Tax Representation

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Tax Faculty

TAXREP 22/06

FINANCE (NO. 2) BILL 2006

PARLIAMENTARY BRIEFINGS

Text of written Briefings submitted in 2006 to Government and Opposition MPs by the Tax Faculty of the Institute of Chartered Accountants

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PARLIAMENTARY BRIEFINGS

FOREWORD

Following the Pre-Budget Report on 5 December 2005 and the Budget on 22 March 2006, Finance (No. 2) Bill 2006 was published on 7 April 2006.

Our representations on the Bill included sending formal representations (TAXREP 13/06 dated 15.5.06 – see ***http://www.icaew.co.uk/index.cfm?route=135941***) and providing briefings written and oral including suggested amendments to Government and Opposition MPs in advance of the various stages of debate in Parliament, meetings with HMRC (including their Open Days) and HM Treasury, and giving evidence to the House of Lords Economic Affairs Committee Finance Bill Sub-committee (report, including our written and oral evidence, was published on 23.6.06 at ***http://www.publications.parliament.uk/pa/ld200506/ldselect/ldeconaf/204/20402.htm***)

A timetable of events is set out in Annex A. John Jeffrey-Cook in his article in *Taxation* 10 August 2006 at pages 530-533 marshals the amendments and debates.

This memorandum reproduces the text of the written briefings submitted prior to the relevant Parliamentary debates. Clause and Schedule numbers are as in the Briefings as submitted. The only change to the numbering between the Finance Bill published in April 2006 and the Finance Act arises from the deletion of clause 143.

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

PCB
18.8.06

Second Reading

ICAEW Briefing

Contents

Issues for the Finance Bill

1. Changes to Capital Allowances for Small Businesses

The Budget announcement increasing, for one year only, the rates of first year capital allowances for small businesses continues a pattern of small and temporary changes which has recently been found to be ineffectual in encouraging business investment. The benefits of such small changes for small business are disproportionately offset by the regulatory impact of uncertainty in the tax rates and the need to keep up-to-date with the changes.

The rates of First Year Allowances (FYA) for expenditure on plant and machinery for small businesses have recently been as follows:

Period	First Year Capital Allowance
1998 - 2004	40%
2004 - 2005	50%
2005 - 2006	40%
2006 - 2007	50%
2007 - 2008	40% (current expectation based on 2006 Budget)

A recent report from the ICAEW on 'The Role of Tax Incentives', utilising interviews with small and medium businesses by the Manchester and Nottingham Universities Business Schools, found that except for the most generous capital allowances (e.g. for energy saving equipment), the tax advantages of capital investment are considered by small and many medium businesses only after the decision to invest is made. Changes, such as 10% for one year, will therefore provide additional resources to business after expenditure has been incurred but will be too small to influence in advance business' decisions to invest.

- ***Incentives for businesses to invest need to be provided by large changes to capital allowances announced well in advance.***
- ***When capital allowances rates are changed, such changes should hold for a significant time.***

2. Research and Development Tax Credits

Small businesses are still not able to make best use of the R&D tax credits. The announcements in the Pre-Budget Report which increase the size of businesses which are able to claim the increased deduction of 150% of expenditure, from up to 250 employees to include businesses with up to up to 500 employees, subject to discussions with the EU, is welcome. The setting-up of dedicated units within HMRC to deal with applications and measures within the Finance Bill are also welcome. However, the hurdles that smaller businesses have to jump to be able to make use of the credits, namely the uncertainty of approval and the disproportionate administration costs, remain.

The problems of R&D tax credits for small business are highlighted in a recent report from the ICAEW on 'The Role of Tax Incentives', utilising qualitative research from the Manchester and Nottingham Universities Business Schools on businesses and their agents. The necessary cost for a small business of employing an R&D tax specialist to prepare, document and make the application can run up to £12,000. For briefing the small business and progressing the claim with HMRC the cost is £3,000. Furthermore, the business has to incur the expenditure on R&D before it knows whether the tax credit will qualify. The problems of such uncertainty are most severe for small business.

- ***Government should examine ways to simplify the administrative process for small business applications for the R&D tax credit.***
- ***Government should consider the possibility of an optional pre-clearance system that allows businesses to present their R&D plans to HMRC for approval before committing resources.***
- ***Government should also consider making payments on account to those businesses which qualify to alleviate the cash flow consequences of having to wait for a repayment some months or even years after incurring the expenditure.***

3. Changes to Corporation Tax Rates and the Impact on Small Businesses

The Finance Bill clauses will remove the non-corporate distribution rate and 0% rate of tax on corporate profits, this effectively takes corporation tax for small business back to the situation of the year 2000, except for one small change. Although the increased simplicity for small businesses is to be welcomed, this does come at a cost to small business.

The changes in the Finance Bill will hopefully now bring to and end a long run of uncertainty and complexity for the taxing of small business profits. Such complexity and the disturbing effect it has had on business is well explained in the overview of the changes in Appendix 1

An unwelcome side effect of the abolition of the 0% rate of tax is that many small clubs and societies which have modest amounts of taxable income from for example bank and building society interest, will once again have to complete corporation tax returns. This carries an administrative cost for the clubs and also HMRC. Furthermore, although many of these clubs may have had volunteer advisers acting for them prior to the introduction of the 0% rate, these will not have been needed in recent years and re-establishing links will be difficult.

- ***Government should introduce a de minimis profit level of £500 below which corporation tax returns need not be submitted by small clubs and societies and tax would not be payable.***

4. Trusts and Inheritance Tax

Overall Impact

The changes to Trusts within the Finance Bill create a mis-balance between wills that use trusts and those that do not (see Neutrality Principle below). Those with existing wills with trusts and existing trusts, running into the millions, will need to review their arrangements with many needing to make amendments so that hitherto unexpected tax charges do not arise. Estimates of the resulting necessary costs vary but under the current measures in the Bill are certainly likely to be significant and of an order where they need to be explicitly considered in relation to the £15 million a year that HMRC has said will be collected by the measures. There is a clear risk that the costs taxpayers will have to incur to review and amend wills and existing trusts is highly disproportionate to the tax that will be collected.

The measures in the Bill also bring about a sizable effective policy change where, from 22 March, Accumulation and Maintenance Trusts (A&M Trusts) and Interest in Possession Trusts (IIP Trusts) cannot be set up in lifetime without incurring IHT, except in very limited circumstances. This is a change to rules introduced originally in 1974 specifically to allow such activity rather than a crackdown on avoidance. The ICAEW believes that such a policy change should have followed good HM Treasury and HMRC practice for prior consultation and could have been addressed through the existing Modernisation of the Tax Treatment of Trusts programme.

- ***A postponement to the changes on trusts should be considered so that the ratio of administrative cost to the extra tax and the other social impacts to the affected beneficiaries and their families can be properly evaluated.***

Spouse Exemption

The new rules may override the current spouse exemption from inheritance tax where existing wills create a trust on death in favour of the surviving spouse or civil partner. For example: a teacher prepares a will so his assets are held in trust for his wife and then for his children so that the assets will pass to his own children on his wife's death or her re-marriage, whichever comes earlier. The Finance Bill changes may result in the assets no longer qualifying for the spouse exemption in such circumstances, most likely requiring the surviving spouse to sell the family home to pay inheritance tax with resulting hardship and impact upon the bereaved family.

- ***Government should commit to maintenance of the spouse exemption in all circumstances.***

Protecting Young Beneficiaries of Trusts

The Finance Bill will effectively require that trust assets are passed to individuals at 18 rather than the current norm of 25. This will apply to existing trusts and trusts in existing wills, where resulting changes will now have to be made, and for the future setting-up of whichever relevant trusts will still be allowed. If assets pass to the beneficiary beyond the age of 18, extra tax charges will arise. We appreciate the point that age 18, being the age of majority, is used for other tax purposes. Practically, however, between 18 and 25 individuals develop their own life choices and build up significant experience in how to manage their finances. We think the change to 18 could put assets in the hands of people too young or too vulnerable to manage capital sensibly for their long-term benefit, with additional impact on those around them. In 1974, when the special rules for A & M trusts were introduced, the age of 25 was used when the age of majority had already been reduced to18, reflecting these sound social considerations. Furthermore not all taxes accept that 18 is an appropriate starting point. For example, Working Tax Credit is not payable until someone reaches the age of 25 unless they have already had a child.

Should Government not accept the argument for retaining the norm of age 25 for assets passing to beneficiaries, then there is the remaining retrospective problem for existing trusts and existing wills. Whilst a two year notice period is welcome, it not clear why taxpayers should be put to the expense of changing these trusts when there is little revenue at stake.

- ***A & M Trusts should not now be penalised, through tax charges, where beneficiaries receive their assets between the ages of 18 and 25.***
- ***Should the government proceed with these changes, then the changes should not affect existing Accumulation and Maintenance settlements***

Loss of the Neutrality Principle

The proposals in the Finance Bill, as they currently stand, will also mean that taxpayers who leave assets in trusts will be treated more harshly than those who make outright gifts. This undermines the principle of neutrality included in the White Paper of 1974. This paper stated that:

"The broad principle to be applied to settled property is that in general the charge to tax should be neither greater nor smaller than the charge on property held absolutely..."

During the recent consultations on the Modernisation of the Tax Treatment of Trusts, this principle of neutrality was reaffirmed. The current proposals on trusts depart from that principle.

- ***Government should make clear whether it is still its intention that the neutrality principle will be maintained and therefore that changes will be made to the Finance Bill to restore this neutrality.***

5. Tackling MTIC Fraud (including Carousel Fraud)

The application to the EU for a derogation to help tackle VAT fraud is welcome as an appropriate way to now tackle the issue. Enhanced powers to enable HMRC to direct listed businesses to keep records are also appropriate in principle. However, the proposed appeal procedures are inadequate and the measures could contravene EC Law. This is because the HMRC direction remains in force whilst waiting for the appeal to be heard and the Tribunal can only apply a limited reasonableness test to the actions of HMRC, so it is not effectively a full appeal.

We hope that the changes the Government are hoping to make will now allow HMRC to once again make it reasonably easy for legitimate enterprises to set up in sectors that happen to be vulnerable to MTIC fraud. A recent example from one of our members of the current difficulties is explained below.

Impact on Enterprise from Dealing with HMRC in Sectors Vulnerable to MTIC Fraud

An ICAEW member has alerted us to the case of a well respected and legitimate company which has set up a new business to buy and sell mobiles phones which has experienced such difficulty in registering for VAT that it has prevented trading taking place. HMRC are refusing to register the company as an intended trader without seeing a signed contract with suppliers. However, suppliers will not deal with the company until it is registered for VAT. Customers for mobile phones have already been identified but no transactions have taken place. A contract with suppliers conditional on VAT registration has been suggested but rejected by HMRC. Such an approach effectively puts up barriers to genuine new enterprise.

- **Government needs to ensure that the new approach to tackling MTIC fraud will allow the dropping of unreasonable barriers to genuine new enterprise in the sectors vulnerable to such fraud.**

6. Changes to Tax Incentives for Employees to Buy Computer Equipment

The ICAEW believes that the Home Computer Initiative (HCI) was making a significant contribution to addressing the 'digital divide' in the UK. Research by the HCI Alliance indicated that more than 500,000 employees were benefiting from the scheme, of which more than 75% were lower paid employees. The HCI scheme, as it existed before the Budget, did need refocusing but the ICAEW is unclear why the decision has been taken to scrap the scheme entirely without any prior consultation. Many businesses were intending to implement schemes from 6 April, and the Chancellor's unexpected announcement means that the time spent in setting up HCI schemes which have not been implemented will have been wasted. This is also the case for the Government Departments in this position, e.g. the DWP and DTI, but the impact of that wasted time will be greater on the small and medium businesses.

- **Government should discuss with the HCI Alliance and other interested bodies how the existing scheme can be amended to continue to contribute to the Government's objectives to tackle the digital divide.**

7. Resulting Uncertainty for Business

The issues of changes to corporation tax, first year capital allowances and tax incentives for purchasing computers, raised in this briefing on the Finance Bill, have the cross-cutting impact of increasing uncertainty for businesses in how they are going to be taxed. This has three primary impacts. Firstly, there is the regulatory impact from the flux of change - business needs to keep up with the changes, often having to pay advisors to deal with it on their behalf. Secondly, businesses may have already taken investment decisions or preparatory work based on expectations of taxation which are now wrong. Thirdly, the changes undermine the confidence of business that any future tax incentives will be maintained. At a time when the regulatory impact of Government is under scrutiny, the impact on the certainty of the tax system, particularly for small business, needs to be considered.

Other Issues of Parallel Concern, Not in the Finance Bill

8. Review of HMRC Links with Large Business by Sir David Varney

The review is welcome but we believe should go further to include the links between HM Treasury and its tax policy making function and large business. It will be difficult and in many ways inappropriate to divorce administration of tax from policy decisions. Each has a significant bearing on the other; good administration allows for better policy and often policy changes are necessary for improved administration.

- ***The review of HMRC links with large business should be widened to a review of how HM Treasury and its policy making function should deal with large business.***

9. Carter Review Proposals for Self-Assessment Dates

The ICAEW is very concerned at Lord Carter's proposals to shift the filing dates for self assessment and the implications for taxpayers, their agents and for HMRC itself. Whilst we support in principle the Government's goal to encourage more people to file online, we believe that there needs to be greater dialogue between ourselves and Government as to how, by working together, this can be achieved. Discussions between ourselves, the other professional bodies, HMRC and HM Treasury on these matters are in progress.

10. Tax Avoidance

Government is to produce draft regulations and regulatory impact assessments this month. ICAEW concern remains that this will not only increase complexity for businesses and advisers who are working within the new disclosure regime but also will not do enough to target the non-compliant minority.

11. Enquiry into HMRC Powers/Need for a Taxpayers Charter

The Institute welcomes the widening of the consultation on HMRC powers, with the paper issued in March 2006. We hope this is the first of several papers which will allow a widespread discussion of the key issues, which will provide a once in a generation opportunity to set appropriate powers for the new HMRC. We would hope to see detailed papers made available before any legislation is proposed.

In addition we would still like to see a commitment to a new 'Taxpayers Charter' or equivalent, setting out the rights and responsibilities for both taxpayers and tax authorities. In light of previous problems of the administration of tax credits and self-assessment, this would, we believe, be a substantial step towards improving the relationship and trust between taxpayers and tax authorities.

12. Review of Government Support for Enterprise

The announcement in the Budget of the review of sub-national support for enterprise and economic development is highly welcome, as is the target to reduce the number of business support schemes. The announcement of targets for the reduction of the administrative cost of tax is also welcome as is the setting-up of an Administrative Burdens Advisory Board to advise HMRC on this work.

Appendix 1

Explanation of the Changes to Taxation of Small Business Profits

Table Based Explanation of Changes to Corporation Tax from 1999 to 2006

1999

Level of Profit	Tax Rate
£0 to £300k	20%
£300k to £1.5m	Marginal rate from 20% to 30%
£1.5m and above	30%

April 2000

Introduction of 10% starting rate of corporation tax causes small business to start to incorporate to take advantage of the lower tax.

Level of Profit	Tax Rate
£0 to £10k	10%
£10k to £50k	Marginal rate from 10% to 20%
£50k to £300k	20%
£300k to £1.5m	Marginal rate from 20% to 30%
£1.5m and above	30%

April 2002

Introduction of 0% starting rate causes incorporation of existing small businesses to gather pace, Government aware this would be likely.

Level of Profit	Tax Rate
£0 to £10k	0%
£10k to £50k	Marginal rate from 0% to 19%
£50k to £300k	19%
£300k to £1.5m	Marginal rate from 19% to 30%
£1.5m and above	30%

April 2004

HMT classifies incorporation to take advantage of 0% rate as avoidance activity and introduced an incredibly complicated Non Corporate Distribution Rate (NCDR).

Level of Profit	Tax Rate
£0 to £10k	0% or NCDR depending on circumstances
£10k to £50k	Marginal rate from 0% to 19% or NCDR depending on circumstances
£50k to £300k	19%
£300k to £1.5m	Marginal rate from 19% to 30%
£1.5m and above	30%

April 2006

Pre-Budget report signals that the taxation of small businesses will be restored to a simpler system but at the expense of extra tax on small business.

Level of Profit	Tax Rate
£0 to £300k	19%
£300k to £1.5m	Marginal rate from 19% to 30%
£1.5m and above	30%

Narrative Explanation of Changes to Corporation Tax from 1999 to 2006

The main rate of corporation tax has been 30% since 1999, and the small companies' rate has been 19% (on the first £300k of profits, subject to various reductions in this limit for associated companies and short accounting periods) since 2002 (20% before that, from 1999). There is a marginal relief calculation when profits are between £300k and £1.5m.

The 10% starting rate of CT was introduced with effect from April 2000. It applied to the first £10k of profits with marginal relief for profits between £10k and £50k. Again, these limits are reduced if there are associated companies or an accounting period of less than 12 months.

From April 2002, the starting rate on the first £10k was nil rather than 10%.

When the 10% band was introduced, small businesses started to incorporate, and of course this gathered pace once the nil rate band came in. There were pros and cons, both tax and otherwise, of incorporating. Some businesses certainly saved tax by doing so, and advisors therefore has to alert them to the potential benefits of doing so as well as the costs. On the other hand, the publicity about the 10% probably did some small businesses a disservice, as they incorporated without understanding the ramifications and ended up with a corporate structure they couldn't handle.

Having encouraged incorporation in this way, HMT then decided that it was exploitation of tax rates and tax avoidance, and should be stopped. The fiendishly complicated Non Corporate Distribution Rate (19%) came in from April 2004, effectively taxing people on taking money out of their companies as dividends rather than salaries, and thus causing problems for those who had (quite legally) incorporated, as a corporate structure is hard to unpick once you have put your business into it.

And then in the 2005 PBR it was announced that the NCD rate and nil rate band would both be abolished from April 2006, so we are back to where we were before April 2000, as the other CT rates and bands are the same as ever.

People are of course left with the dregs of the NCD regime to sort out for the two years when it existed and we still do not have a level tax treatment of similar unincorporated and incorporated businesses.

Committee of the Whole House

ICAEW Briefing 1 of 2

Clause 26

Abolition of Corporation Tax Starting Rate and Non-Corporate Distribution Rate

The abolition of the starting rate and non-corporate distribution rates will result in a welcome simplification of the corporation tax system and associated compliance costs. This welcome simplification will, however, be at the expense of an increase in corporation tax rates for many small businesses. Given the number of changes to the corporation tax rules for small businesses in recent years, we think it is now vital that small business taxation enjoys a period of stability.

Concern Over Impact on Small Clubs and Societies

Proposed amendment

After clause 26(11), insert clause 26(12), as follows

(12) Insert the following new sub-section at the end of section 8 of ICTA.

> 8(4) Notwithstanding the above sub-sections, corporation tax shall not be charged on the profits of a company where the profits of the company for any accounting period in question do not exceed a limit of £500. Where an accounting period is shorter than twelve months, the £500 limit shall be reduced in proportion to the reduction in the accounting period. Where a company has associated companies, the £500 limit shall be reduced in proportion to the number of associates in the accounting period.

Comment

We are concerned that many small clubs and societies will once more have to pay corporation tax on small amounts of income. The compliance costs for both taxpayers and HMRC are likely to outweigh any tax raised. Other likely problems that may arise include:

- Many small companies may become non-compliant through ignorance.
- There will be a major administrative task for HMRC in tracking down such organisations who have not been in contact since the introduction of the 0% rate in 2002.
- The need to begin re-submitting tax returns may discourage the financially astute from assuming voluntary treasurer positions of small clubs.

Given these concerns, our amendment provides for the introduction of a monetary limit so that companies with profits below the limit do not pay corporation tax. The proposed amendment is a proposed deregulatory measure to help companies that only receive small amounts of income from having to prepare and submit corporation tax returns and pay tax on small amounts of income.

Should it be found that it is unsuitable to bring a de-minimus about through primary legislation, we request that Government make it clear and apparent to small clubs and societies its intentions in regard to the collection of tax from such small entities.

Clause 61

Home Computer Initiative

We believe that this Clause should be amended so that the Home Computer Initiative (HCI) is not withdrawn but is instead refocused so that the definition of computer is correctly targeted onto home computers and not other equipment such as iPODs and games consoles.

The sudden withdrawal of the scheme without any prior consultation has resulted in considerable amounts of wasted time and costs by employers and computer equipment suppliers. Many employers, including the DWP and DTI, were intending to implement schemes from 6 April 2006, but the impact of that wasted time will be proportionately greater on the small and medium businesses. There is also the question of how this relates to building-up the skills base of the UK economy, particularly on general IT skills.

The ICAEW believes that the Home Computer Initiative (HCI) was making a significant contribution to addressing the 'digital divide' in the UK. We are struck by the research by the HCI Alliance which indicated that more than 500,000 employees were benefiting from the scheme, of which more than 75% were lower paid employees. If the HCI scheme was being abused by employees being given equipment such as iPODs and games consoles, it should have been refocused so that the exemption applied only to normal computer equipment. The Government is anxious to encourage the take-up of e-services (for example the Carter report published on the same day) and it looks wrong in principle to remove this incentive at a time when HMRC are encouraging online filing of payroll and tax returns.

Specific Concern on Estimating Proportion of Personal Usage of Work Computers

The Clause as it now stands will also result in additional ongoing costs because of the need to estimate the private use percentage.

For example, many teachers are now provided with a laptop and, inevitably, will use it privately for part of the time when they are at home. The time and costs of estimating the private use for that laptop are likely to be out of proportion to the resulting benefits.

Given the above concerns about the one-off and ongoing costs to both businesses and individuals, it is particularly disappointing that those Regulatory Imapct Assessment has been published to examine the benefits of the proposed measure will outweigh the costs and to consider other alternatives.

Committee of the Whole House

ICAEW Briefing 2 of 2

This document is further to the first briefing from the ICAEW for the consideration of the 2006 Finance Bill in the Committee of the Whole House. It provides supplementary information on the issues around Clause 26.

Clause 26

Supplementary Notes on the Concern Over Impact on Small Clubs and Societies

The problem

The abolition of the nil rate corporate tax band, announced in the 2005 Pre-Budget Report, could mean that clubs and associations will have to pay tax on negligible amounts of interest with all the associated costs of dealing with their tax affairs. The issue may also stand for small apartment management companies e.g. a company set-up by to own the freehold of a house by the owners of the flats within that house.

The point was raised with HMRC at the Corporation Tax Operational Consultative Committee (CTOCC) meeting on 16 January 2006. The representative bodies present at the meeting were given an assurance that instructions will be given to the HMRC network that small amounts of interest should not be taxed. There are apparently 64,000 small clubs and associations which would otherwise be affected.

However, we are highly concerned it will not be possible to promulgate this policy in a formal way because of the House of Lords decision in the *Wilkinson* case (*R v IRC, ex parte Wilkinson* [2005] UKHL 30). That decision cast doubt on the extent of the discretionary powers of HMRC not to apply the strict letter of the law in appropriate circumstances.

Without HMRC being able to put their policy into effect with a public announcement to potentially affected clubs and societies, those which are most astute in regard to their finances may believe they have to undertake excessive administrative activity (see admin burden below). HMRC will also have to deal with their enquiries.

We would prefer HMRC to be able to deal with this through concession, and historically would have recommended this approach. However, given the doubts that the promulgation of such a policy is possible, we have proposed an amendment to enable the matter to be brought fully to the attention of the House.

The administrative burden

There will be a significant administrative burden, with an associated cost, both on the small clubs and associations and also on HMRC. For instance, the entities chargeable will have to be identified, which in itself will be difficult since many will have been disbanded and many new ones set up since tax was last charged on them in 2002.

Even if HMRC expends no effort in undertaking pursuing small clubs and societies for tax, without promulgation of the policy, the most responsible clubs will realise the greatest burden of undertaking unnecessary enquiries into their tax affairs. They may also believe they need to seek new or differently skilled officers. The likelihood of this has been increased by the substantial coverage of the frequent changes to small business tax over the last 6 years.

Proposed solution

The most appropriate solution should tackle the fundamental problem highlighted by *Wilkinson* which also affects other concessions. Most of the old Revenue Concessions have been incorporated into law during the Tax Law Rewrite process but for those concessions unresolved, this is a problem. Another example of the problem is the inability for HMRC to make concessions concerning the problem of determining associated companies, a necessary task when deciding what rate of tax a company must pay.

Section 1 Taxes Management Act 1970 has recently been redrafted but adds to the current difficulty. This section used to give to HMRC '*care and management*' powers. The redrafted section gives HMRC responsibility for the '*collection and management*' of tax.

One potential solution is to reintroduce some sort of power for HMRC to issue simplifying and common sense concessions. However, we understand that there will be many interested parties which do not think it appropriate to devolve such powers to HMRC in an unsupervised manner. A possible solution to this objection would be to have a panel comprising HMRC and bodies representative of key stakeholders to oversee how this is used.

We request that Government now consult urgently to ensure that small clubs and societies can be properly informed by HMRC of their responsibilities. We also request that Government undertake to consult to tackle the fundamental problem of concessions exposed by *Wilkinson*.

Standing Committee

ICAEW Briefing 1 of 5

This briefing provides detailed comments on Parts 1 and 2 of the Finance Bill for consideration in Standing Committee of the House of Commons. It is supplementary to the Briefings for Second Reading and the Committee of the Whole House.

PART 1

EXCISE DUTIES

Tobacco products duty

Clause 2 - Tobacco products duty: evasion

The ICAEW believes Government needs to clarify why clause 2 is necessary.

In legal terms, section 77A Customs and Excise Management Act 1979 and Schedule 11 VAT Act 1994 provide powers to HMRC that appear to fulfil the same objective. In practical terms, as stated at para 5.6 of the HMT/HMRC March 2006 paper *New Responses to New Challenges: Reinforcing the Tackling Tobacco Smuggling Strategy*, voluntary cooperation between HMRC and UK tobacco manufacturers through the 'Memorandum of Understanding' ('MoU') procedure has been acknowledged as a success:

> 'MoUs between HMRC and the UK tobacco manufacturers have been an important element of the strategy, and have played a crucial role in restricting the availability of genuine cigarettes to smugglers. Since its peak in 2000/01, the incidence of UK manufactured cigarettes being smuggled into the UK has fallen markedly, from about 75 per cent of large seizures to 28 per cent in 2003/04.'

We are concerned that the duplication of existing law and the introduction of a penalty of up to £5 million may discourage such future dialogue between the tobacco manufacturers and the Government', particularly since the clause will be difficult to implement.

We also question whether the clause will be legal under European law because of the subjective nature of the tests that manufacturers are expected to carry out. The clause implies that it is possible for a business to second guess the intentions and future actions of a customer. This is an impossible requirement. The test should be objective, i.e. the manufacturer should be advised not to trade with specific named customers.

Further concerns of the ICAEW include:

- The clause gives disproportionate sweeping powers to HMRC and that some of the provisions can be introduced by secondary legislation

- There are jurisdiction and territoriality problems with this clause. For example, it is difficult to see how HMRC can enforce the clause on any non-UK manufacturer, for the simple reason that such a person is outside the jurisdiction of the UK government and courts.

- The provisions of this clause may result in legitimate transactions being obstructed, thereby restricting trade, and leaving HMRC open to claims for damages.

- In new section 7C(3), the review by HMRC does not provide for it to be carried out by any particular person, e.g., someone different from the officer who authorised the notice. Any such review should be at Board level.

- There appears to be no adequate provision for independent review of the actions of HMRC. In new section 7C, there is no amendment proposed to section 83 VAT Act so it is not clear on what grounds a taxpayer can appeal to the Tribunal.

- The giving of a notice under these clauses should be subject to HMRC having to apply to the Tribunal in advance. If Government/HMRC really wish to defeat smuggling, then it will have to be done by consensus rather than confrontation with manufacturers, therefore any such hearing should be *inter partes*.

- The size of the fine (up to £5million) means that it is criminal in nature, and so we question whether it either appropriate or lawful for it to be imposed administratively, and not by a court.

In short, it seems likely to us that unless tobacco manufacturers are content with the wording of this clause, it risks being the subject of lengthy litigation in the UK and at the ECJ.

PART 2

VALUE ADDED TAX

Land

Clause 17 - Buildings and land

The ICAEW believes that such changes should be brought about through primary legislation rather than by means of Statutory Instruments. Further comment on most of the clause is difficult as it contains only enabling provisions.

We are particularly concerned that revisions to Schedule 10 of the VATA should be amended in a Finance Act, helping ensure proper Parliamentary scrutiny and public debate. The ICAEW has contributed to HMRC's consultation exercise on the redrafted Schedule 10, and consider that there should be further consultation on the rewrite of all of the Schedule once the responses to the first consultation have been analysed and another draft of the law produced. Given the complexity of the existing legislation, we consider that the final text of the law needs to be generally accepted by HMRC and taxpayer representatives alike as being not only in conformity with EU law and the EU Treaty, but as being practical to administer. The final outcome should take into account the views of those who have contributed to publicly-available exposure drafts, as is the case with the direct tax Tax Law Rewrite Project.

Imported works of art etc

Clause 18 - Value of imported works of art etc: auctioneer's commission

This clause implements the ECJ judgment of 9 February 2006, which decided that the UK had failed to implement the law correctly. The effect of the judgment is to increase the VAT chargeable on auctioneers' commissions from 5% to the 17.5% standard rate.

It is necessary to implement the judgment but this compounds the damage to the London art market from the UK agreement in 1994 to the respective change in European Law.

Avoidance and fraud

Clause 19 - Missing trader intra-community fraud

General comments on Clause 19

The ICAEW welcomed the decision to apply the reverse charge to supplies of goods liable to be used on MTIC fraud down the supply chain until the retail stage. This is something we have recommended for some years. We note the UK's request to the European Commission for a derogation to this effect. The use of the reverse charge will provide a partial, but substantial, solution to the problem. As HMRC know, the change will create a further avenue for fraud - a dishonest purchaser will fail to apply the reverse charge and will be able to sell the goods 'VAT free'. However, we agree with HMRC that the extent of this new fraud is likely to be considerably less than if MTIC fraud itself were allowed to continue in its present form.

The Government's strategy should be to work with business and their representatives, the European Commission and other EU Member States to prevent MTIC fraud. This is unlikely to be achieved in the UK if we continue to pass legislation which makes honest businesses responsible for paying VAT misappropriated by others in the chain of transactions. As a European Commission official stated in a letter published in the Tax Journal of 24 April 2004, explaining why the Commission had intervened against the UK in the *Optigen* case:

"It is naturally necessary to take vigorous measures to combat tax fraud, but that objective does not justify making innocent bystanders pay for the crimes of others."

As they stand, the provisions in Clause 21 are likely to create further similar injustices, further court cases, and further defeats for the UK.

Detailed comments on Clause 19

The 'disregarded amount'

We understand that the 'disregarded amount' in new section 55A(1)(d) applies only for the purposes of ascertaining liability to be registered. However, we question the practicality of having a disregard of £1,000 which is only going to affect businesses with turnover of between £60-61,000. It appears to introduce unnecessary complexity and we would welcome clarification of its rationale.

We would welcome confirmation in new section 55A(3) of how the wording 'in so far as their total value exceeds' is applied where transactions exceed the disregarded amount. For example, on the basis of a disregard of £1,000 and transactions of £10,000, are we correct in concluding that the first £1,000 is ignored and only £9,000 is taken into account for the purposes of Schedule 1?

Impossible proofs

New section 55A(6) sets out the conditions when the reverse charge will apply and the recipient, rather than the supplier, needs to account for the VAT due on the supply. The clause states:

> (6) If—
> a taxable person makes a supply of goods to a person ("the recipient") at any time,
> the supply is of goods to which this section applies and is not an excepted supply, and
> the recipient is a taxable person at that time and is supplied in connection with the carrying on by him of any business,
> it is for the recipient, on the supplier's behalf, to account for and pay tax on the supply and not for the supplier.

First, it is not clear as to what is meant by 'on the supplier's behalf'. If the supplier is to be held jointly and severally (or otherwise) liable for the VAT due if the recipient does not in fact account for the VAT under the reverse charge procedure, then, unless the supplier has acted recklessly or is a party to the fraud, it is yet again a question of 'making innocent bystanders pay for the crimes of others'.

Secondly, it is unclear how the supplier can verify for certain that the two conditions in sub-para (c) have been met.

The taxpayer making the supply of the 'relevant', but not 'excepted' goods, will have to determine under new sub-section 55A(6)(c) that:

> (i) his customer is registered for VAT at the time the supply is made, and
> (ii) that the customer will use the goods for a business purpose.

If either test is failed, the supplier will have to pay the VAT over to HMRC, even though he neither charged it to, nor received it from, his customer. Test (i) is difficult – whilst the supplier can telephone HMRC to confirm the VAT registration number and name and address of the customer, many businesses have more than one address. Hijacked VAT numbers are also used in this type of fraud, giving an appearance of legality. Test (ii) requires the supplier to decide what his customer will in fact do with the goods.

We consider that it is not possible for any supplier, acting in good faith and with normal diligence, to obtain absolute proof that these two conditions have been met, since he is neither entitled nor privy to the necessary information. As a result, he is faced with what is known in EC Law as an impossible proof, or *probatio diabolica*. The clause therefore risks being unlawful since it does not meet the principle of legal certainty. Irrespective of the legal position, we question whether it is moral or appropriate for a tax authority to legislate to impose impossible conditions on taxpayers.

A partial solution to such legal challenges could be brought about by giving the supplier an unfettered right of appeal to the courts on a 'reasonable excuse' basis, namely that he did take all reasonable steps to ensure that the conditions were met. In addition, HMRC should publish guidance on what they consider those steps should be.

Relevant supplies - cat and mouse

Given that the supplies within the clause, namely 'relevant supplies', have to be listed in a Treasury Order under new section 55A(9), there remains the risk that fraudsters will ensure that the goods they use as part of their MTIC fraud are not those within the provisions of this clause. This will create a cat and mouse situation with HMRC having to include additional goods within the regime once they discover what goods are being used by the MTIC fraudsters. The fraud could also move to services.

Clause 20 - Power to inspect goods

The breadth of powers

The Institute appreciates the value of this clause, as it will deter the multiple use of the same goods in MTIC frauds. Nevertheless, we are concerned that this clause goes far further than necessary, and contains insufficient safeguards. The clause effectively gives HMRC the power to have any goods (whether linked to MTIC fraud or not) completely unpacked and then marked.

The legislation should require HMRC to apply the new law in a proportionate way, and only to MTIC fraud. To ensure this, there should be a requirement for HMRC to act reasonably, with a full right of appeal to the VAT Tribunal, and the new sub-paragraph 10(2A)(a) should include a provision to ensure that marks are such that they do not damage or spoil the goods or its packaging or otherwise decrease their value.

The cost to business

There should also be a specific provision requiring HMRC to pay compensation if the value of the goods is impaired, or their sale unreasonable delayed. We accept that under current law, businesses have to bear the cost of any damage or repackaging when HMRC inspect goods or take samples, but normally only a few items are involved. These new provisions can be applied to all the goods held by a business, and it is both unreasonable and disproportionate for a business to be required to bear what could be very significant extra costs.

Power to record information

In new sub-paragraph 10(2A)(b), we would welcome clarification of the meaning of 'information … relating to the goods'. We suggest that this should be the same as the information required to be shown on a tax invoice.

Clause 21 - Directions to keep records where belief VAT might not be paid

General comments

If clause 21 is used to require a business to keep what are normal business records, then it is unexceptionable, except that HMRC already have the power to do that under existing law.

If it is asking them to keep records out of the ordinary, for example, for reasons that have nothing to do with the business itself but with another business of which the first may not even have heard, then that must be subject to the proportionality test. It could force businesses to additional expense, perhaps hiring further staff.

Right of appeal

Sub-clause 21(4) extends the list of matters that can be appealed to a tribunal in section 83 VATA 1994 to include the direction to keep records introduced by this clause but sub-clause (5) amends section 84 VATA 1994 to block any effective right of appeal.

The appeal procedures probably contravene EU, and human rights law, for the following reasons.

a) The Tribunal can only apply the 'reasonable' test to HMRC, so it is not even a proper appeal - only the facts that HMRC had at the time of their decision can be reviewed.

b) A right of appeal is meaningless if it is limited to cases where the taxpayer has to show that HMRC could not reasonably have been satisfied that there were grounds for issuing a direction. Quite apart from the fact that the taxpayer does not know what information HMRC have (and HMRC might not be prepared to inform him, since it may not involve the taxpayer at all but another business totally unknown to him), the Tribunals have interpreted this restriction in appeal rights to mean that they cannot even look at all the evidence available to them at the time of the hearing. They are instead limited to looking at what information was available to HMRC when they made the direction, and deciding if in the light of that material the direction was reasonable. In effect, if HMRC only have half the facts when they make the direction, perhaps because the facts were not available or because HMRC have been unable fully to investigate them, there is nothing the Tribunal can do about it other than to request HMRC informally to review its decision whilst turning down the appeal.

c) Coupled with this, the HMRC direction remains in force whilst waiting for the appeal to be heard.

We can see the sense of businesses having to keep the records during an appeal, but the quid pro quo for that must be that:

(a) the business has a full right of appeal and the courts an unfettered jurisdiction to decide,

(b) the onus of proof must be on HMRC, since only they will have all the information and the business may well know nothing; and

(c) HMRC will pay compensation for any extra record-keeping costs, without the business incurring the cost of having to sue, if the court holds that HMRC have acted unreasonably.

If left unchanged, these provisions will merely lead to further litigation and Government defeats in the courts, particularly the ECJ. We do not think that UK businesses should have to seek relief at the ECJ when the UK could take a measured and proportionate approach in the legislation.

HMRC needs to appreciate that the war against fraud will only be won by engaging the cooperation of legitimate businessmen and advisers, not by alienating them.

Changes to amount of penalty

Clause 21(2) inserts a new section 69B into VATA 1994 which provides that a person is liable to a fixed penalty for failing to comply with a direction to keep records. Sub-section 69B(4) provides that where there is a 'change in the value of money' the Treasury may by Order substitute new sums in place of those specified. We assume that this is intended to be a simple means of indexation or approximate indexation to keep the penalties level in real terms; however, confirmation would be appreciated. We would also welcome clarification of how the 'change in the value of money' in new section 69B(4) will be measured.

The maximum penalty for failing to comply with a direction to keep records is £6000, which can be regarded as a criminal sanction, particularly for a small business. We consider it preferable that changes to criminal penalties are specifically legislated for by Parliament in primary legislation, rather than put through without full debate in an SI.

Standing Committee

ICAEW Briefing 2 of 5

This briefing provides detailed comments on Part 3 Chapters 1 and 2 of the Finance Bill for consideration in Standing Committee of the House of Commons. It is supplementary to the Briefings for Second Reading and the Committee of the Whole House. 'ICAEW Briefing 1' covered Parts 1 and 2 of the Finance Bill.

PART 3

INCOME TAX, CORPORATION TAX AND CAPITAL GAINS TAX

CHAPTER 2

RELIEFS FOR BUSINESSES

Clause 27 and Schedule 1 – Group relief where surrendering company not resident in UK

Proposed amendments

Schedule 1
Page 153, Line 37

Replace existing paragraph 6(4) with the following:

6 (4) An amount is regarded for the purposes of this paragraph as meeting conditions A and B if (but only if) every reasonable step to secure that the amount is so taken into account or relieved is taken (whether by the company or any other person).

Schedule 1
Page 154, Line 21

Replace existing paragraph 7(4) with the following:

7 (4) In determining for the purposes of conditions A and B whether an amount can be so taken into account or relieved, the time at which the determination is to be made is the time when the company makes the claim or claims for group relief.

Comment

Clause 27 and Schedule 1 are designed to give effect to the European Court of Justice decision in the case of *Marks & Spencer plc v David Halsey* (C-446/03). We believe that, as currently drafted, paragraphs 6(4) and 7(4) are impossible to comply with and neither provision complies with the EU legal principle of effective remedy.

Paragraph 6(4)

The conditions in paragraph 6(4) are impossible to meet because the trader has to make sure that a third party has taken 'every step' to ensure that the loss in question has been taken into account or relieved. In the case of Marks & Spencer (M&S), that would have required M&S to know how Galeries Lafayette (the purchaser) had used the losses in question and, moreover, for M&S to procure that Galeries Lafayette did (or did not) pursue certain courses of action with respect to the losses. Our understanding is that M&S would have had no enforceable means of procuring this information and did not have the ability to procure that Galeries Lafayette did (or did not) pursue a particular course of action in respect of the M&S France SA's losses.

The proposed ICAEW amendment requires the claimant to take 'every **reasonable** step'. We believe that the interposition of the word 'reasonable' means that the test is in conformity with the EU principle of effective remedy.

Paragraph 7(4)

The *Marks & Spencer* case has been referred back to the UK Courts to determine the practical implications of the decision. In the UK High Court, Park J gave his Judgment on 10 April 2006 ([2006] EWHC 881). The judgment considers the 'relevant time at which M&S has to demonstrate that the conditions of paragraph 55 [of the ECJ decision] were satisfied in relation to the losses of [the German and Belgian subsidiaries]. The first option is 'the end of the accounting period of loss' of those subsidiaries and this is the time limit set out in the existing paragraph 7(4) of the Finance Bill. However Park J states at paragraph 44 of his judgment that '[This] time is too soon, and would be likely to rule out virtually every case'. In other words, if the law is enacted as currently drafted it will be almost impossible for any claims to be made.

Park J goes on to say (in paragraph 44) that in his judgment the correct time for the claim is 'the time or times when M&S made the claim or claims for group relief.

The above ICAEW amendment in respect of paragraph 7(4) reflects the recommendation of Park J in his judgment.

Clause 30 – Temporary increase in amount of first-year allowances for small enterprises

This clause enacts the Budget announcement increasing, for one year only, the rates of first year capital allowances for small businesses. It continues a pattern of small and temporary changes which a recent study has found to be ineffectual in encouraging business investment. The benefits of such minor changes in the rate of First Year Allowance (FYA) for small business are disproportionately offset by the regulatory impact of uncertainty in the tax rates and the need to keep up-to-date with the changes.

The rates of FYA for expenditure on plant and machinery for small businesses have recently been as follows:

Period	First Year Capital Allowance

1998 - 2004	40%
2004 - 2005	50%
2005 - 2006	40%
2006 - 2007	50%
2007 - 2008	40% (current expectation based on 2006 Budget)

A recent ICAEW research report by the Manchester and Nottingham Universities Business Schools for on 'The Role of Tax Incentives', utilising interviews with small and medium businesses, found that except for the most generous capital allowances (e.g. for energy saving equipment where the allowance is 100%), the tax advantages of capital investment are considered by small and many medium businesses only after the decision to invest has been made. Whilst minor changes in the rate such as a 10% increase for one year will provide additional resources to business after expenditure has been incurred, it is insufficient to influence in advance business' decisions to invest.

If Government policy is to encourage businesses to invest, the incentives on offer will need to be increased over and above those included in the Bill. Given that research suggests that rates of 50% will not encourage investment, this would suggest rates of FYA of between 75% and 100%. In order to fully assist with business planning and investment decisions, any such changes to the rates of capital allowances should be announced well in advance and maintained for a reasonable period of time. We would suggest three years.

Standing Committee

ICAEW Briefing 3 of 5

This briefing provides detailed comments on for consideration on the remainder of Part 3 of the Finance Bill in Standing Committee of the House of Commons. It is supplementary to the previous Briefings for Second Reading and the Committee of the Whole House, covering subsequent Clauses.

PART 3

CHAPTER 5

PERSONAL TAXATION

Mobile telephones and computers

Clause 60 – Mobile telephones

Cost of administration

If significant private use of mobile telephones is to be taxable once again, we suggest that there should be a flat rate charge, as was the case before it was abolished from 6 April 1999. This would avoid the need for complex benefit calculations resulting from the availability of a wide variety of payment plans. Given that the cost of mobile phones and calls has most likely dropped in real terms, we suggest the cost of the taxable benefit should be £200 per year, apportioned on a time basis if the period of availability is less than the whole year.

Where telephones are provided to those otherwise earning under £8,500, for example non-executive directors and part timers, it will be difficult to value in advance the potential benefit of the phone. Employers will have to put in place procedures to identify if the benefit of the mobile phone takes the individual over the £8,500 threshold. Unless a scale charge is adopted, such procedures are likely to cost more than any resulting taxable benefits.

Given that the benefit is not the calls made but the availability of the phone, we would welcome confirmation of the position where mobile phones contain SIM cards with two telephone numbers, for example, one number for business and one for private use.

Working abroad

Where more than one telephone is provided, a not uncommon situation for those who go abroad so that users can take advantage of local rates rather than use the 'roam' facility or have to change the SIM card, we would welcome confirmation as to who will decide which instrument is covered by this exemption.

Vouchers and tokens

Clause 63 – Power to exempt use of vouchers or tokens to obtain exempt benefits

The ICAEW welcomes this provision which will simplify compliance procedures and ensure benefits are exempt in whichever equivalent form they are received.

CHAPTER 6

THE LONDON OLYMPIC GAMES AND PARALYMPIC GAMES

Clause 65 - London Organising Committee

This clause sets out a potential model for far simpler charity tax trading rules which currently are fraught with complexity. The Institute believes that it should be considered whether this clause could be extended, in the future, so that it applies more generally to the income of charities.

In order to help initiate consideration of the potential of this clause for charities in general, the Institute would welcome clarification as to whether the tax exemption given is considered more generous than those available to other charities carrying on trading activities.

Clause 68 – Competitors and staff

The Government has aimed over recent years to align the rules for PAYE and NIC in order to reduce complexity for business. The Institute would therefore welcome clarification that any exemptions granted under this section will apply also for NIC.

CHAPTER 7

CHARGEABLE GAINS

Capital losses

Clause 70 – Restrictions on companies buying losses or gains

This clause tightens up the capital loss anti-avoidance measures, but the result is considerable complexity that very few taxpayers and advisers are likely to understand and resulting increased costs of compliance.

The Institute believes that these provisions, as a whole, now need to be reviewed to see if they can be simplified. It would also aid clarity if all of these provisions were consolidated into a single place in the legislation. The ICAEW would be happy assist with such a review.

CHAPTER 8

AVOIDANCE: MISCELLANEOUS

International matters

Clause 78 – Controlled foreign company and treaty non-resident companies

The ICAEW welcomes Conditions A and B which prevent the main provisions applying in the stated circumstances. However we believe clause 78(3), introducing new sub-sections 90(3) – (4) into the Finance Act 2002, is likely to inhibit cross-border merger and acquisition activity both inward bound to the UK and outward bound from the UK.

Clause 79 – Transfer of assets abroad

Introduction

The transfer of assets abroad rules are very broad in application given the definitions of 'transfer of assets' and 'associated operations'. Their objective should be to successfully target deliberate avoidance of tax by the transfer of assets abroad without imposing a punitive tax regime on individuals who may make a transfer of assets abroad for non-tax reasons, e.g. establishing a business overseas. The rules in the new draft clauses in Schedule 7 to the Finance Bill are pivotal to achieving this objective.

Burden of argument

Under the new provisions, the taxpayer is require to demonstrate '*that it would not be reasonable to draw the conclusion ...*' that tax avoidance was the purpose of the transaction. If there is a dispute between HMRC and the taxpayer as to whether exemption under section 741A is available, the terms of this section would appear to suggest that it would not suffice for a taxpayer to demonstrate before the Court that on balance his analysis is the better one. The ICAEW believes the taxpayer need to go further and demonstrate that the conclusion drawn by HMRC is unreasonable (i.e. one which no reasonable person could have arrived at)?

There is no such burden of argument imposed on the taxpayer in other provisions concerning a tax avoidance motive (see for example section 703 ICTA 1988, section 137 TCGA 1982).

It would be fairer to the taxpayer to alter the wording such that he is merely required to demonstrate that the conditions in section 741A(1) and (2) are satisfied with a separate section specifying that all the circumstances of the case are to be looked at in considering this.

Condition A

We would welcome guidance on the circumstances in which HMRC believe Condition A would be satisfied.

Paragraph 60 of the HMRC document '*Transfer of Assets Abroad – Technical Notes on Draft Clause'*' sets outs HMRC's view that the new provisions will require that all relevant circumstances of the case must be considered including the 'actual objective outcome of the transactions'.

If the actual objective outcome of the transactions is that there is no reduction in the amount of UK tax payable then arguably there would be no need for HMRC to invoke the provisions in section 739 (which would render the exemption in section 741A otiose).

We request clarification of whether HMRC envisage any scenarios in which the actual objective outcome of the transactions results in the reduction of UK tax but where the exemption under s741A (1) (a) would still be allowed by virtue of Condition A being satisfied?

Condition B

The condition will not be satisfied if any transfer or associated operation is not one that would have been made between independent persons acting at arm's length. If such a transaction occurs, the exemption will be denied even if in all other respects the transactions did not involve any element of tax avoidance. For example, one can envisage a scenario where a UK resident individual establishes a foreign company to trade in another country (which may have higher corporation tax rates than the UK). If the individual provides finance or other assets from his own resources to this company on favourable terms he may view this as 'commercial' to the extent that initially the company may not be generating sufficient revenue to pay interest on the finance or rent for the use of the assets. Nonetheless, the exemption will be denied even if the establishment of the foreign company was entirely motivated by commercial factors.

A more equitable approach would be to consider the commerciality of such transactions as one of the factors to be taken into account in determining whether the transactions were more than incidentally designed for the purposes of avoiding liability to taxation rather than making it a pre-condition for the exemption with no discretion on the point being allowed to HMRC.

Clearance

The current HMRC policy is for any application for exemption under section 741 to be dealt with under the Self Assessment system. This means that if an individual entered into a transaction, such as establishing a foreign company on 7 April 2006, he would have to claim the exemption in his 2007 tax return.

Assuming the taxpayer submitted his return before the 31 January 2008 deadline and that full disclosure were made, HMRC would then have until 31 January 2009 to open an enquiry into the tax return. This effectively means that a taxpayer would not know for certain whether he has a UK tax liability in respect of the company's income until almost three years after the date the company was established.

A solution to this issue would be the introduction of a formal clearance procedure such as exists under section 138 TCGA 1992, or at least a change of policy from HMRC to give a ruling on the motive defence at a much earlier stage than is the case under Self Assessment.

We are disappointed to have received a letter dated 12 May 2006 indicating that Ministers are not proposing to have a clearance system. The letter does indicate that the Government are willing to consider without commitment any further supporting evidence that might be put forward showing why a clearance system is necessary. We will now consult further with our members and consider what further supporting evidence it would be appropriate to put forward in support of our request for a clearance system.

Pre-owned assets

Clause 80 - Restriction of exemption from charge to income tax

The restriction to the exemption from the income tax charge where property is comprised in a person's estate is not properly targeted and catches many situations that should not be caught. The mischief at which the clause is aimed is where property is part of an individual's estate as a result of section 49 IHTA 1984 but will revert to a settlor when that interest comes to an end on death. The clause therefore needs to be more specifically aimed at that since at present it appears to deny the benefit of the relief where an individual has the relevant property in his estate even where the revertor to settlor exemption is not available.

The ICAEW believes the clause should apply only to interests created on or after 5 December 2005 and not to other interests.

Paragraph 11 of schedule 15 to FA 2004 also needs to be amended to reflect the IHT changes in Schedule 20 of this Bill. The principle to be applied is that Schedule 15 FA 2004 imposes an income tax charge in cases of what is seen as IHT avoidance. Where certain interests in possession have now become relevant property, and so are within the IHT regime, there can by definition be no IHT avoidance. It is therefore necessary to ensure that there is no income tax charge under Schedule 15.

CHAPTER 9

MISCELLANEOUS PROVISIONS

Leasing of plant and machinery

Clause 81 and Schedules 8 & 9 – Leases of plant or machinery

The thrust of Schedule 8 is to move capital allowances on long funding leases (greater than seven years) from the lessor to the lessee.

Whilst the ICAEW appreciates the policy purpose for this provision, we have a number of concerns. It may disadvantage small business start ups seeking lease finance where they would prefer capital allowances to remain with the lessor and benefit from reduced rentals. Whether this will be a significant problem in practice is debatable but we request that the impact of this measure on small business start ups be kept under review.

The proposal may inhibit cross-border trade where lessees do not receive the tax depreciation (eg UK lessor, French lessee – in France the lessee will not receive the benefit of tax depreciation in such circumstances).

The Institute remains concerned that long funding lease provisions are still contrary to the EC Treaty in that in the case of a cross border lease with France there will be no allowances available to the UK lessor and there are no allowances available in France to the lessee. This is in contrast to an equivalent UK – UK lease where the UK lessee would be able to claim the allowances.

New section 70YJ of the CAA 2001 gives power to HM Treasury to amend for tax purposes the meaning of 'plant or machinery lease'. We do not understand the necessity for this wide believe it should be withdrawn.

Settlements

Clause 88 and Schedule 12 – Settlements, etc: chargeable gains

Paragraph 1 of Schedule 12

The Institute welcomes the principles behind the new definition of settlor set out in section 68A but are concerned that sub-section (6) of the new section 68A may not work properly. Suppose that A has settled assets on a trust but is not the only settlor; the trustees have sold a property and now have cash from this disposal as well as other cash from other transactions; the trustees advance cash to a beneficiary. We would welcome clarification that A has ceased to be a settlor in relation to this settlement.

A similar point arises in sub-paragraph (3) of new section 68B where we would be grateful for clarification on how the property disposed of by the settlor is to be identified.

In new section 68C, please confirm our understanding of the effect of sub-para (5) as set out in the following example. Under his will A leaves property on an interest in possession trust for B; B creates a trust for his minor children and enters into a variation of A's will whereby the property that would have gone onto life interest trust for A is varied into the trust created by B. We understand that A, rather than B, will be treated as the settlor of the settlement.

Paragraph 2 of Schedule 12

There is no provision to assist UK trustees equivalent to the present section 69(2) TCGA 1992. We understand that this is in relation to concerns that such a provision would amount to State Aid. Given that similar concerns have been expressed in relation to the new relief for a film qualifying as a British film under clause 40 and that an application has been made to the EU for the measure to be accepted even though it may be qualified as State Aid, we suggest that a similar request is made for a provision equivalent to section 69(2).

Paragraph 3 of Schedule 12

Given that the gains of trusts are in general now taxed at 40%, we see no need for this paragraph,. It adds unnecessary complication simply for the purpose of a possible reduction in CGT since the settlor may have an annual exemption or losses available.

It would be consistent with normal practice to provide that the changes in paragraph 3 should apply only to settlements created on or after the 22 March 2006 or for property added to an existing settlement after that date. It is wrong in principle to change retrospectively the treatment of settlements already existing from which a settlor is excluded.

Paragraph 4 of Schedule 12

The ICAEW remains to be convinced for case for now denying hold over relief where an individual transfers property to a settlement for his dependent children. This produces a complete anomaly in that a transfer of the same property to be held by trustees as bare trustees for a child under the age 18 would be eligible for hold over relief as would a transfer to a trust for the benefit of children over 18. There is little purpose in creating this discontinuity and we request that it is removed from the Bill.

Considering the issues over this particular change, we believe it is more appropriate that it should apply only to settlements created on or after 22 March 2006 or property added to an existing settlement on or after that date.

Under Schedule 20 there will now be an IHT charge on all transfers by a settlor to a trust for his minor children after 21 March 2006. The normal CGT hold-over relief should therefore apply to such transfers.

Paragraph 6 of Schedule 12

Paragraph 6 introduces nearly four and a half pages of legislation to provide for sub-funds to be able to be treated as a separate settlement. Whilst we welcome the principle that trustees may elect that sub-funds are treated separately for tax purposes, we believe in practice this will not happen because the effect of such an election is to create a potential charge to CGT. There seems no reason why such an election cannot be accompanied by a provision that deems the property to pass for CGT at a no gain no loss basis so that there is no step-up in base cost and thus no loss of CGT. Without such a provision, this welcome approach will be of virtually no effect.

Sub-section 8 introduces an unnecessary condition. There seems no avoidance in such a situation and it is in practice quite likely that those who are beneficiaries of the principal settlement may be reversionary beneficiaries under the sub-fund in the event that all the sub-fund beneficiaries fail.

The information requirement in sub-section 12 (c) needs to be narrowed and limited to information relevant to the sub-fund election. There is a growing tendency to make information provisions much wider than are strictly necessary. There is no reason at all to know about property no longer in the settlement or anything about the settlor or the beneficiaries as these are not relevant factors.

Similar comments apply to those made above in relation to sub-section 16. There seems no reason at all why HMRC should have any ability to make enquiries of anybody who is or has been a beneficiary or anyone who is or has been a settlor as their circumstances cannot be relevant to the sub-fund election.

Clause 89 and Schedule 13 - Settlements, etc: income

Paragraph 1 of Schedule 13

The new section 685(A) introduced by paragraph 1 of Schedule 13 will have the effect that some trusts will become bare for income tax with the result that the beneficiaries, rather than the trustees, will be liable to pay the tax. As this would be a significant change for those trusts, it would be helpful if this change could take effect only from 6 April 2007 to allow trustees time to prepare for the change and inform the beneficiaries.

Paragraph 6 of new section 685(B) and sub-section 5 of the new section 685(D) need to deal with the same issue that was noted for CGT in relation to paragraph 1 of schedule 12 above.

We note that the new section 685(F) follows the starting date of 15 June 1989 used on the introduction of section 110 FA 1989 but are not clear why the same starting date is retained in relation to this change. The start date should be amended to apply in relation to income payable or benefits received from 6 April 2006.

Paragraph 4 of Schedule 13

It is not realistic to suppose that anyone will set up multiple settlements where the yearly benefit that can be obtained is limited to £800 at 20% = £160 per settlement. The initial costs and annual costs will be at least equal to that. We recommend that this paragraph is removed.

Paragraph 6 of Schedule 13

Please confirm that new section 685(A) treats a discretionary beneficiary as having received a payment which has suffered tax at 40% in a case where the settlor of the relevant settlement is not domiciled in the UK and the income arising within the settlement is not UK source and not remitted to the UK.

Paragraph 36 of Schedule 13

We understand the purpose of this provision but in sub-section (2)c) it refers to "a relevant child within the meaning given by section 629 of ITTOIA". We cannot see that the term "relevant child" is defined in that section.

Clause 90 - Special trust tax rates not to apply to social landlords' service charge income

The Institute welcomes this clause which goes some way to solving a problem that has been identified for many years.

Many service charges will arise, however, in respect of housing/residents associations that will not meet the conditions necessary in new section 6ZA to qualify as a 'relevant housing body'. Therefore, we remain concerned that residents' associations which set up sinking funds rather than service charges are actually setting up discretionary trusts without appreciating the consequences. We see no reason in principle why the special trust rate should apply in these circumstances and request that consideration is given to extending this clause so that such associations are included.

Investment reliefs

Clause 91 – Venture capital schemes

We do not understand why the gross assets limits for companies using the EIS, VCT or corporate venturing schemes have been halved. We believe that this may be counter-productive as the costs of raising finance using these schemes may be disproportionate in a smaller company, making the schemes unattractive. The increased risk inherent in a smaller company is in any event likely to deter investors. If the Government is concerned that companies of this size find the cost of raising capital prohibitive, we doubt that the measures introduced will improve matters.

Employment related securities

Clause 92 – Avoidance using options etc

It is perfectly reasonable for the government to counter tax avoidance through the introduction of specifically targeted legislation. However, as we said in previous submissions concerning avoidance of income tax and NIC on remuneration, we remain opposed in principle to retrospective taxation. This change makes a change to UK law with retrospective effect, namely from 2 December 2004. Whilst we appreciate that on 2 December 2004 the Paymaster General warned that future counter measures may be back-dated to that date, given the uncertainty about the precise scope of these new rules we think this these proposed measures should apply only from 22 March 2006.

The new provision means that all options which are not ‘securities options’ will henceforth, and backdated to 2 December 2004, rank as ‘securities’ and be taxed on the grant of the option, not the exercise, and generally be subject to the extensive anti-avoidance provisions in Chapters 2 to 4 of Part 7 ITEPA 2003. This would mean that the new provisions will potentially extend to a whole range of mainstream employee rewards including, for example, ‘put’ options over employer share rights (rights to dispose of such shares, rather than acquire them) share appreciation rights and rights under phantom share option schemes and other forms of option arrangement regardless of whether or not there is a tax avoidance motive.

We understand HMRC have indicated a change of practice in relation to phantom share option schemes and have concluded that they are not in fact ‘options’ and so will not generally be caught by clause 92. Nevertheless the extremely wide-ranging nature of the proposals, dating back to 2 December 2004, does give real cause for concern about the practical implications of recourse to retrospective legislation.

PAYE

Clause 94 - PAYE retrospective notional payments

If reimbursement is not made within 90 days, an employer could be severely disadvantaged in cases where the employee has left the employment.

Accounting practice

Clause 102 and Schedule 15 – Accountancy change: spreading of adjustment

Proposed amendments

In paragraph 1(1)(b), line 13 omit '22 June 2005' and insert '10 March 2005'.

In paragraph 9(1)(b), line 27 omit '22 June 2005' and insert '10 March 2005'.

Reasons for amendment

The spreading provision of an adjustment arising out of UITF 40 is welcome, but it applies only businesses that adopted UITF 40 from its official start date of 22 June 2005. However, early adoption of accounting standards is encouraged and in the interests of good governance and a desire to follow best practice, many businesses adopted UITF Abstract 40 at an earlier date. Those businesses which undertook to move to UITF Abstract 40 before the official start date are, in effect, being denied a relief as a result of following the highest standards of accounting and best practice.

The proposed amendment backdates the spreading relief to 10 March 2005, the date when UITF Abstract 40 was published and sends out a powerful message to businesses that early adoption of accounting standards in accordance with the highest standards of corporate governance will be encourage and will not result in such businesses being penalised.

Remaining issues

We believe that there is lack of clarity in Part 1 of Schedule 15 concerning the effect of the spreading rules on cessation of a business within the scope of income tax.

The main rules in paragraph 2 set out the amount chargeable in each tax year. This appears to be clear. Paragraph 3 then states:

> "If before the whole of the adjustment income has been charged to tax the person permanently ceases to carry on the business in question, paragraph 2 continues to apply but with the omission of the alternative limit … referring to the profits of the business".

This seems to provide a clear result for tax years before and after cessation, but is unclear in relation to the actual tax year of cessation. The main rules in paragraph 2 charge adjustment income according to tax years. A cessation will, however, normally occur part way through a tax year. The unclear wording in paragraph 3 might be read as excluding the business profits test in the year of cessation, or alternatively as only referring to years after that of cessation.

It is unclear how long is the final period. If it is, say, a full twelve months then there appears to be no reason why the business profits test should not apply. On the other hand, the business might only trade for (say) one month during the final tax year, in which case the business profits limit could provide an unreasonably low figure for that year. The Institute requests that the rules are clarified.

A similar difficulty, although the wording is different, arises on a partnership cessation, where it is unclear how the profit sharing rules apply in the tax year of cessation.

Standing Committee

ICAEW Briefing 4 of 5

Clause 157 and Schedule 20

Key changes to Trusts

Contents

Introduction

This ICAEW Briefing focuses on issues in relation to Clause 157 in relation to Trusts. The Institute is distributing this briefing well ahead of discussion in Standing Committee to allow appropriate time for consideration of this complex issue.

The Finance Bill makes major changes to long-standing arrangements for trusts. The Institute believes that the measures as they stand will have a number of severe unintended consequences affecting many more families than was originally intended. The Institute, here, proposes amendments to the Bill that would deal with these issues, whilst preserving the key original objectives of the legislation. In order to help bring clarity to the debate, the ICAEW has concentrated on two particular areas - the spouse exemption and the retrospective nature of the changes to Accumulation and Maintenance Trusts. Other professional bodies may bring forward proposals on other issues and rather than replicate such work and potentially confuse the debate, the Institute may wish to make clear its views in regard to such proposals through further communications.

1. Protecting Inheritance Tax Spouse Exemption Rules

Background

Schedule 20 makes radical changes to the inheritance tax treatment of interest-in-possession trusts (IIP trusts). The ICAEW understands the Government wishes to tax most interest in possession trusts on the same basis as discretionary trusts to stem a perceived loss of tax and does not object to such changes per se. The Institute is highly concerned, however, that in very many cases the legislation will remove the usual complete exemption from inheritance tax for transfers between spouses and civil partners. The Institute believes this was not the intention of Government and so the first set of amendments is designed to preserve the spouse exemption. The second set of amendments is designed to deal with the fact that the position in regard to the spouse exemption has not been clear to families or their advisors since the Budget and so if it is not preserved, these amendments would bring the changes into effect from 6 April 2007 allowing families some time to plan accordingly.

An IIP trust is, broadly, one under which a beneficiary is entitled to the whole of the income, rather than it being distributed at the discretion of the trustees. Under the current rules the property of an IIP trust is treated in the same way as if the life tenant (the beneficiary) owned that property absolutely. Under the new rules in the Bill most IIP trusts, unless they meet very restrictive conditions, will be treated in the same way as discretionary trusts. In other words they will be liable to an inheritance tax charge on entry, every 10 years, and when property leaves the trust, subject to some transitional protection for existing trusts.

Thus a transfer into such a trust for the benefit of a spouse, whether made in life or on death, will not be eligible (as it is now) for the exemption for transfers between spouses. This means that the spouse exemption will be denied to large numbers of people, unless they rewrite their wills. That will have a huge administrative cost, as well as a sizeable practical cost as many individuals will be unable to leave their property to their family in the way that they would wish. The Government has given no reason why it wishes to deny the spouse exemption to such families and underlying this briefing is the Institute's assumption that it does not wish to do so.

The issue is that the current proposals deny the spouse exemption in many cases where there can be no question of any tax avoidance. An example of such a case follows. As a result, very many wills may need to be reviewed and redrafted simply because no one who makes a will can know what will happen after his or her death. The Government's aim can be met without prejudicing the spouse exemption unnecessarily as these amendments show. This will remove the present uncertainty, meet the Government's aim and ensure large numbers of individuals will not need to change their will as a result of these aims.

1 (a) The key issue in regard to spouse exemption

First Set of Amendments: To preserve the spouse exemption

Schedule **20**, page **114**, line **32**, leave out 'an immediate post-death interest' and insert 'an interest for the transferor's spouse'.

Schedule **20**, page **115**, line **2**, leave out from beginning to end of line 18 on page 116.

Schedule **20**, page **119**, line **24**, leave out 'an immediate post-death interest' and insert 'an interest for the transferor's spouse'.

Schedule **20**, page **119**, line **41**, leave out paragraph 12.

Schedule **20**, page **120**, line **23**, leave out 'an immediate post-death interest' and insert 'an interest for the transferor's spouse'.

Schedule **20** page **120**, line **32**, leave out 'an immediate post-death interest' and insert 'an interest for the transferor's spouse'.

Schedule **20**, page **121**, line 20, leave out from beginning to end of line 34.

Schedule **20**, page **121**, line **37**, leave out '(1), (2) and (2B)' and insert '(1) and (2)'.

Schedule **20**, page **121**, line **39**, leave out 'or (2B)'.

Schedule **20**, page **122**, line **20**, leave out 'an immediate post-death interest', and insert 'an interest for the transferor's spouse'.

Schedule **20**, page **123**, line **4**, leave out 'an immediate post-death interest', and insert 'an interest for the transferor's spouse'.

Schedule **20**, page **123**, line **31**, leave out 'an immediate post-death interest' and insert 'an interest for the transferor's spouse'.

Schedule **20**, page **123**, line **39**, leave out 'immediate post-death interest' and insert 'interest for the transferor's spouse'.

Schedule **20**, page **125**, line **10**, leave out 'an immediate post-death interest', and insert 'an interest for the transferor's spouse'.

Schedule **20**, page **125**, line **17**, leave out ‘immediate post-death interest’ and insert ‘interest for the transferor’s spouse’.

Schedule **20**, page **125**, line **19**, leave out ‘immediate post-death interest’ and insert ‘interest for the transferor’s spouse’.

Schedule **20**, page **125**, line **27**, leave out ‘an immediate post-death interest’ and insert ‘an interest for the transferor’s spouse’.

Schedule **20**, page **125**, line **37**, leave out ‘an immediate post-death interest’, and insert ‘an interest for the transferor’s spouse’.

Schedule **20**, page **126**, line **3**, leave out ‘an immediate post-death interest’ and insert ‘an interest for the transferor’s spouse’.

Schedule **20**, page **126**, line **24**, leave out ‘an immediate post-death interest’, and insert ‘an interest for the transferor’s spouse’.

Schedule **20**, page **126**, line **31**, leave out from beginning to end of line 33 and insert ‘ “an interest for a transferor’s spouse” means an interest in possession in settled property to which the spouse becomes beneficially entitled as a result of a transfer of value that is, or to the extent that it is, an exempt transfer by virtue of section 18 above in consequence of the operation of section 49 above;’.

Schedule **20**, page **127**, line **9**, leave out ‘an immediate post-death interest’, and insert ‘an interest for the transferor’s spouse’.

Schedule **20**, page **128**, line **10**, leave out ‘an immediate post-death interest’ and insert ‘an interest for the transferor’s spouse’.

Example of where spouse exemption is lost

Bob is a policeman aged 45 and earning £40,000 a year. He has two children from his first marriage and two from his present marriage. He lives in a semi-detached house in Leyton which is now worth £300,000 and which he owned before his second marriage. When he married for the second time he drew up a will under which his wife received the house for life or until she remarried, and it would then be held in trust until the younger of his two children from his first marriage reached the age of 25, at which time it would be sold and divided between them.

That is not an unusual set of circumstances these days. Bob was simply being prudent and making sure that his children would be looked after in the event of his early death. He is by no means a wealthy man, and tax avoidance never entered his thoughts. In drawing up his will, he imagined that his children would by 25 have finished their education but did not want them to have the proceeds of sale before that age. Since his children were below 25 when he made his will, he needed to use a trust to carry out his wishes.

If Bob died before Budget Day there would have been no inheritance tax charge. His house would have been left to his wife – not absolutely, but as a life interest – and the transfer would have been completely covered by the spouse exemption.

Suppose Bob dies in 2010 at the age of 49, when the children from his first marriage are aged seven and nine. To this sad set of circumstances the Government has added a further trial. Because of the 2012 Olympics his house has risen in value to £450,000, and the inheritance tax nil rate band is, let us say, £325,000. Inheritance tax of £50,000 would be due, and the trustees would likely have to sell the family home to pay the tax.

Numbers of taxpayers potentially affected

The Finance Bill introduces a fundamental change in the treatment of property held in trusts, which has continued unchanged since IHT was introduced (as capital transfer tax) in 1974. Few existing wills that leave property in trust for a spouse will meet the restrictive conditions now imposed. The Society of Trust and Estate Practitioners, and other professional bodies, estimate that the changes will require over a million wills to be rewritten.

The number of wills with provisions utilising the legal entity of trust will always be far greater than the actual number of estates that will actually be affected. The majority of people who make a will which prepares for a worst case scenario where they die before their children are grown-up is rightly far more than the number of people who will suffer such unfortunate circumstances. Therefore the ICAEW is not saying that a million *estates* will be affected but we are currently convinced that such a large number of *wills* will have to be reviewed with the associated costs. There is also the unintended consequence of those who have taken the cautious step to prepare a will, a step beneficial to their family and society in general, now having to go the expense to have it revised. In practice, very few people will actually regularly review their wills once they are made. Thus these proposals as they currently stand effectively penalise the cautious with an additional cost. Increased uncertainty in the rules effectively acts as a disincentive to making early provision for tragic occurrences.

In the experience of ICAEW members, one of the most common forms of will is that an individual leaves his assets in trust for the surviving spouse for life and then in trust for the children. Such wills have no tax avoidance intent, indeed the word ‘trust’ may not even be included but are affected by the Government’s proposals.

Furthermore, under Shari’a law it is common for a husband to leave his estate on trust for his wife, and for distributions to be made to other family members without the consent of the wife. Whatever the precise mechanics, and whatever the reason for this, it appears the spouse exemption will also be lost in these circumstances.

Meeting Government’s stated objectives without impacting unnecessarily on the spouse exemption

The concern underlying the measures put forward by the Government appears to be that under many trusts which give an individual an IIP the trustees nevertheless have some discretion to deal with changing family circumstances, particularly as regards the allocation of the assets once the interest in possession comes to an end. If the Government believes that such trusts are being used for tax avoidance reasons, then they are entitled to act to close off those possibilities.

We suggest that the spouse exemption can be protected, whilst ensuring the Government’s concerns can be met, by widening the classes of trust excepted from the new rules to include any case where the interest in possession under the trust is initially held by (and continues to be held by) the spouse of the settlor. This is what the first set of amendments are designed to do. The spouse exemption will thus remain where for family reasons an individual leaves his or her spouse a life interest in his or her estate rather than an outright interest.

1. (b) Supplementary issues should the spouse exemption not be preserved

Second Set of Amendments: To defer impact on spouse exemption to deaths on or after 6 April 2007

Schedule **20**, page **114**, line **30**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **114**, line **36**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **114**, line **40**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **116**, line **25**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **116**, line **26**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **116**, line **31**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **116**, line **38**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **118**, line **5**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **118**, line **27**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **119**, line **22**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **119**, line **32**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **119**, line **37**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **120**, line **1**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **120**, line **20**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **120**, line **29**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **120**, line **40**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **121**, line **1**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **121**, line **15**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **121**, line **21**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **122**, line **1**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **122**, line **12**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **122**, line **18**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **123**, line **2**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **123**, line **16**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **123**, line **21**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **123**, line **30**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **123**, line **38**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **123**, line **42**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **124**, line **29**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **124**, line **33**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **125**, line **35**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **125**, line **45**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **126**, line **21**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **126**, line **42**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **127**, line **3**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **127**, line **21**, leave out '22nd March 2006' and insert '6 April 2007'.

Schedule **20**, page **127**, line **32**, leave out '22nd March 2006' and insert '6 April 2007'.

The uncertainty under the provisions in the Bill

The second set of amendments is designed to deal with the issue of uncertainty. It is still not clear to ICAEW members with the greatest expertise in this area whether, under the Bill, many common structures will be denied the spouse exemption or not.

For example, one of the very restricted set of circumstances in which the present treatment of IIP trusts continues, so that the spouse exemption will continue to be available, is where the spouse's interest is an 'immediate post-death interest' as defined in paragraph 5 on page 115 of the Bill. To be within that definition various conditions must be met. Condition 4, in the new section 49A(5) inserted by the Bill, requires that on the coming to the end of that interest:

- somebody will become absolutely entitled to the property. (That is section 49A(5)(a)); or
- the property will be within one of the new trusts for bereaved minors. (That is the reference to s71A in paragraph (b)); or
- that it will be within a trust for a disabled person. (That is the reference to section 89 in paragraph (c)); or
- that it will be held for charitable purposes. (That is referred to in paragraph (d).)

Suppose that a man leaves his property in trust for his second wife with remainder to his adult children. At first sight that appears to be within new s49A(5)(a). But the children might die before their stepmother, particularly if they are older than her or in poor health. In some cases, taking these factors into account, the prospect of the children eventually inheriting the property would be exceedingly slight. Queries have therefore been raised, and not yet resolved, as to whether that condition can ever be met with the required degree of confidence.

Uncertainty for intestate estates

Particular uncertainty arises in cases of intestacy where, again, one cannot predict which of the deceased's relatives may or may not be alive at the time of his death. Take for example the case of Mr Smith, a deputy headmaster in South East England, who lives with his wife and three children in a house that he inherited from his parents. He dies intestate on 1 August 2006. The value of his estate, which comprises the house and contents and not much else, is £500,000. Mrs Smith receives the personal chattels plus the statutory legacy of £125,000, plus a life interest in half the residue. The children receive half of the residue on statutory trusts plus the other half on statutory trusts following the eventual death of Mrs. Smith.

Mrs Smith's interest in possession appears not to meet the conditions in new s49A, so an inheritance tax charge will arise on the excess of the value of the estate over the statutory legacy of £125,000 (after taking account of the nil-rate band). In other words, the spouse exemption will apply to less than half of what Mr Smith leaves his wife. Further charges will arise at ten-year intervals. Before the Budget, by contrast, the charge would have been only on the amount passing to the children under statutory trusts (which, after applying the nil-rate band, would have resulted in no charge).

Legislation by reference to contingencies not actual events

There is a problem arising from the fact that the legislation is framed to impose a charge not when the offending event happens, but when it appears that it is a possibility. So, the mischief (if such it be) that the Government intends to catch may be, for example, a husband inheriting an interest in possession in the family home from his wife and subsequently passing on the same interest in possession to his daughter. If that possibility is not excluded by the original trust then the spouse exemption will be denied, even though that eventuality may never arise.

The charge ought to be imposed when the offending act happens. It ought not to be imposed at the time of the wife's death simply because the passing of the interest in possession to the daughter *might* happen at a later stage. It is this insistence on legislating by reference to what *might* happen rather than by reference to what *has* happened that is at the root of the uncertainties in the Bill.

Unfairness for those who have died after 21 March 2006

The provisions under the Bill have effect from Budget Day. This has meant that the families of those people unfortunate enough to have died since that time have been subjected to a period of worry and uncertainty as they wait to discover whether they will be affected by the Bill and thus, in some cases, whether they will have to sell the family home.

It has long been the convention that legislation has taken effect from Budget Day only if sufficient information on that legislation can be made available to enable taxpayers to have reasonable certainty as to their position. That convention was not observed in this case, and this must have caused considerable anxiety for bereaved relatives at a difficult time.

The Institute's second set of amendments propose that, should Government not take our first preference of fixing the problem as per the first set of amendments, the uncertainty for these people be dealt with by the deferred implementation of the Bill so that it applies to deaths on or after 6 April 2007. This will also give an opportunity to analyse the Bill and tease out its meaning. At the same time the Government will have time to re-consider whether the anomalous effects of the Bill as it stands are really what it is seeking to achieve.

2. Unfair Retrospective Impact on Existing Accumulation and Maintenance trusts

Amendments to preserve the existing IHT treatment for current Accumulation and Maintenance trusts

Schedule 20, page 111, line 13, leave out 'settled property (including property settled before 22nd March 2006' and insert 'property settled on or after 22nd March 2006'.

Schedule 20, page 113, line 12, leave out from 'subsection,' to end of line 23 and insert 'there were substituted for the reference to 13th March 1975 in subsection 8(b) a reference to 22nd March 2006.'.

Schedule 20, page 113, line 36, leave out 'at any particular time on or'.

Schedule 20, page 113, line 42, leave out from beginning to end of line 44.

Schedule 20, page 114, line 9, leave out from beginning to end of line 23.

Schedule 20, page 114, line 38, after 'section' insert '71 or'.

Schedule 20, page 115, line 22, after 'section' insert '71 or'.

Schedule 20, page 115, line 27, after 'section' insert '71 or'.

Schedule 20, page 116, line 29, after 'possession' insert 'or was property to which section 71 applied'.

Schedule 20, page 116, line 31, leave out 'but before 6th April 2008'.

Schedule 20, page 116, line 35, after 'section' insert '71 or'.

Background

Accumulation and Maintenance Trusts were introduced by Denis Healey in the 1970's. It has been a favoured tax treatment to recognise that it is not appropriate to make outright gifts or legacies to children who may not yet be fit to manage their financial affairs. Thus until the children reach an appropriate age the assets are not subject to the normal charges which would apply to a discretionary trust. The ICAEW is of the firm opinion that families who have created such trusts (often in their wills) are in no way involved, per se, in tax avoidance since they are simply using the current tax regime which has existed for thirty years under both Labour and Conservative governments.

The amendments are designed to preserve the existing inheritance tax treatment for assets already in Accumulation and Maintenance trusts (A&M trusts) on Budget Day. These are, very broadly, trusts for the education and maintenance of children or grandchildren who either will become absolutely entitled to the settled property on or before attaining a specified age (not exceeding 25), or will become entitled to an 'interest in possession' in that property. Under the current law, inheritance tax will apply in either case when that happens as the property is treated as in the estate of the beneficiary.

The Finance Bill removes the existing special treatment of A&M trusts and substitutes a much narrower category of 'trusts for bereaved minors' under which favourable inheritance tax treatment will be available only to trusts where the child will become absolutely entitled to the assets on or before reaching the age of 18.

The Institutes leaves aside here the issue of 18 versus 25 (though we do have reservations) to concentrate on the retrospective way in which those in current trusts will be penalised and the original choice of those who have planned their families' finances will be undermined in a way they could not have predicted. The ICAEW believes that the issue is one of long-term family financial planning, akin to retrospectively changing the rules in a disadvantageous manner for pensions. Similarly, just as the current pensions debate rightly focuses on the need to provide constancy and predictability for families so they can take long term decisions, the retrospective nature of these changes will lower the level of trust individuals can place in other current and future tax advantages the Government may provide through legislation.

Normal practice is not to disadvantage existing structures

The immediate concern here is with the position of existing A&M trusts, to which the existing rules will cease to apply from 6 April 2008 (unless the trusts are altered to provide that the beneficiaries must take an absolute interest on or before the age of 18). This will result either in tax charges that could not have been foreseen when the trusts were set up or (if they are altered to comply with the new rules) in a situation where children have absolute entitlement to assets at an age of 18 when the family may not have not equipped them to organise their financial affairs.

It is a significant departure from established conventions to make far-reaching changes to the tax treatment of long-term financial structures, as is done in the Bill. The proposed transitional measure from Government allows time for changes to be made but does not preserve the position of existing arrangements.

Individuals enter into long-term arrangements in expectation of a particular tax treatment. The ICAEW believes Government should not bring forward legislation which bears upon the decisions of families who have no opportunity to unravel arrangements that they would never have entered into if they had known the change was coming.

Transitional measure proposed is not adequate

The transitional provision in the Bill does not meet the ICAEW's concerns. The proposed amendments will preserve the existing treatment of existing trusts.

If the settlor who in many cases will be a prematurely deceased parent, had known that these changes were coming they might well have made different arrangements altogether. They might have chosen, for example, to create a completely discretionary trust and bear the inheritance tax charge that will now arise in any case if nothing is done. However, they (or rather the trustees, on whom the responsibility now falls) cannot go back to that position now. All they can do is create an absolute interest in the property at the age of 18, knowing that this is not what the settlor wanted, or make no change and be taxed as a discretionary trust but without having the flexibility in the disposition of the property that such a trust usually offers. Sometimes they will not even have the option of creating an absolute interest as not all the beneficiaries will agree.

3. The Need to Allow Appropriate Transition For Existing Accumulation and Maintenance trusts

Amendments to the inheritance tax rules on transitional serial interests to allow transition for existing Accumulation and Maintenance trusts

Schedule **20**, page **116**, line **23**, after 'if' insert 'section 49D below applies or'.

Schedule **20**, page **116**, line **39**, at end insert**—**

'49D Alternative condition to be transitional serial interest

(1) Where a person ("B") is beneficially entitled to an interest in possession in settled property ("the current interest") for the purposes of this Chapter that interest is "a transitional serial interest" if the following conditions are met.

(2) Condition 1 is that:

(a) the settlement commenced before 22nd March 2006; and
(b) immediately before 22nd March 2006, the property then comprised in the settlement was settled property to which section 71 applied.

(3) Condition 2 is that B became beneficially entitled to the current interest in that property after 22nd March 2006 but before 6 April 2008.

(4) Condition 3 is that until B became entitled to the current interest the property remained property to which section 71 applied.

(5) To determine whether section 71 applied for the purposes of Condition 3 above, the amendments to section 71 made by paragraph 3 of Schedule 20 to the Finance Act 2006 are not to have effect.'

Explanation

If it is accepted by Government that the changes proposed to Accumulation and Maintenance (A&M) Trusts should not apply to property already in such a trust, these amendments are not required. Should Government go forward with the retrospective changes to existing trusts, these amendments seek to ensure that where an interest in possession arises in an existing A&M trust, that interest is given the transitional protection already available to other similar interests.

The existing rule under which the property in an interest in possession trust is treated as forming part of the estate of the life tenant continues only in three case: where the interest is an 'immediate post-death interest' (as defined); where it is a disabled person's interest; or where it is a 'transitional serial interest'. A transitional serial interest as defined by new section 49C is, broadly, an interest in possession to which an individual became entitled on the ending of a previous interest in possession (whether held by the individual or someone else) between Budget Day and 6 April 2008. This provision thus affords a measure of transitional relief.

The amendment extends this definition to include an interest in possession to which an individual becomes entitled on the property ceasing to be within an A&M trust.

As it is required for favourable tax treatment that a beneficiary of such a trust should become entitled to an interest in possession no later that age 25, if that happens in the transitional period before 6 April 2008, it seems logical that the holder of such an interest should be treated in the same way as any other holder of a similar interests.

4. Protecting the Interests of Families who have Taken Necessary Steps to Deal with Current Uncertainty

Amendment to clarify operation of section 144 IHTA 1984

Schedule **20,** Page **126**, line **20**, remove paragraph 27.

Explanation

Many people will need to amend their wills because of the provisions in the Finance Bill. They affect in a particularly unfortunate manner the families on those who have died on or after Budget Day. The Budget Day press release (B N 25) was itself very unclear and subsequent publication of the legislation has not clarified some very important issues for those affected.

The ICAEW is aware that those who are revising their wills, during this period of uncertainty, are advised that the only practical course is to make use of an existing provision in the inheritance tax legislation in Section 144. In brief, this provides that where a will is drafted to create a discretionary trust, then if within 2 years after the death property passes on to a separate trust for a surviving spouse, then for the purposes of inheritance tax the result is that the spouse exemption is available. This is a long standing provision but its use has become much more likely as a result of the current uncertainty.

The amendment is a probing amendment to prompt clarification by Government of its position in respect of Section 144. The ICAEW's first concern is to ask whether it is thought that the proposed changes are technically sound and allow the Section to work as it did previously under the new legislation. The Institute is aware that some doubts have been expressed by representative bodies such as the Law Society and STEP. Accordingly, the Institute would be grateful if the Government could confirm either that these technical doubts have been resolved or else that Government will table amendments to deal with them.

The consequentially second concern of the ICAEW is the most important. Since Government, by this legislation, has required people to rely on Section 144 where previously they would not have needed to do so, the Institute would be grateful for a clear commitment that Section 144 will remain available to serve these purposes as long as this new regime does. It would be unfair to have forced people to rely on this provision because of the uncertainty of the legislation combined with the timing of a death then to deny them the protection of it by a future decision to remove the operation of Section 144.

Standing Committee

ICAEW Briefing 5 of 5

This is the fifth and final main Parliamentary Briefing from the Institute of Chartered Accountants in England and Wales for the Finance Bill Standing Committee, covering any key issues the Institute would like to raise in Parts 7 to 10 of the Bill. ICAEW Briefings 1-3 were numbered as such. The ICAEW Briefing on Trusts (Clause 157 and Schedule 20) was distributed sometime ahead of consideration of the relevant parts and in effect became ICAEW Briefing 4.

PART 7

PENSIONS

Clause 161 and Schedule 22 - Inheritance tax

POINTS OF CONCERN AND REQUESTS FOR CLARIFICATION

Paragraph 2 of Schedule 22

Paragraph 2A provides that sub-section (2B) applies in a case where section 10 IHTA 1984 would prevent any charge arising. The ICAEW is concerned that if section 10 above applies so that there is no charge, then there is nothing on which the IHT legislation can bite. We would be grateful for clarification of this provision.

The ICAEW opposes the provisions in new paragraph 2(C) as this puts what the Institute believes to be an intolerable imposition upon the executors and relatives of the deceased who are required to establish what he knew about his life expectancy in the period of two years before his death. It is likely to involve harrowing enquiries having to be made by the executors and relatives of the deceased. In addition, the burden of proof is unreasonable since it is very likely that there will be no evidence available to show what the deceased's actual understanding was of his life expectancy.

It would be helpful to understand precisely what HMRC think individuals should keep by way of records about their understanding of their medical position. If they do not keep them, then does that mean that there will automatically be an IHT charge because it will not be possible to show a reason for relief? We recommend that the whole issue is reconsidered and if there is not to be a complete exemption, then the burden of showing what were the motives of the deceased should fall upon HMRC.

Even after applying the provisions of paragraph 2C, paragraph 2D then appears to exempt such an occasion from being a transfer of value to the extent that it results in the provision of a lump sum death benefit to a relevant dependant (as defined). In other words, after seeking to apply these complicated provisions, most cases are likely to be exempt. The Institute questions whether a simpler approach could be undertaken.

The legislation in paragraphs 2C and 2E for someone who has reached age 75 refers to "an actual pensions disposition". However, the term is not defined and the Institute believes it should be defined in schedule 22.

Paragraph 2E provides that a disposition by someone who has reached age 75 is not a transfer of value if it includes omitting to exercise pension rights under the pension scheme. The ICAEW recommends that this provision should apply also to those under 75.

The ICAEW also requests that Government confirm whether there is a 35% income tax charge under section 206 FA 2004 where there is an IHT charge under paragraph 2 and, if there is, how the two interact? It appears to give an effective rate of tax of 61%. The ICAEW sees no need for an IHT charge where there is a 35% income tax charge since any benefits that are actually received by a spouse or dependants will themselves give rise to taxable income.

Paragraph 4

The Institute has similar comments to those made above on the arrangements for alternatively secured pensions in paragraph 4. We believe that it could be intended that there should be both an income tax charge at 35% and an IHT charge and the ICAEW believes this to be wrong in principle.

PART 8

STAMP TAXES

Stamp duty land tax

Clause 164 - Partnerships

REQUEST FOR CONFIRMATION

The ICAEW welcomes the removal of a charge to stamp duty land tax where there is a transfer of an interest in a partnership if the partnership property includes land for all partnerships whose main activity is the carrying on of a trade (other than a trade of dealing in or developing land) or a profession and the provisions that allow a double charge (the charge on 'actual consideration' in paragraph 10 of Schedule 15 and the interaction between paragraphs 14, 17 and 17A of Schedule 15).

Given the enormous complexity of the new SDLT regime, which was officially acknowledged by delaying implementation and HMRC agreeing that a light touch would initially be operated, many will have not have applied the rules correctly to transactions during the period up to when the Finance Bill provisions will come into effect.

The ICAEW would welcome confirmation from the Minister that HMRC will treat with a light touch cases where the rules have not been followed correctly.

Clause 168 - Demutualisation of insurance companies

NECESSARY AMENDMENTS TO EXTEND CLAUSE TO PARALLEL ISSUE OF INTRA-GROUP TRANSFER

Proposed Amendments

Clause 168, page 138, line 14,

leave out….
'at the end insert – "For another exception to this, see sub-paragraph (3A)"'

and insert …..
'delete from "This does not apply" to "the same group as the acquiring company.".'.

Clause 168, page 138, line 23

leave out….
'and (b) the conditions for relief under that section are intended to be met'

and insert….
'or (b) section 75 of the Finance Act 1986 is intended to apply (stamp duty: Acquisitions: reliefs), and (c) the conditions for relief under the relevant section are intended to be met.'

Background

Clause 168 is welcome. It removes an anomaly whereby SDLT group relief might be denied where intra group transfers of property are effected in preparation for a demutualisation of an insurance group.

But there is another very similar anomaly which arises where intra group transfers of property are effected in preparation for a reconstruction of a corporate group. These amendments extend the Government's clause to remove this anomaly as well

The Need for the Amendment

A demutualisation of an insurance company involves a business transfer from a mutual company to a new company and the issue of shares by the latter to the policyholders of the mutual. A reconstruction also involves a business transfer from an existing company to a new company and the latter would issue shares to the shareholders of the former.

In both cases there are SDLT exemptions where the business transfers involve transfers of property

- section 63 Finance Act 2003 – relief for demutualisations
- paragraph 7 Schedule 7 Finance Act 2003 – relief for reconstructions.

This recognises the fact that such transfers do not result in a change of overall ownership of the businesses.

However, these reliefs only apply to transfers at the final stage of demutualisation or reconstruction. If property transfers are required as a preparatory step, eg in order to get the right assets in the right place, then group relief (paragraph 1 Schedule 7 Finance Act 2003) needs to be claimed. But group relief is subject to anti avoidance provisions which deny the relief if the group companies which are party to the property transfers are to be de-grouped. It is anomalous for the group relief to be denied for transfers preparatory to a demutualisation or reconstruction if the demutualisation or reconstruction itself enjoys a specific exemption.

The Effect of the Proposed Amendments

Clause 168 recognises the anomaly in relation to demutualisations. It disapplies the group relief anti-avoidance provisions where the property transfers are preparatory to a demutualisation. However, the Government have not taken the opportunity to correct the similar anomaly in relation to reconstructions.

The ICAEW believes it logical that the similar anomaly for reconstructions is These amendments seek to remedy this, i.e. to disapply the group relief anti-avoidance provisions where the property transfers are preparatory to a reconstruction.

Clause 170 - Reliefs for certain company acquisitions

AMENDMENT TO REMOVE UNNECESSARY RESTRICTIONS ON RECONSTRUCTION OF A CORPORATE GROUP OR A DEMUTUALISATION

Proposed Amendments

Clause 170, page 139, after line 41, insert

‘ “(5) In section 42 of the Finance Act 1930 (Relief from transfer stamp duty in case of transfer of property as between associated companies), insert at the end of sub-section (2)

“This proviso does not apply to arrangements in so far as they are for the purpose of facilitating a transfer of the whole or part of the business of a company to another company in relation to which –

(a) section 96 of the Finance Act 1986 is intended to apply (stamp duty relief: demutualisation of insurance companies), or

(b) section 75 of the Finance Act 1986 is intended to apply (stamp duty: Acquisitions: reliefs), and

(c) the conditions for relief under the relevant section are intended to be met.”

(6) In section 27 of the Finance Act 1967 (Conveyances and transfers on sale: reduction of duty), insert at the end of sub-section (3)

“Sub-section (c) does not apply to arrangements in so far as they are for the purpose of facilitating a transfer of the whole or part of the business of a company to another company in relation to which –

(a) section 96 of the Finance Act 1986 is intended to apply (stamp duty relief: demutualisation of insurance companies), or

(b) section 75 of the Finance Act 1986 is intended to apply (stamp duty: Acquisitions: reliefs), and

(c) the conditions for relief under the relevant section are intended to be met." '

Clause 170, page 140, line 1

Delete '(5)'

Insert '(7)'

Background

Clause 170 is welcome. It relaxes unnecessary tight conditions applying to various stamp duty reconstruction reliefs. It removes the requirement that the acquiring company must be UK-incorporated. It also relaxes the requirement that the shareholders be issued shares in exactly the same proportions as the shares held prior to the transaction.

The proposed amendments take the opportunity, because this is a stamp duty clause, to remove other anomalies arising where intra group transfers of shares are effected in preparation for a reconstruction of a corporate group or a demutualisation of an insurance group. Anti avoidance provisions deny the group relief in such cases.

These anomalies are also discussed in the notes to the Institute's proposed amendments to clause 168. That is a SDLT clause and this clause seeks to remove similar anomalies relating to stamp duty.

The Anomaly

A demutualisation of an insurance company involves a business transfer from a mutual company to a new company and the issue of shares by the latter to the policyholders of the mutual. A reconstruction also involves a business transfer from an existing company to a new company and the latter would issue shares to the shareholders of the former.

In both cases there are stamp duty exemptions where the business transfers involve transfers of shares

- section 96 Finance Act 1997 – relief for demutualisations
- section 75 Finance Act 1986 – relief for reconstructions.

This recognises the fact that such transfers do not result in a change of overall ownership of the businesses.

But these reliefs only apply to transfers at the final stage of demutualisation or reconstruction. If share transfers are required as a preparatory step, eg in order to get the right assets in the right place, then stamp duty group relief (section 42 Finance Act 1930) needs to be claimed. But group relief is subject to anti avoidance provisions (section 27(3) Finance Act 1967) which deny the relief if the group companies which are party to the property transfers are to be de-grouped. It is anomalous for the group relief to be denied for transfers preparatory to a demutualisation or reconstruction if the demutualisation or reconstruction itself enjoys a specific exemption.

The Effect of the Proposed Amendments

The amendments are not directly related to the purpose of the Government's clause and do not amend their proposals in any way.

These amendments seek to disapply the group relief anti-avoidance provisions where the share transfers are preparatory to a demutualisation or reconstruction thereby freeing up businesses to undertake such legitimate activity.

Part 9

MISCELLANEOUS PROVISIONS

Clause 174 – International tax enforcement arrangements

NEED TO PREVENT POTENTIAL ABUSE OF HUMAN RIGHTS OF TAXPAYERS CAUSED BY VEXATIOUS REQUESTS BY OVERSEAS TERRITORIES WHICH ARE LESS SCRUPULOUS THAN THE UK

Proposed Amendment

Clause 174, page 143, after line 21, insert:

'(5A) Information is not to be given to any person nor debts recovered nor documents served in pursuance of any arrangements having effect under this section unless with the consent of the appropriate judicial authority as defined in section 20D Taxes Management Act 1970; and that authority is to give his consent only on being satisfied that in all the circumstances, including in particular due observance of the taxpayer's human rights, it is justified to so proceed.'

Background

Clause 174 follows on from the UK signing up to the OECD/Council of Europe Convention on Mutual Assistance in Tax Matters. The ICAEW welcomes the UK's signing up to the Convention, as this will facilitate the fight against fraud.

However, the Institute is concerned that a consequence of this could be that the UK would be asked to share information with or enforce tax collection or serve documents on behalf of the tax authorities of overseas jurisdictions, which might in the future be party to the multilateral convention, which do not have the same high standards of 'due process' as the UK to ensure that tax is properly payable by the person against whom the enforcement was being required.

Where this is the case, this could breach the Human Rights of the person against whom the information or enforcement or service of documents was being required. This is compounded by the fact that HMRC officers have a unilateral power to disclose information or enforce debts or serve documents, and the taxpayer has no rights of appeal, nor to know that it has even happened.

Clause 174(5) indicates that the provision will not be applicable if the overseas jurisdiction does not have appropriate rules of confidentiality. However we do not believe this provision overcomes our objection as the rules of confidentiality do not prevent abuses of Human Rights.

Our Suggested Solution

Requests for disclosure of information, enforcement of debts and service of documents should have to be approved by a High Court Judge (or regional equivalent – see below under Definitions).

This will provide a means to ensure that the Human Rights of the person in respect of whom the overseas territory is seeking information, enforcement of debt or service of documents are not likely to be breached in that territory. As the actions authorised by this clause that may prejudice the Human Rights of the person in respect of whom the overseas territory is seeking information, enforcement of debt or service of documents are being undertaken by the UK, the Judge will as part of his deliberations consider whether the Human Rights of the person under consideration will be protected not only in the UK but also in the overseas territory. Such considerations would have to include the manner in which the overseas territory would utilise the information or the basis upon which the UK undertakes the recovery of debt or service of the document.

Notes on our Suggested Amendment

In drafting the new sub-section, we have adapted the wording in section 20A(3) TMA 1970 (Power to call for papers of tax accountant).

Definitions in our suggested amendment

The definition of ‘appropriate judicial authority’ is the same as for the production of documents and information powers in sections 20-20D Taxes Management Act 1970. It is defined in section 20D(1) Taxes Management Act as, namely, in England and Wales, a Circuit Judge or a District Judge (Magistrates’ Courts); in Scotland, a Sheriff; and in Northern Ireland, a County Court Judge.

Fallback if amendment falls

Should the amendment not be accepted, the ICAEW requests that the Minister will confirm that HMRC when enforcing its obligations under this clause, will only do so if it is satisfied that the Human Rights, not only in the UK but also in the overseas territory, of the person in respect of whom the overseas territory is seeking information, enforcement of debt or service of documents will not be prejudiced by its actions.

ADDITIONAL MATTER: REQUEST FOR CLARIFICATION ABOUT LEGISLATION THAT THIS CLAUSE REPLACES

The Explanatory Notes state that this clause ‘replaces a variety of different existing provisions concerning international agreements for the exchange of information, all of which will be repealed’. It is not clear exactly what are the ‘variety of existing provisions’ that are being replaced and the extent to which these powers have been extended.

The ICAEW would welcome a clarification from the Minister as to what provisions this clause replaces and how the powers are extended or indication that HMRC will shortly provide such a clarification.

Report Stage

ICAEW Briefing 1 of 2

This briefing provides detailed comments for consideration at Report Stage of the Finance Bill in the House of Commons. It is supplementary to the previous Briefings for Second Reading and Committee Stage.

PART 2

VALUE ADDED TAX

Avoidance and fraud

VAT MTIC CLAUSES 19-20-21

Clause 19 – Missing trader intra-community fraud

A 'probatio diabolica'
(partially debated on Standing Committee; included in ICAEW briefing 1)

Proposed amendments

Clause **19**, Vol **1**, page **21**, line **26** insert after 'supplier'

'save that where the tests in new sub-section (c) have not been met despite the supplier acting with normal diligence and in good faith in ascertaining the facts, then the supplier shall be treated as having had a reasonable excuse for not accounting for and paying over to HMRC the VAT that he has not received from the recipient'.

Clause **19**, Vol **1**, page **22**, insert after line **12**

(2) 'In section 83 VAT Act 1994 insert:
"(ma) any question of whether the trader has a reasonable excuse for not accounting for VAT where the tests in section 55A(6)(c) are not met."'

Clause **19**, Vol **1**, page **22**, line **13,** change (2) to (3)
Clause **19**, Vol **1**, page **23**, line **1,** change (3) to (4) and
Clause **19**, Vol **1**, page **23**, line **4,** change (4) to (5)

Synopsis

The supplier is faced in new section 55A(6)(c) (*Vol 1, page 21, lines 23-24*) with a *probatio diabolica*, or an impossible proof. If either test is failed, the supplier will have to account to HMRC for the VAT, even though he neither charged it to, nor received it from, his customer.

There should be an unfettered right of appeal for the supplier on a reasonable excuse basis where it transpires that the tests in new section 55A(6)(c) (Clause 19 (1)) have not been met despite the supplier acting with normal diligence and in good faith, and where the appeal is successful, that is to say, it is found that the tests in new sub-section 55A(6)(c) are not passed but the supplier has acted with normal diligence and in good faith in trying to ascertain the facts, then he should not have to account and pay over to HMRC the VAT that he has not received from the recipient.

Explanation

How does the 'probatio diabolica' arise?

Clause 19 provides for a new section 55A under which where a supplier makes a supply of 'relevant', but not 'excepted' goods, he has to ascertain that the two conditions in sub-para (c) of new sub-section 55A(6) are satisfied, namely that:
(i) the recipient is registered for VAT at the time the supply is made, and
(ii) the recipient is supplied in connection with his carrying on a business.

If either test is failed, the supplier will have to account to HMRC for the VAT, even though he neither charged it to, nor received it from, his customer.

Test (i) is difficult – whilst the supplier can telephone HMRC to confirm the VAT registration number and name and address of the customer, many businesses have more than one address. Hijacked VAT numbers are also used in this type of fraud: thus the VAT registration number might a valid number, giving an appearance of legality, but does not belong to that customer. Test (ii) requires the supplier to ascertain what his customer will in fact do with the goods.

We consider that it is not possible for any supplier, acting in good faith and with normal diligence, to obtain absolute proof that the two conditions in sub-section 55A(6)(c) have been met, since he is neither entitled nor privy to the necessary information. As a result, he is faced with what is known in EC Law as an impossible proof, or *probatio diabolica*.

Legal – and moral – aspects

From a legal viewpoint, the clause therefore risks being unlawful since it does not meet the principle of legal certainty.

Irrespective of the legal position, we question whether it is moral or appropriate for a tax authority to legislate to impose impossible conditions on taxpayers.

'Innocent bystanders paying for the crimes of others'

We remain unclear what is meant by 'on the supplier's behalf' in new section 55A(6) (Vol 1, page 21, line 25). If the supplier were to be held jointly and severally (or otherwise) liable for the VAT due if the recipient does not in fact account for the VAT under the reverse charge procedure, then, unless the supplier has acted recklessly or is a party to the fraud, it will be a question of (in the words of a European Commission official in a letter to Tax Journal dated

24 April 2006, explaining why the Commission had intervened in the *Optigen* case): ‘making innocent bystanders pay for the crimes of others’.

We welcome the Paymaster General’s assurance in Standing Committee A on 11 May 2006 at Column 135-6 that where the recipient is VAT-registered and buys goods for the purpose of the business (ie the tests in new sub-section 55A(6)(c) are passed) but fails to account for the VAT even though under new clause 55A it is his responsibility to do so, then there will be no liability on the supplier.

However, this does not cover the case where the tests referred to are not passed, despite the supplier using normal diligence and acting in good faith to ascertain the facts.

Where the tests in new sub-section 55A(6)(c) are not passed but the supplier has acted with normal diligence and in good faith, then he should not have to account and pay over to HMRC the VAT that he has not received from the recipient.

Our proposed solution

A partial solution to both the difficulties faced by the trader in having to undertake impossible proofs and potential legal challenges about the lawfulness of the provision could be achieved by giving the supplier an unfettered right of appeal to the courts on a ‘reasonable excuse’ basis, namely that he did take all reasonable steps to ensure that the two conditions in new sub-section 55A(6)(c) were met. Where the appeal is successful, the supplier should not be liable to account for the VAT that he has not received from the customer.

In addition, HMRC should publish guidance on what they consider those steps should be.

Extract from Standing Committee debate

SCA 11.5.06
Cols 135-136
Mr. Gauke: ... I want to raise again the specific drafting point about subsection (6)—“on the supplier’s behalf”—and whether, in the event of the recipient not paying the VAT, the supplier may have some liability. …
Dawn Primarolo: I am sorry—it is unavoidable and I can see no way around it—but the supplier would be required to take reasonable steps to satisfy themselves that the customer is VAT-registered and the purchase is
Column number: 136
for business purposes. If the customer is VAT-registered and buys goods for the purposes of the business, it is the recipient’s responsibility to account for the VAT. If the customer fails to do so, there will be no liability on the suppliers. That will be a principle in respect of the requirements as well, if the Commission responds by saying that it want to see certain adjustments in the legislation. We will need to look carefully and see that the reverse charge does what we want but does not extend into areas that we would not want it to. I hope that I have answered all the questions.

Cat and mouse –
(not debated on Standing Committee, although included in ICAEW briefing 1)

Given that the supplies within the clause, namely 'relevant supplies', have to be listed in a Treasury Order under new section 55A(9), there remains the risk that fraudsters will ensure that the goods they use as part of their MTIC fraud are not those within the provisions of this clause. This will create a cat and mouse situation with HMRC having to include additional goods within the regime once they discover what goods are being used by the MTIC fraudsters. The fraud could also move to services.

Clause 20 - Power to inspect goods

Suggested amendment

Clause **20,** Vol **1**, page **23**, after line **18** insert:

'In exercising these powers, the authorised person must act reasonably and the marks must be such as to not spoil the goods or the packaging or otherwise decrease their value and if the authorised person does not act reasonably or the value of goods is impaired or their sale unreasonably delayed, then the authorised person shall pay compensation and any question of whether the authorised person has complied with the foregoing shall be determined by the tribunal.'

Explanation

The breadth of powers

The Institute appreciates the value of this clause, as it will deter the multiple use of the same goods in MTIC frauds. Nevertheless, we are concerned that this clause goes far further than necessary. The assurance provided by the Minister in Standing Committee, whilst welcome as far as it goes, does not comprise a legislative safeguard against unreasonable conduct by the authorized person nor any remedy where things go wrong. The clause effectively gives HMRC the power to have any goods (whether linked to MTIC fraud or not) completely unpacked and then marked.

The legislation should require HMRC to apply the new law in a proportionate way, and only to MTIC fraud. To ensure this, there should be a requirement for HMRC to act reasonably, with a full right of appeal to the VAT Tribunal, and the new sub-paragraph 10(2A)(a) should include a provision to ensure that marks are such that they do not damage or spoil the goods or its packaging or otherwise decrease their value.

The cost to business

There should also be a specific provision requiring HMRC to pay compensation if the value of the goods is impaired, or their sale unreasonable delayed. We accept that under current law, businesses have to bear the cost of any damage or repackaging when HMRC inspect goods or take samples, but normally only a few items are involved. These new provisions can be applied to all the goods held by a business, and it is both unreasonable and disproportionate for a business to be required to bear what could be very significant extra costs.

Extract from Standing Committee debate

SCA 11.5.06
Cols 136-137
Dawn Primarolo: The purpose of the clause is to put beyond doubt HMRC officers' power when inspecting goods for VAT purposes, to evidence that inspection by applying a date stamp to the goods or their packaging, and to scan barcode information into a database. What the [Opposition's] amendment would do—first and foremost and absolutely uniquely—is defeat the main purpose of the clause, which is that if it is the same goods circulating, and they are stamped and we have the barcode, that information will be provided. If the amendment prevents us from doing that, we have no power. The amendment therefore strikes at the very heart of how
Column number: 137
we are trying to deal with those issues in the clause. I hope that the hon. Member for Falmouth and Camborne will understand that we are talking about recording barcodes or information about the goods in a way that is acceptable to business, so that if the same goods come round again, we know it. … .

SCA 11..5.06
Cols 140-141
Dawn Primarolo: As I said in my introductory remarks, the clause will simply put beyond doubt the right of the HMRC's officers to evidence the inspection of goods and to make a record of any information relating to them. Under schedule 11(10) of the Value Added Tax Act 1994, they already have such powers. I do not know why hon. Gentlemen are suddenly so worried. Those powers are operating perfectly well. Although they are predominantly used to tackle MTIC fraud, their use is not limited to that area and never has been. I do not consider it necessary to restrict the scope in an area where it is already operating because to do so could undermine the HMRC's existing rights to record information during routine VAT inspections.
Let us not run away with the idea that suddenly there are loads of extra powers; there are not. The HMRC's officers already have the powers. The provision is to put the powers beyond doubt in what is a difficult area with regard to MTIC fraud. The powers go back to 1973, so they have existed for a long time.
Mr. Dunne: The right hon. Lady has explained that the powers to stamp packaging already exist. Do they also exist to mark goods?
Dawn Primarolo: Yes, I believe so. The next issue is one that the hon. Gentleman raised, as did others. They painted a picture of an Armageddon in which huge amounts of goods would suddenly be unpacked, stamped and thus damaged. That would then be at the trader's cost.
Column number: 141
The requirements are no different from that those that exist for the inspection of goods under the current powers. The HMRC does not require access to individual product items to carry out the stamping and scanning. Hence, my point to the hon. Member for Falmouth and Camborne about the importance of needing to be able to scan the barcode and record such information. There is an HMRC date stamp on the outer packing of goods, such as boxes containing retail consignments of mobile phones. It is a matter to which we will need to pay careful attention, but it is dealt with at the moment.
I should not really answer the questions about cigarettes, but they are stamped and there is no extension to those powers either.

Clause 21 - Directions to keep records where belief VAT might not be paid

General comments

If clause 21 is used to require a business to keep what are normal business records, then it is unexceptionable, except that HMRC already have the power to do that under existing law.

If it is asking them to keep records out of the ordinary, for example, for reasons that have nothing to do with the business itself but with another business of which the first may not even have heard, then that must be subject to the proportionality test. It could force businesses to additional expense, perhaps hiring further staff.

SCA 9.5.06
Cols 144-145
Dawn Primarolo: First, I want to assure the Committee that HMRC has no plans to use the powers for purposes other than to counter large-scale fraud, such as MTIC fraud. In that context, any additional burdens imposed under the measure are, in my view, entirely proportionate given the serious revenue losses that arise from such fraud. We had a constructive debate earlier on exactly what the challenges were.
I was also challenged by hon. Members to explain what the Government are doing now. The record-keeping requirement is part of that. It is a well-established principle that VAT must be administered in a proportionate fashion, so I turn first to the question whether the power is drawn too widely.
I have given the undertaking and made it clear that the power should be used specifically to combat large-scale fraud, such as MTIC fraud. It is totally impracticable to try to limit the scope of the measure by attempting to have a legal definition of MTIC fraud. Given everything that has been said about how it mutates and what the challenges are, I was a little taken aback that Members could flip so quickly from a discussion recognising the complexity of the challenge to providing a legal definition that says, “This is MTIC fraud; everything else you do is okay as long as you manage to legally get outside the definition.” In order for the clause to be effective, it needs to be applied in this way.
HMRC will have to demonstrate reasonable grounds to believe that additional records might assist in identifying supplies on which VAT might not have been paid. The whole purpose of the measure is to assist HMRC in detecting and challenging fraud, and that would be seriously undermined if HMRC had to prove knowing involvement in a specific fraud before using the direction, particularly given the point made by the
Column number: 145
hon. Member for Dundee, East. By the time HMRC had sufficient evidence to prove a fraud, the business concerns would be long gone. That is the nature of such fraud.
I want to deal with what constitutes reasonable grounds for deciding the direction, in practical terms. The Department will exercise its discretion carefully. It has to do so, as the area is complex and litigious. As the hon. Member for Rugby and Kenilworth pointed out, we can end up consuming huge amounts of resources for no gain and we have still lost the revenue. The main criterion is likely to be the previous involvement of the business or persons associated with the business in transaction chains that have led to a VAT loss through MTIC fraud. Anyone who receives a direction and does not believe that HMRC has acted reasonably in issuing it will have the right of appeal to the VAT and duties tribunal.
The direction would require the business to keep records that identify the goods it bought or sold, such as mobile phone serial or batch numbers, or the lock numbers for computer chips. The direction notice will set out clearly the records to be maintained. In order to apply the measure, HMRC must have reasonable grounds. I have explained what those reasonable grounds are and, given the magnitude of the problem that we want to deal with, that is entirely proportionate.
The final point was with regard to the penalty. The whole point of these clauses and the penalties that support them is not to use the penalties but to hope that they have a deterrent effect and that businesses keep better records in the first place to ensure that if they are in a

sensitive area they can always demonstrate the facts of the case and that they complied with the legislation.

The scale of the fraud could be up to £1.9 billion of stolen VAT. It is theft, not business. It is like robbing a bank; it is just a different bank that they are robbing currently. They are doing it against the Exchequer. In the light of this, the level of penalty must be appropriate to act as a deterrent. I do not know whether £6,000 is high enough. However, within the range of penalties that the Department operates across the piece, that is the appropriate level and that is how we will back it up.

If businesses keep the correct records they always know to whom they have sold and from whom they are purchasing. If they have kept the batch numbers and they can demonstrate that, it helps to pave the way exactly to the point made by the hon. Member for Rugby and Kenilworth. Where somebody within a chain took all possible steps and could not have reasonably known, or have had access to the knowledge, and can demonstrate the facts with the records, it will take them outside consideration for MTIC fraud. That seems very important.

Stewart Hosie: The Paymaster General suggested that businesses should keep correct records of goods, numbers, customers and so on. That is reasonable. But in a previous debate it was suggested that tobacco manufacturers should not supply to people who they

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believe will smuggle; they should not supply to businesses, possibly illegal ones, which may then resupply to smuggling operations. Would it be reasonable under proposed new section 6A(1) for the commissioners to direct a company to keep records, not only of its immediate customers, but perhaps of the customers' customers? That is the implication of the tobacco smuggling issue. If that became impossible, because a business simply could not identify it, and the commissioners thought that it was reasonable in order to try to stop major fraud, would the penalty then apply?

Dawn Primarolo: We are talking about an entirely different case here. As I made clear to the hon. Gentleman, the requirement for the direction to keep more records is because of involvement in, or suspected involvement in, a previous chain. This has operated perfectly well. The legislation depends and has depended in other areas on this definition of reasonableness and then the test at the tribunal. It is entirely appropriate in this area. The question that we still have to deal with as Members of this House, and I have to deal with as the Minister responsible for this area, is whether the combination of these clauses, the reverse charge and the increased activity, will have the required deterrent effect on MTIC fraud, or whether further steps will need to be taken. That is a matter that we can resolve only when we see the exact details of the reverse charge and the derogation we may be granted by the Commission.

Right of appeal

Sub-clause 21(4) extends the list of matters that can be appealed to a tribunal in section 83 VATA 1994 to include the direction to keep records introduced by this clause but sub-clause (5) amends section 84 VATA 1994 to block any effective right of appeal.

The appeal procedures probably contravene EU, and human rights law, for the following reasons.

d) The Tribunal can only apply the 'reasonable' test to HMRC, so it is not even a proper appeal - only the facts that HMRC had at the time of their decision can be reviewed.

e) A right of appeal is meaningless if it is limited to cases where the taxpayer has to show that HMRC could not reasonably have been satisfied that there were grounds for issuing a direction. Quite apart from the fact that the taxpayer does not know what information HMRC have (and HMRC might not be prepared to inform him, since it may not involve the taxpayer at all but another business totally unknown to him), the Tribunals have interpreted this restriction in appeal rights to mean that they cannot even look at all the evidence available to them at the time of the hearing. They are instead limited to looking at what information was available to HMRC when they made the direction, and deciding if in the light of that material the direction was reasonable. In effect, if HMRC only have half the facts when they make the direction, perhaps because the facts were not available or because HMRC have been unable fully to investigate them, there is nothing the Tribunal can do about it other than to request HMRC informally to review its decision whilst turning down the appeal.

f) Coupled with this, the HMRC direction remains in force whilst waiting for the appeal to be heard.

We can see the sense of businesses having to keep the records during an appeal, but the quid pro quo for that must be that:

(a) the business has a full right of appeal and the courts an unfettered jurisdiction to decide,

(b) the onus of proof must be on HMRC, since only they will have all the information and the business may well know nothing; and

(c) HMRC will pay compensation for any extra record-keeping costs, without the business incurring the cost of having to sue, if the court holds that HMRC have acted unreasonably.

If left unchanged, these provisions will merely lead to further litigation and Government defeats in the courts, particularly the ECJ. We do not think that UK businesses should have to seek relief at the ECJ when the UK could take a measured and proportionate approach in the legislation.

HMRC needs to appreciate that the war against fraud will only be won by engaging the cooperation of legitimate businessmen and advisers, not by alienating them.

Changes to amount of penalty

Clause 21(2) inserts a new section 69B into VATA 1994 which provides that a person is liable to a fixed penalty for failing to comply with a direction to keep records. Sub-section 69B(4) provides that where there is a 'change in the value of money' the Treasury may by Order substitute new sums in place of those specified. We assume that this is intended to be a simple means of indexation or approximate indexation to keep the penalties level in real terms; however, confirmation would be appreciated. We would also welcome clarification of how the 'change in the value of money' in new section 69B(4) will be measured.

The maximum penalty for failing to comply with a direction to keep records is £6000, which can be regarded as a criminal sanction, particularly for a small business. We consider it preferable that changes to criminal penalties are specifically legislated for by Parliament in primary legislation, rather than put through without full debate in an SI.

Report Stage

ICAEW Briefing 2 of 2

PART 6

INHERITANCE TAX

Trusts

Clause 156 & Schedule 20 - Rules for trusts etc

This briefing provides detailed comments on clause 156 and Schedule 20 for consideration at Report Stage of the Finance Bill in the House of Commons. It is supplementary to our first Standing Committee Briefing Note on clauses 19 to 21 and the previous Briefings for Second Reading and Committee Stage.

Schedule 20 – Inheritance tax rules for trusts etc

Pension policies

Proposed amendments

References below are to Volume II of the Finance (No 2) Bill not amended in the Committee and as amended in Standing Committee A.

Page 393, line 10 *[title of the new para 11 Sch 20]*, after 'assurance' insert 'and pension'.

Page 393, line 12 *[title of the new s46A IHTA 1984 inserted by the new para 10A(1) Sch 20 inserted by amendment 391 at Committee Stage]*, after 'insurance' insert ', or death benefit under pension policy,'

Page 393 line 16 *[new s46A(b)]*, after insurance' insert 'or pension policy giving rise to a death benefit'.

Page 393 line 17 *[new s46A(c)]*, after 'paid,' insert 'or a contribution under the policy is made'.

Page 393, line 18 *[new s46A(c)]*, after 'made to the contract' insert 'or policy'.

Page 393 line 21 *[new s46A(d)]*, after 'contract' insert 'or rights to a death benefit under the policy'.

Page 393 line 27 *[new s46A(e)]*, after 'contract' insert 'or rights to a death benefit under the policy'.

Page 393 line 28 *[new s46A(e)]*, after 'premium' insert 'or contribution'.

Page 393 line 32 *[new s46A(f)]*, after 'contract' insert 'or policy'.

Page 393 line 34 *[new s46A(f)(i)]*, after 'contract' insert 'or the rights to a death benefit under the policy'.

Page 393, line 36 *[new s46A(f)(ii)]*, after 'contract' insert 'or the period for which a death benefit could be payable under the policy'.

Page 394, line 18 *[new s46A(4)]*, after 'premium' insert 'or contribution'.

Page 394, line 21 *[new s46A(5)]*, after 'contract' insert 'or policy'.

Page 394, line 23 *[new s46A(5)]*, after 'contract' insert 'or policy'.

Page 394, line 30 *[title of the new s46B IHTA 1984 inserted by the new para 11 Sch 20]*, after 'insurance' insert ', or death benefit under pension policy,'

Page 394, line 34 *[new s46B(1)(b)]*, after insurance' insert 'or pension policy giving rise to a death benefit'.

Page 394, line 35 *[new s46B(1)(c)]*, after 'paid,' insert 'or a contribution under the policy is made'.

Page 394, line 36 *[new s46B(1)(c)]*, after 'made to the contract' insert 'or policy'.

Page 394 line 39 *[new s46B(1)(d)]*, after 'contract' insert 'or rights to a death benefit under the policy'.

Page 394 line 44 *[new s46B(1)(e)]*, after 'contract' insert 'or rights to a death benefit under the policy'.

Page 394 line 45 *[new s46B(1)(e)]*, after 'premium' insert 'or contribution'.

Page 394 line 47 *[new s46B(1)(f)]*, after 'contract' insert 'or policy'.

Page 395 line 1 *[new s46B(1)(f)(i)]*, after 'contract' insert 'or the rights to a death benefit under the policy'.

Page 395, line 3 *[new s46B(1)(f)(ii)]*, after 'contract' insert 'or the period for which a death benefit could be payable under the policy'.

Page 395, line 11 *[new s46B(3)(b)]*, after 'insurance' insert 'or pension policy giving rise to a death benefit'.

Page 395, line 12 *[new s46B(3)(c)]*, after 'paid' insert 'or a contribution under the policy is made'.

Page 395 line 13 *[new s46B(3)(c)]*, after 'contract' insert 'or policy'.

Page 395, line 14 *[new s46B(3)(c)]* after 'contract' insert 'or rights to a death benefit under the policy'.

Page 395 line 23 *[new s46B(3)(d)]* after 'contract' insert 'or rights to a death benefit under the policy'.

Page 395, line 24 *[new s46B(3)(d)]*, after 'premium' insert 'or contribution'.

Page 395, line 26 *[new s46B(3)(e)]*, after 'contract' insert 'or policy'.

Page 395, line 28 *[new s46B(3)(e)(i)]*, after 'contract'; insert 'or the rights to a death benefit under the policy'.

Page 395 line 30 *[new s46B(3)(e)(ii)]*, after 'contract' insert 'or the period for which a death benefit could be payable under the policy'.

Page 395, line 48 *[new s46B(5)]*, after 'premium' insert 'or contribution'.

Page 396, line 1 *[new s46B(6)]*, after 'contract' insert 'or policy'.

Page 396, line 3 *[new s46B(6)]*, after 'contract' insert 'or policy'.

Explanation

The Government has introduced radical changes to the treatment of trusts without any prior consultation. This is most undesirable and has caused considerable unfairness for those who have put in place normal planning arrangements which are now subject to a new tax treatment with no notice. It is particularly unfortunate to introduce such unfair changes to penalise individuals who have prudently made provision for their families in the event of their unexpected death.

The right answer to the problem is a fair transitional regime so that existing trusts which have been created before Budget Day are left with the existing treatment. Since by definition such treatment will not apply to any new property added to trust on or after Budget Day, there can be no forestalling to cause loss of tax revenue. If the Government accepted this then the resulting legislation could be much simpler. Since it has not, it introduced very complex provision designed to achieve exactly that protection where life assurance policies were held in trust.

Self-employed individuals and many now in employment make their own pension provision and are not able to rely on pension benefits provided by employers. For such individuals, it is very common for those pension arrangements to provide significant sums in the event of death before receiving a pension and they will have structured those benefits for the protection of their family on precisely the same kind of trusts that are used for life assurance policies. In the Committee stage amendments the Government recognised the case to give transitional provision to those life assurance policies and they should therefore afford the same protection to those who have provided exactly the same structure for their family with pension policies rather than with life assurance policies.

There is no question of avoidance here since the protection will apply exactly as the Government has deemed it to be appropriate for existing life insurance policies. Not to do so will be to send out a message that the Government have no regard for what are necessarily different arrangements for the self-employed and those without access to an employer pension scheme. Those individuals will reasonably have decided not to take out life insurance policies because they have comparable benefits under their pension arrangements and they should receive the same tax treatment.

Background Note

At Committee stage, the Government introduced complex provisions to provide that where a life insurance policy was already settled in trust by an individual for the benefit of his family or dependants, that policy should continue to attract the same inheritance tax treatment as applied before Budget Day.

For individuals who are self-employed or not in occupational pension schemes, exactly the same arrangements are used with the death benefit written under their pensions policies. These benefits are written into trust for the benefit of the individual's family. If the individual survives to draw the pension, there will be no death benefit left in the trust and nothing to draw down. The benefits will be paid only in the unfortunate case where the individual dies before being able to take the pension benefits and is thus entirely parallel with the arrangements for life assurance policies held in trust which the Government has favoured.

Non-domiciled settlors

Proposed amendment

Page 400, line 44 *[para 23 Sch 20]* at the end of new section 80(4) of IHTA 1984 add –

> "(5) Subject to sub-section (4) above, this section shall not apply where the time at which property will be treated as becoming comprised in a separate settlement under subsection (1) above would be on or after 22nd March 2006."

Explanation

Where an individual is not domiciled in the UK and creates a settlement at the time, then as long as the settlement contains property which is not situated in the UK it is excluded property outside the scope of inheritance tax. Section 80, together with section 82, provide that where a settlor creates a settlement in which he or his spouse has an initial interest in possession, then the excluded property status requires that both the original settlor and the person who has the last interest in possession before the property becomes held on trusts in which there is no interest in possession must be non UK domiciled. This is achieved by the combination of section 80 and section 82.

When the Finance Bill was introduced the original amendment to section 80 in Schedule 20, para 23 provided that section 80 would not apply for any property settled on or after 22 March 2006. Thus for a non-domiciled individual who created a settlement on or after Budget Day, section 80 and the extended test for excluded property when an interest in possession came to an end, would not apply. As the Government has not yet announced the results of its continuing review of the tax treatment of those not domiciled in the UK, it seems reasonable that the same position should apply to an existing settlement created before Budget Day.

Under a Government amendment at Committee Stage (number 373) the lack of symmetry for trusts created before Budget Day and on or after it would have been continued since this amendment to section 80 applies only where the relevant settlement was created on or after 22 March 2006. The amendment proposed applies to existing settlements to create this symmetry and does this by restricting the operation of section 80 to cases where either the initial creation of the settlement or the termination of the interest in possession which causes section 80 to apply takes place on or after Budget Day 2006.

Background Note

Section 80 Inheritance Tax Act 1984 provides that where a settlor creates a trust in life or on death with an initial interest in possession for himself or his spouse, for the purposes of the discretionary trust regime, the settlement is not treated as starting until property moves from the last interest in possession into no interest in possession.

The Finance Bill as originally drafted disapplied section 80 for property settled on or after 21 March 2006. This had the unfortunate effect that a trust for a spouse created on death by a testator entered into the calculation of the rate of tax on other trusts created by the will since the trust for the spouse was treated as a related settlement. Previously, it would not have been because it was treated as coming into effect for these rules only when the last life interest ceased.

Government amendment 373 at Committee Stage means that section 80 can apply on or after 22 March 2006 but only where a settlor leaves an interest in possession for his spouse on death which qualifies as an immediate post-death interest. As a result, since section 80 applies, such an interest for a spouse will not be taken into account in computing the tax charges on other trusts created by the will.

This is thus a welcome amendment to reverse an unfair new tax charge. It needs a minor change to ensure it works fairly for foreign domiciliaries.

Where a new inter vivos trust is created on or after 22 March 2006, section 80 cannot apply. At present it can apply to trusts established before that date.

If a foreign domiciled individual creates a trust, as long as the trust contains non-UK property it is outside the scope of UK IHT. Where a trust falls within section 80 both the settlor and the person who last ceased to have the interest in possession must be non-domiciled at the relevant time to achieve excluded property status.

The Government has for some years been reviewing the tax treatment of non-domiciliaries but has not announced any changes. There is therefore no reason to make section 80 apply to non-domiciliaries as a result of the trust changes.

Calculating the charge under s66 IHTA 1984

Proposed amendment

Page 403, line 18 *[para 27 Sch 20]* at end insert new heading and paragraph as follows–

Rate of ten-yearly charge

27A In section 66 IHTA 1984, after subsection (6) insert –

> "(7) Where property has become relevant property as a result of para 3 Schedule 20 of the Finance Act 2006, sub-section 5(a) above and section 67 below shall apply with a reference to 22nd March 1992 instead of to 27th March 1974.

Explanation

The Government proposals bring about a very extensive change in the inheritance tax treatment of trusts. As a result, trusts that were previously outside the so called relevant property regime now come within it. This is wrong in principle since it is unfair and unreasonable to introduce such a significant change without consultation and so that it affects many existing trusts.

There are many problems that arise that could have been dealt with by a fair transitional regime to provide that new property added to such trusts was within the new rules but that existing property remained on the old rules. If that sensible route is not followed, then tax payers and their advisers will be faced with major administrative problems which are likely to result in non compliance.

Trusts which have been accumulation and maintenance trusts for perhaps 25 years have had no need to keep records of the transactions carried out by the settlor before he created the trust. Since these trusts are now brought into the relevant property regime, in order to calculate the tax charges the trustees need to know the history of any chargeable transfers made by the settlor in the seven years before he created the trust. In some cases such information will not be available as there has been no need to keep such records and it will not be possible to recreate them.

An example is where an individual created a discretionary trust in 1986 which involved a chargeable transfer on creation. The trust was subsequently wound up in 1995 and no longer exists. He also created an A&M settlement in 1992 and the transfer on creation therefore became an exempt transfer in 1999. There is no reason why he or anybody associated with the trust should have kept records of the history of the discretionary trust through to 2006 and it will not therefore be possible to recreate the history in 1992. The purpose of this amendment is to put beyond doubt that it will be acceptable for trustees to not take into account transfers more than 14 years before 22 March 2006 since that is the limit of records required under the existing legislation.

Background Note

Under the Government's proposals, existing accumulation and maintenance trusts that do not change their terms will be taxed under the so called relevant property regime from 6 April 2008.

This regime provides a tax charge every ten years working from the creation of the settlement or on certain other occasions when property leaves the settlement. For the purposes of the charge it is necessary to know the chargeable transfers of the settlor in the seven years before he created the settlement. This may require going back to periods when the settlement was not within the relevant property regime and when there was no need for this record because no charge could arise under the accumulation and maintenance regime.

Inheritance tax at present works on a seven year history of cumulation. So when an individual makes a transfer, for example into a discretionary trust, it is necessary to look at the chargeable transfers made within the previous seven years to see if at that time they exceed the nil rate band (£285,000 in 2006/07) so tax is due. For example, if an individual makes a transfer on 1st September 2006, it is necessary to take account of any transfers made back to 1st September 1999 as these could affect the level of charge.

The maximum time for which records are required for a transfer on Budget Day 22nd March 2006 would be for a transfer made by an individual on 22nd March 1999 for which it would be necessary to look back to the history of chargeable transfers up to 22 March 1992.

There is no requirement at present for an individual to keep records for inheritance tax earlier than this and the amendment seeks to ensure that settlors and trusts are not put in the impossible position of trying to create records that they have had no obligation to keep.

References in trust deeds to s71 IHTA 1984

Proposed amendment

Page 403, line 29 *[para 28 Sch 20]* insert at end new heading and paragraph as follows–

> *Interpretation of documents*
>
> 28A After section 272 of IHTA 1984 insert –
>
> > **"272A Interpretation of documents**
> >
> > Any reference to section 71 of IHTA 1984 in any document executed, made, served or issued on or before the passing of the Finance Act 2006 shall have effect as a reference to that section before the amendments made to it by the Finance Act 2006." '.

Explanation

The changes made in the Finance Bill to the treatment of trusts are the most dramatic alterations in around 25 years. It is therefore very likely that such changes will affect existing trusts for many years to come.

Where individuals have transferred assets that are intended to be held on qualifying accumulation and maintenance trusts, the relevant trust documents will invariably require the trustees not to take any action which would cause the tax benefits to be lost. In technical terms this means remaining within the confines of section 71 of the Inheritance Tax Act 1984, particularly as regards the creation of a qualifying interest in possession.

The radical changes introduced by the Government have the effect of making that definition untenable for the future. This will lead to considerable problems for the trustees as they come to consider whether it is appropriate for the beneficiaries to change the terms of the trust to take account of the much more complex new regime introduced in this Finance Bill. In particular, they will face a conundrum in trying to decide what their powers are as these depend upon a definition of section 71 which has now been substantially amended and will be different from 6 April 2008.

In these circumstances, it is appropriate for the Government to clarify the position and make it clear that the trustees' powers can continue to be exercised by looking at the definition of section 71 as it stood before the amendments made to it by this year's Finance Act. In the absence of such a provision, trustees will need to incur the expense of going to Court in order to obtain clarification of how their powers are to be used. This seems unnecessary as it is caused only by the Government's changes. There is a precedent for such action in the Finance Act 1986 when inheritance tax was introduced in 1986, when to avoid the same problem references in deeds that needed to be read to replace capital transfer tax with inheritance tax were deemed to be amended by part of the 1986 Finance Bill.

Background Note

Virtually all accumulation and maintenance trusts are drafted so that the trustees can exercise their powers only in a way which is consistent with maintaining the tax benefits that were previously provided by section 71 of Inheritance Tax Act 1984. In particular, the trustees are not allowed to create an interest in possession other than one that would qualify within the terms of section 71.

Under the Finance Bill proposals the definition of a qualifying interest in possession is substantially amended so that this restriction will not work well in the new regime. In addition, the definition of what qualifies as a trust within section 71 is itself amended from 6 April 2008. If there is nothing specific in the Finance Bill, trustees will probably need to go to Court for guidance on how they are allowed to exercise their powers both in the transitional period and more particularly afterwards. The problems are that the definition will have changed after 5 April 2008 and that the sort of the interest in possession they would previously have created no longer has the same tax treatment because such interests now fall within the discretionary trust or relevant property regime.

When inheritance tax replaced capital transfer tax in 1986, the 1986 Finance Act specifically provided (section 100) that any references to capital transfer tax in any documents executed before the passing of that Finance Act should be read as a reference to inheritance tax. It is precisely this kind of general deeming provision which is required here in view of the very wide spread use of reference to the current provisions as part of the draft in accumulation and maintenance trusts. It is not reasonable to expect the Government to pass such provision every time a Finance Act makes a tax change but this year's changes are so wide ranging that the 1986 precedent is the one that should be followed.

CGT Holdover relief

Proposed amendment

Page 404, line 33 *[para 32 Sch 20]* at end insert new paragraph 32A as follows –

> '32A In section 169B after subsection (2) insert –
>
> > "(2A) In applying subsection (2) above in order to determine whether section 260(3) applies in relation to a disposal, the question of whether a settlor has

an interest in a settlement shall be determined without reference to subsection (3A) of section 169F inserted by paragraph 4 of schedule 12 to the Finance Act 2006." '.

Explanation

A disposal of assets such as a transfer into a trust can give rise to both capital gains tax and inheritance tax but for many years now there have been provisions to ensure that there is no double taxation. This is done by allowing the inheritance tax charge to proceed, but deferring the CGT charge by the use of hold over relief. This seems an entirely sensible and unexceptional principle.

In its Budget Day press notice No.25 at para 14, the Government said "Transfers into and out of trust that will now come within the "relevant property ……." rules will automatically be eligible for hold over relief under s260(2)(a) TCGA 1972." In the face of that unequivocal statement it is disappointing that the relevant provisions have yet to appear in the Finance Bill.

In addition to the basic principle described above, and which must still hold good, the issue has become much more pressing as a result of the Finance Bill changes. First, transfers to previously favoured accumulation and maintenance trust for children and grandchildren will now in many cases become subject to immediate charges to inheritance tax. In addition, there are technical reasons which prevent the legislation working as it should and as the Government set out in BN25. These arise because under a separate part of the Finance Bill, there have been changes to the definition of what constitutes a settlor-interested trust for capital gains tax. This change makes a trust settlor-interested where the settlor, even though he excludes himself and his spouse, creates a trust for the benefit of children of his who are under 18. In December 2003, the Government introduced changes to deny hold over relief to settlor-interested trusts which they saw as being used for the purposes of tax avoidance by the settlor. But that argument cannot apply to a trust a settlor creates for the benefit of his children and from which he is excluded.

In summary, BN25 assured us that the Government would follow the normal principles by not imposing double taxation on a disposal. Double taxation has been imposed by the interaction of one part of the Finance Bill with the part on trusts. This would have been avoided by sensible consultation.

It is for the Government now to honour the pledge it gave in BN25 and relieve that double taxation as this amendment does.

Background Note

In general, where there is a possible charge to inheritance tax, the same disposal should not also give rise to capital gains tax. This is achieved by allowing the capital gains tax to be held over so no advantages are gained. The transferor is deemed to dispose of the asset at a price which gives neither gain nor loss and the transferee acquires the asset at the same base cost so any gain is charged on a future disposal.

A common example of this would be where an individual created a discretionary trust for inheritance tax and transferred assets to it. Since there is a possibility of an inheritance tax charge, the capital gains tax can be held over.

In December 2003 hold over relief was denied to settlor interested trusts (a trust in which the settlor or his spouse retained an interest) because it was thought they were being used for tax avoidance. At the time those changes were made, this allowed hold over relief to continue in a case where the settlor created a trust for his children. Inheritance tax charges on transfers to such trusts for children will now be much more common since the previous freedom to make potentially exempt transfers into an accumulation and maintenance trust has been removed from 22 March 2006.

The real problem arises because the capital gains tax provisions in Schedule 12 to this Finance Bill extend the definition of a settlor-interested trust to include a trust that the settlor makes for his children under 18, even if he is entirely excluded from it. Even though that was not something at which the anti-avoidance provisions in 2003 were aimed, the effect of the drafting is to make such trusts settlor-interested and so deny them the normal hold over relief.

In its Budget Notice 25 about the trust changes the Government said clearly that the normal hold over relief would be available where there was an inheritance tax charge on the creation of discretionary trusts or on transfers out of them. This is the right approach but has been frustrated by the extended definition of settlor interested trust.

Where inheritance tax is paid on such a transfer, there is a limited form of relief. This allows the trustees to take account of the inheritance tax payable and deduct this from the capital gains tax due on a subsequent disposal. This is not a complete answer to the need for hold over relief to avoid double taxation because;

1) the relief is given to the wrong person, to the trustees rather than to the transferor;

2) the relief comes at the wrong time since the inheritance tax will have to be paid and the relief only comes on the calculation of later capital gains which may be many years down the road;

3) the relief is inadequate because it is a deduction against the capital gains tax rather than a credit.

ANNEX A

TIMETABLE OF EVENTS

Date (2006)	Event
22 March	Budget Day
7 April	Publication of Finance (No.2) Bill 2006
20 April	*Written ICAEW Second Reading Briefing submitted*
24 April	Second Reading
27 and 28 April	*Written ICAEW Committee of Whole House Briefings 1 and 2 submitted*
2 and 3 May	Committee of Whole House (Clauses 13 to 15, 26, 61, 91 & Schedule14, and 106 and new clause relating to section 18 of the Inheritance Tax Act 1984)
5 May	HMRC Open Day
8 May	Meeting with HM Treasury (Trusts IHT)
8 May	Oral evidence given to House of Lords Economic Affairs Committee Finance Bill S/c (MTIC, trusts IHT, employee remuneration)
8 May et seq	*Written ICAEW Standing Committee Briefings 1 to 5 submitted and oral briefings given*
9 May	Standing Committee A: 1st and 2nd sittings
11 May	Standing Committee A: 3rd and 4th sittings
15 May	Formal representations (TAXREP 13/06) submitted
16 May	Letter to ICAEW Members from The President
16 May	Standing Committee A: 5th and 6th sittings
18 May	Standing Committee A: 7th and 8th sittings
23 May	Standing Committee A: 9th and 10th sittings
25 May	Standing Committee A: 11th sitting
6 June	Standing Committee A: 12th and 13th sittings
8 June	Standing Committee A: 14th and 15th sittings
13 June	Standing Committee A: 16th and 17th sittings
15 June	Standing Committee A: 18th and 19th sittings
20 June	Standing Committee A: 20th and 21st sittings
28 and 29 June	*Written ICAEW Report Stage Briefings 1 and 2 submitted*
4-5 July	Report Stage and (on 5 July) Third Reading
17 July	Lords debates (all stages) (Debated with report of Economic Affairs Committee on Finance Bill 2006 (HL 204 2005-06))
19 July	Royal Assent: Finance Act 2006

ANNEX B

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.

To find our more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at tdtf@icaew.co.uk or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

ANNEX C

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.