The Government should commit to improve tax policy formulation by engaging in consultation with key stakeholders on proposed tax policy changes. This should be undertaken as a matter of course unless there are exceptional circumstances, for example an urgent need to counter avoidance.
- The consultation should be started at an early stage when policy options are being considered and before any formal policy decisions are made. Where necessary, for example if the issues are market sensitive, this could be done confidentially.
- Tax policy formulation should allow adequate time for consultation responses to be analysed and factored in to tax policy formulation.
- The legitimate expectations of taxpayers should be preserved and where major policy changes are announced, taxpayers should be given a reasonable period of time to reorganise their affairs.
- Tax change measures should, by default, be announced at the Pre-Budget Report or Budget to avoid creating uncertainty.
- Tax changes should be prospective not retrospective.
- Costs of compliance should be minimised for both those who pay tax on their own account and those who collect taxes on behalf of Government.

## **2. Simplifying the tax system – taking a strategic approach**

There is a growing perception that the UK has an overly complicated tax system that few understand, which is likely to catch out taxpayers in unexpected ways and which changes too frequently to allow stability and certainty.

We welcome the Government's stated commitment to simplification and appreciate that a number of detailed proposals have been made to simplify the system. However, given the growth in the complexity of the UK tax system, such a comprehensive simplification of the system will be a serious task that will require a project managed, strategic approach.

We believe that it is in the public interest that the full spectrum of the UK tax code is simplified and that this will require radical action. However, a radical tax simplification programme will need to be balanced against the principles of fairness and preserving reasonable expectations. If a tax reform is designed to be revenue neutral, it will produce winners and losers and the effect on losers will be exacerbated where any tax simplification measure is planned to raise revenue. Unless consideration is given to protecting the reasonable expectations of taxpayers, a radical approach that seeks to be revenue neutral or revenue raising is therefore always likely to prove highly controversial, because the losers will always object more fiercely to those who will be better off. This was demonstrated by the reaction to the CGT proposals announced in the 2007 PBR: the principle behind the flat-rate CGT reform was clear but the proposals were damaged because the transitional provisions were not adequate.

### ***The way forward***

We want to work with the Government to identify a tax simplification strategy and set of principles that can receive the support of stakeholders and receive cross party backing. A number of tax simplification working groups have been established dealing with areas such as CGT and groups, related companies and anti-avoidance.

We recommend that tax simplification working groups charged with examining proposals for specific taxes should also be established, together with an overarching technical and policy committee that draws together the conclusions to provide the strategic plan for simplification.

### ***The Tax Law Rewrite Project and simplification***

We think that the Tax Law Rewrite Project has undertaken valuable work analysing legislation and noting possible areas for simplification. We think that rather than winding down this project after the rewrite of corporation tax, it could have a valuable role in leading on a more radical simplification agenda.

We therefore recommend that the decision to wind down the Tax Law Rewrite Project is reconsidered and that instead its focus is changed to concentrate on a simplification agenda, for example considering the policy issues that the project team have identified during the rewrite process.

### ***Department for Business, Enterprise and Regulatory Reform (DBERR)***

Finally, we note that DBERR has issued a consultation document proposing to set 'regulatory budgets' for departments with the aim of cutting regulatory burdens. In principle we see no reason why this methodology should not be applied to tax, and we are disappointed to see in paragraph 4.5 that *'tax measures would be outside the scope of regulatory budgets because tax is not part of the classic regulatory regime. Tax is controlled through the financial budget process, ensuring that Government can flexibly and fairly finance public services.'*

In view of the continuing commitment to reduce tax admin costs through the report by KPMG into admin burdens and the establishment of the Admin Burdens Advisory Board (ABAB) we would have expected that as a minimum the BERR proposals would have dovetailed with and supported the ongoing work of ABAB to reduce the admin burdens faced by UK taxpayers.

Given that most taxes are either self assessed (e.g. income tax, corporation tax, capital gains tax, IHT) or collected on behalf of Government by business and employers (e.g. VAT, PAYE, NIC, SDLT, IPT), we see no reason why regulatory burdens for tax should be treated differently to other burdens. We believe that if these proposals go forward, the decision to exclude tax should be reviewed and that

any proposals adopted should be applied to tax, although we recognise that some modifications might be needed.

### **Recommendations**

- Tax simplification working groups charged with examining proposals for specific taxes should be established with an overarching technical and policy committee that draws together the conclusions and input from all stakeholders. This overarching committee should be charged with overseeing the development of a clear tax simplification strategy.
- The Tax Law Rewrite Project should not be wound down but refocused towards developing the tax simplification programme.
- The recently published BERR consultation on regulatory reform should be extended to cover tax regulations and should be integrated with the existing work of ABAB.

### **3. Income shifting and small business tax policy**

We welcomed the Government's announcement earlier this year to defer the proposed income shifting rules, which were announced in the 2007 PBR, pending further consultation.

We remain concerned that any revised income shifting proposals, based on the original outline, will not address the underlying problems that exist in the small business sector. We believe that piecemeal changes are being made in a reactive way that is damaging the confidence that small business owners have in the ability of the Government to provide a suitable fiscal framework for what is a key growth sector of the economy.

We propose that there should be a fundamental review of small business taxation.

There have been a number of attempts to review the taxation of small businesses. A discussion paper, *'Small Companies, the self-employed and the tax system'*, was published in December 2004, but progress over the past three and a half years has been slow. During recent years we have seen legislation announced which is aimed at solving perceived abuses in the small business arena. Our concern is that these measures have addressed some of the symptoms but not the underlying cause of the problem.

In relation to income shifting, we submitted a representation on this (TAXREP 17/08) which set out in some detail our concerns about the proposals set out in the 2007 PBR. Our real concern is that the proposals looked to apply transfer pricing rules (and the associated regulatory burdens and costs) that might be appropriate for multi-national businesses but which are wholly inappropriate for small and micro businesses.

We also note that these concerns have been raised by the Treasury Select Committee. In their report on the 2008 Budget, they stated:

*'We welcome the Chancellor of the Exchequer's decision to undertake a further consultation on the issue of income shifting. However, we are concerned that this proposed legislation would place an additional tax burden*

*on small businesses and we note that it caused widespread concern during the previous consultation period. We recommend that the terms of the consultation be widened to constitute a full review of the principles of small business taxation to ensure that the taxation system rests on practical, workable rules for the small business community.'* Treasury Select Committee report on the 2008 Budget, pg 67

### **Recommendations**

- That there is an announcement in the 2008 PBR that the small business tax review will be re-energised in consultation with businesses and their advisers with the aim of providing a comprehensive review of small business taxation.
- An update on progress should be published in the 2009 Budget and a detailed report and recommendations for change produced no later than the 2009 PBR.
- That any income shifting proposals will be put on hold pending this review.

### **4. A Taxpayers' Charter**

We welcome the consultation on a Taxpayers' Charter which is something we have advocated for many years. We believe that a Charter is essential and brings the UK in line with other developed countries and with OECD recommendations.

We believe any Charter should have 'teeth' and be capable of being relied upon and enforced. Otherwise:

- it will not provide taxpayers with the certainty of an enforceable safeguard;
- it will be simply guidance, with limited assistance in a court of law;
- it will too easily fall into disuse or be watered down (as occurred with the last UK Taxpayers' Charter).

It is important that taxpayers are able to hold HMRC to account for its actions, and that when – as inevitably sometimes happens – things go wrong, the taxpayer has some appropriate remedies. These remedies need to be effective and 'real'. For example, taxpayers may have a right of judicial review in some situations but in practice it is out of most people's reach as it is far too expensive.

We do not support the assumption in HMRC's June 2008 consultation document that the Charter will not be in legislation. We strongly believe that it needs legal underpinning. This reflects our more general concern with the powers review that taxpayer safeguards need to be enshrined in legislation and not just in non-statutory guidance.

The statutory backing to a Charter does not have to be very complicated. It could involve setting out in one enabling clause:

- that a Charter will be published which will set out taxpayers' rights upon which the taxpayer will be able to rely;

- that the Charter and in particular HMRC's operational performance under it will be subject to an annual review, and this would be done by an independent body; and
- that HMRC will ensure that the Charter is made readily available to taxpayers at an early stage in their dealings with HMRC and as a matter of course if there is any dispute.

### ***Recommendations***

- A Taxpayers' Charter should be published which has statutory backing set out in the Finance Act 2009.
- The Charter should set out taxpayers' fundamental rights in their dealings with Government departments in respect of tax, tax credits and related matters.
- The Charter should be underpinned by an effective route for redress for taxpayers when things go wrong.
- The Charter and its operation should be subject to an annual independent review.

## **5. Review of HMRC's powers**

HMRC's review of powers, deterrents and safeguards has progressed on a topic-by-topic basis, with each consultation document and piece of legislation dealing with a particular aspect of tax administration. This makes it hard to see the bigger picture. We would like to see a route-map that shows clearly and transparently how HMRC will progress its review of its powers and an overview of the tax administration system which it is ultimately aiming to put in place. This should include the further steps that are being proposed (with reasoning) together with an estimated timescale for implementation. Although we have been privy to many discussions with HMRC on this area, it remains opaque to many and the underlying principles behind the review would benefit from being more open and accessible, not least to address the concern that a review by HMRC of its own powers is unlikely to have a balanced outcome.

We believe that HMRC should outline its strategy on the powers review for the following reasons:

- This is a once in a generation opportunity to review the powers of HMRC. It is therefore important to use this opportunity to set out clearly how the proposals fit into the long term strategy and how powers and safeguards are being matched to give a clear signal that this is not a rush to legislate but a well thought out plan.
- There is a great deal of consultation going on behind the scenes in this area but the ultimate strategy is not very clear to either the tax profession or the broader public, nor is it clear how the various parts of the review fit together. A lack of public information on this review creates a vacuum that leads to suspicion of this project rather than an understanding of its aim and objectives. This could be alleviated by providing a transparent and clear road map on the full project.



- The interaction with the tribunal system and the law courts means that a more strategic relationship with the Ministry for Justice is needed to ensure that the various outcomes of the powers review align with the work of that department.

Following the changes enacted in the Finance Act 2008, two further consultation documents have been published, namely 'Penalties for late filing' and 'Interest on overdue tax'.

We will be responding separately to these consultations but remain concerned that further powers will be granted to HMRC which could penalise taxpayers but which will not result in improved compliance. We think that a detailed study needs to be undertaken about taxpayer compliance and trends, including the reasons for non-compliance and what structural changes are necessary to the tax system to make it more user friendly and easier for taxpayers to comply with their obligations.

### ***Recommendations***

- A clear set of guiding principles and timelines for the Powers Review needs to be published setting out in detail what action has been achieved so far, what further proposals are being considered (and why) plus an estimated timetable of progress from consultation documents through to proposed legislation.
- A detailed study should be undertaken about the nature and causes of why taxpayers do not always comply with their responsibilities. This study should include an analysis of trends over, say, the past ten years. This should then be used to inform further consultation about what structural changes HMRC can make so as to make it easier for taxpayers to comply.

## **6. A statutory residence test**

We welcome the commitment given by the Financial Secretary during the debates on the Finance Bill 2008 to examining, in conjunction with the professional bodies, the case for a statutory residence test which is easy to understand and apply. The concept of residence is fundamental to the UK tax system but the existing rules are confusing and unclear so that taxpayers do not have certainty about their UK tax position.

We also believe that the review should encompass the position of ordinary residence and if still relevant this concept should also have a statutory basis.

Clear rules will provide certainty and improve the UK's competitiveness. In the global economy, countries are, to a degree, in competition to attract:

- Multi national companies which will invest in the local economy;
- the deployment by such companies of overseas personnel on secondment to the UK;
- highly skilled entrepreneurial individuals, whose skills will lead to new innovative businesses being formed; and
- high net worth individuals, whose spending will bolster the economy.

The UK has many attractions to businesses and individuals, and we support the UK Government's approach not to compete aggressively solely by reference to tax. However, we are concerned that the present lack of clarity about the UK residence rules puts the UK at a competitive disadvantage and that this needs to be addressed.

We, therefore, believe that a statutory test has clear public benefits and we are currently working, in the public interest, with the other professional bodies and HMRC/HM Treasury to design a satisfactory test for both residence and ordinary residence. We understand and accept the parameters within which the Government proposes such a test should be developed, namely that any test will enhance UK competitiveness, in particular by providing certainty, will reduce compliance costs and will be, broadly, revenue neutral.

We believe that, if in conjunction with HMRC/HM Treasury, satisfactory tests of residence and ordinary residence can be devised, the tests will be welcomed by all stakeholders, including taxpayers and their advisers and by the wider international community.

### ***Recommendations***

- The Government should continue its support for HMRC/HM Treasury working with the professions to develop statutory tests for residence and ordinary residence which will be enacted in Finance Act 2009.
- We believe that the tests should be based on objective criteria by reference to the number of days of presence in the UK.

## **7. Taxation of non-domiciles**

We welcome the Government's commitment to the suggestion we made in our Finance Bill Report Stage briefing that a joint committee will be established to review the operation of the legislation in practice. Given the far-reaching changes and the highly complicated legislation, it is important that the new regime not only meets the Government's policy objectives but works in the best interests of taxpayers. We will be delighted to play a major role in the work of that committee and have proposed some members for the committee.

In advance of the work of that committee, we remain concerned about a number of aspects of the changes introduced in Finance Act 2008. In particular, we remain of the view that the legislation is too complicated and likely to be impractical to operate, with the result that taxpayers will not be able to adequately self-assess and compliance will be poor.

In our Committee and Report Stage Briefings, we set out a number of detailed areas where the legislation in relation to the remittance basis should be amended. We propose to submit a written submission to the joint committee, referred to above, summarising the points in our earlier submissions that are still relevant.

### ***Recommendations***

- We welcome the formation of a joint committee to review the operation of these provisions and we are committed to making it a success. We recommend that a pragmatic approach should be adopted to evaluating the operation of these provisions and if, for example, election time limits or certain provisions are found to be impractical, a commitment should be made to introducing legislation in Finance Act 2009 to improve the rules.

- Whilst these rules are bedding in we think it is important that HMRC operate them using a light touch under their care and management powers.

## **8. Taxation of overseas profits**

We welcome the publication of the Technical Note on 21 July 2008 but we remain concerned that the continued uncertainty surrounding these proposals is damaging business confidence. Our understanding of the Government's position is that:

- it is still minded to introduce a dividend exemption but is concerned about fiscal risk i.e. cost including behavioural change, and it is not intended to include any proposals in Finance Bill 2009;
- it is not proposing to continue with the more contentious aspects of the Controlled Company (CC) income based proposals, in particular those relating to intellectual property, and is prepared to consider retention of the current entity based Controlled Foreign Companies regime but with necessary modifications; and
- it proposes as part of any package to introduce some restrictions on interest relief, the main proposal being that tax relief for UK interest would be capped by reference to worldwide net external funding costs.

We appreciate that the Government has listened to the concerns of business, for example by reference to the proposed changes to the CFC rules. Further, we also appreciate that the need to move this review to a conclusion has to be balanced against the need to ensure that any proposals are right for UK plc and inbound investment and that any changes do not provide scope for tax avoidance. Nevertheless, we remain concerned that this review has now been in progress for over two years and little concrete progress has been achieved.

Whilst we understand why the Government wishes the reform to be on a broadly revenue neutral basis, we wonder if this requirement is a major impediment to progress and that the Government might need to accept that the proposed reform may result in a revenue loss that needs to be recouped in other ways?

This situation is creating continued uncertainty and potentially is damaging the reputation of the UK as a place to locate investment. We understand the Government's dilemma and the need to get this right at a reasonable cost, but this needs to be weighed against the risk of damaging confidence in the UK. We are keen to work with the Government to try and resolve these issues and make a decision one way or the other by the time of Budget 2009.

## **Recommendations**

- The Government needs to decide as soon as possible whether the need for this reform to be broadly revenue neutral is a feasible aim in the near future. In order to move this towards a successful conclusion, we think that the Government should be prepared to accept a modest revenue loss.
- In order to provide evidence of the behavioural risk aspects, we think that a there should be a study undertaken of multi national companies (both UK PLCs and non-UK companies considering investing in the UK) with the aim of providing quantitative and qualitative data from which a view can be taken.

- If the Government is willing to accept some revenue loss in order to secure an improved tax system for the taxation of overseas company profits, then the review should be brought to a conclusion and a dividend exemption system introduced in the Finance Bill 2009.

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## 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/index.cfm?route=118111>

**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](mailto:taxfac@icaew.com) or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.