

REFORM OF CORPORATION TAX

Text of a memorandum submitted in October 2002 by the Tax Faculty to the Inland Revenue in response to a consultation document published in August 2002

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REFORM OF CORPORATION TAX

A INTRODUCTION

- 1 The consultation document outlines three suggested areas for possible reform of the corporation tax system, as follows:
 - taxation of capital assets
 - the rationalisation of the schedular system; and
 - the treatment of trading and investment companies.
- 2 The document sets out a list of questions at the end of each chapter devoted to the above areas, together with a further list of questions in the Conclusion. All of the questions are summarised in Appendix C of the document.
- 3 We have set out our comments and answers to the questions posed in the consultation document in section B below. We have then set out in Section C some more general comments on how companies should be taxed as compared with unincorporated businesses.
- 4 We welcome the opportunity to review the current corporation tax regime, particularly in the light of the changes to accounting principles that may result from the review of International Accounting Standards (IAS) and the proposal that the revised Standards should be adopted for listed companies in the UK from 2005 onwards.
- 5 These potential changes could have a significant impact on UK company accounts and the tax implications will need to be considered very carefully. Our current view is that this may seriously disadvantage certain sectors of the economy and that impact will need to be carefully assessed.
- 6 We welcome the fact that tax may be based on the accounts but if different accounting standards apply to listed and non listed companies this could raise significant issues.
- 7 We feel that these issues will need more debate but in the present paper we have restricted our comments to the specific questions raised in the Consultative Document itself.

B REFORM OF CORPORATION TAX

- 8 Our comments on the consultation document follow the structure of the paper and are divided into four sections.

Taxation of capital assets

General comments

- 9 We are in broad agreement that the objectives of modernisation should be as set out in paragraph 1.15. In particular, the key requirement is to have a corporation tax system which is as simple as possible. We are concerned with the steadily increasing complexity of the corporation tax legislation. Examples of major complexity include, for example:
- the changes to the system of double taxation relief introduced in 2000 (and amended in 2001);
 - the new rules for the taxation of intangible fixed assets; and
 - the new rules for the taxation of corporate debt, foreign exchange and derivatives.
- 10 In respect of the latter two sets of rules, one is a new system and the second is a reform of existing rules which were themselves relatively new. What both sets of rules have in common is the principle that tax will follow the accounting treatment. We support this principle. However, although this principle is relatively straightforward, these two measures alone require 205 pages of legislation. What should on the face of it be a simpler system is proving extremely complicated to implement in practice.
- 11 The result is that companies have recently had to cope with several radical changes to the corporation tax system. Our overriding concern is therefore to ensure that any further reform leads to a real simplification of the existing system, which for the vast majority of companies and situations is reasonably well understood and does not create undue difficulties. If this result cannot be demonstrated, then the reforms should not be taken forward.
- 12 We also believe that any review should be taken as an opportunity to simplify the current corporation tax regime in certain other respects which we identify below, which would be to the potential benefit of both taxpayers and the Inland Revenue.
- 13 Whilst in theory the proposal to tax all gains as income has some logic, we are concerned that legislation could result in a more complicated system. In other words, we will have swapped a complicated but familiar system for one which is even more complicated and is unfamiliar. The complexity of the legislation which was found to be necessary to bring intangibles into the income regime illustrates the scale of the problem. We find it difficult to comment at this stage without some indication of the sort of change that would be proposed.
- 14 In our view, the requirement for a simple system is paramount. Whilst we do not necessarily disagree with the economic case for change as set out in chapter 2 of the consultation document, there is not enough detail in the Consultative Document to gauge the danger of increased complexity. The current system is tried and tested and the case for change must be overwhelming. The rewards of reforming the system do not appear to

outweigh the disadvantages and our conclusion is that the existing system should be retained.

- 15 We feel it important that changes do not, overall, increase the tax burden on business.
- 16 We believe any changes should reflect the Tax Faculty's ten tenets on taxation. We attach these as an Appendix.

Specific points

- 17 Although we have reached the conclusion that the existing system should not be changed, we have nevertheless answered the specific points posed in paragraph 3.25.

What would be the economic impact of moving the remaining capital gains assets into an income regime? What investment decisions might be affected by the reforms?

- 18 We are not in a position to judge what the economic impact would be and we doubt that anyone has the necessary data to answer the question. Even the Revenue's data, whilst it encompasses all taxpayers, is historic. Given the considerable impact of taxation on business investment decisions, especially where capital assets are concerned, much will depend on whether the capital gains reliefs such as roll-over are carried over into an income regime. If they are not, then this is likely to have a negative impact upon investment decisions and will serve merely to stifle enterprise.
- 19 For example, companies may decide not to move to more suitable premises if it results in a taxable profit. If roll-over reliefs are carried over, then the economic impact and possible distortions created will be reduced but the complexity of the legislation will be greatly increased. For stable and established businesses not looking to expand, the impact of the proposals may not be so critical, but the aim of the reform is to encourage growth and high levels of employment (paragraph 2.1), not to encourage companies to stand still.
- 20 We have a particular concern that this proposal might result in tax charges arising on unrealised gains as a result of changes in accounting standards. Accounting standard setters are moving steadily towards a 'mark-to-market' basis for all capital assets. If that happened, we would not want to see that in a few years' time, as a result of a move to international accounting standards, unrealised gains on investment assets became taxable. Taxing unrealised gains would require companies to pay the tax at a time when they have no disposal proceeds in their hands, and would have a wholly unacceptable impact on company cash flows.

Would moving the remaining capital gains assets into an income regime and taxing the profits accordingly, deliver real simplification benefits?

- 21 See comments above. We do not think that this proposal will produce real simplification benefits. Indeed, there is a real risk that it would merely add to the complexity of the existing system and increase deadweight tax costs to companies.

Would it be necessary to introduce a rollover relief for gains on assets within an income regime? Is there any concern that a departure from the accounts for this purpose would introduce complexity?

- 22 As already mentioned above, we think that it would be necessary to introduce some form of rollover relief. An ongoing business will usually wish at the least to maintain its pool of fixed assets in order to generate its profits and provide for growth. If this pool is depleted by tax charges when assets are replaced, this will distort business decisions. A company may wish to move premises and expand. However, it may be reluctant to do so if the result of the move creates a tax charge. Rollover relief was introduced for this reason and it would be necessary to retain some form of it. There is of course a precedent in the new intellectual property rules for rolling over gains on disposals of intellectual property assets into acquisitions of new intellectual property assets. However, this certainly would introduce greater complexity. As a form of rollover relief already exists under the capital gains regime and is well understood, this is one reason why we do not favour the proposal to move capital assets into an income regime.

Would there be particular difficulties in relation to certain classes of asset, for example, pooled assets, or assets on which expenditure was incurred either side of a commencement day?

- 23 We suspect that there would be many difficulties, particularly in relation to expenditure on assets incurred either side of commencement day. This adds to our concern that the proposal would merely increase complexity.

What are respondents' views on the outline transitional arrangements and the length of any transitional period? Would a shorter and more certain transition period be preferable and how might this be achieved?

- 24 We agree that there would need to be a commencement day and that only assets acquired on or after the commencement day should be included in the new regime. This would be necessary in order to preserve taxpayer companies' legitimate expectations.
- 25 We are not convinced that assets acquired before commencement day which are accounted for on a 'mark-to-market' basis should come into the new regime in accordance with the proposed transitional relief set out in the fourth bullet point at paragraph 3.7. As with any other capital asset, the company's legitimate expectation would be that gains would only be taxed on realisation.
- 26 In principle we favour a long transition period. However there are obvious disadvantages in a system which requires companies to maintain records of the exact date of acquisition of every capital asset, possibly for several decades, and we therefore think that there should be an option for companies to elect fully into the new regime should they wish to do so.

What are respondents' views on the proposed treatment of the accumulated capital losses brought forward at the commencement day?

- 27 There is a concern that companies could lose the benefit of previously realised losses as there may not be any assets remaining within the chargeable gains regime which could realise gains against which the losses could be offset. We consider that these losses should continue to be available to set off against profits on disposals of capital assets, whether or not those assets are brought within the income regime.

Is it considered necessary to retain the existing capital allowances regime? If so, do the concerns with possible change relate to particular sectors or types of investment?

- 28 The capital allowances regime would need to be retained for existing assets acquired before commencement day. There is no actual necessity to retain capital allowances for new assets and, as the consultation document recognises, a hybrid system which does retain them would be substantially more complex. That is so whether they continue actually to be called capital allowances or are replaced by something with a different name such as accelerated depreciation.
- 29 Using accounts-based depreciation for tax purposes, to the exclusion of any other form of capital allowances, would certainly be simpler, and would be the fairest approach if one were designing a tax system from scratch. However moving to such a system from the present one would inevitably involve substantial winners and losers (or a very substantial revenue cost if there are to be no losers) and this would arguably be unfair in itself, when the development of the whole existing structure of business investment has been influenced by the current tax regime. In any case, while it is obviously important that the tax system should be fair as between companies which are in direct competition with one another, fairness as between different business sectors is a more elusive target. A truly level playing field is not achievable unless Government is going to forgo completely the use of the tax system to provide incentives for particular activities or classes of business as an instrument of social policy. The decision here is ultimately a question of policy, which is of course for the Government to decide.

Are there business sectors for which particular issues or difficulties are raised by these proposals?

- 30 The particular business sector which would be most affected by these proposals is probably the property investment industry. We expect that this industry will identify the issues and difficulties that would need specific consideration in more detail in its own response to the consultation document.
- 31 Portfolio investment companies (i.e. those holding investments in shares and securities which do not qualify for the relief for gains on substantial shareholdings) would also be seriously affected. However the most significant companies in this category are probably the investment trusts and OIECs, and we anticipate that these would in any case have to be excluded from the new regime in order to preserve the broad equivalence for an individual between investing through these collective vehicles and investing directly.

- 32 No doubt the insurance industry will also have specific issues and difficulties that will need to be addressed.

Are there significant issues for small and medium-sized companies in the proposals?

- 33 We have commented at the end of our response on our concern at the growing disparity between the tax treatment of companies as against unincorporated businesses. Whilst these proposals will not impact differentially upon small and medium sized businesses, they will impact on the decision as to what structure a business should adopt. We are not convinced by the Government's apparent desire to favour companies as against unincorporated businesses. This strategy appears to be at odds with the EU wide drive to encourage small and medium sized businesses, as EU initiatives are aimed at enterprises rather than companies.
- 34 If, as we suspect will be the case, any reforms in this area result in companies incurring additional time and monetary costs, these costs will fall disproportionately on small and medium sized enterprises. The record-keeping requirements are likely to be particularly burdensome and this will be a major problem where companies do not have a sophisticated fixed assets register.

Rationalisation of the schedular system

What are respondents' views on the present schedular system? Which particular aspects cause problems? Please elaborate on the nature of any such problems, for instance, how are investment decisions affected?

- 35 The present schedular system is not well suited to modern business needs, being based upon a tax system originally introduced more than 200 years ago.
- 36 Whilst it is necessary to ensure that for tax purposes expenses are matched with the income in connection with which they have been incurred, the different rules for different sources of income do not sit well with a system based upon taxing profits as shown in the accounts. These differences are sometimes inconvenient, for example the remaining differences between Schedule A and Schedule D Case I, although we are not sure that in practice they cause many problems for corporate taxpayers, who have the benefit of the enhanced relief for Schedule A losses under section 392A of the Taxes Act.

Of the options identified in this chapter, which would be most useful and deliver most economic benefits and greatest simplification? In particular, regard should be had to the possibility that the more expansive (sic) options might not be affordable, at least in a single step.

- 37 The system that would be the most useful and deliver the greatest simplification is the abandonment of the schedular system and amalgamation of business profits taxed under Schedules A and D into a single pool with a single set of rules. It would of course be necessary for some profits to be excluded. We have already argued above that capital

gains should be excluded and it would be necessary to continue to exclude dividends from other UK companies.

- 38 A single profits pool would provide a corporation tax regime which would (subject to the comments in the above paragraph) largely satisfy the requirements set out in paragraph 2.3 of the consultation document, namely a neutral system which would minimise the chance of taxation issues distorting investment decisions.
- 39 We recognise the key problem area as being loss relief and that pooling all losses may result in a revenue cost. There are two specific problem areas: future relief in respect of brought forward losses incurred before commencement day, and losses incurred after commencement day.
- 40 In respect of brought forward losses, we accept that these would need to be identified and streamed and set against income in accordance with the existing schedular system. Companies which have to carry out such streaming calculations would not obtain any effective benefit from the reform, in terms of simplification, until their pre-commencement losses are used up. In fact they would be subject to the additional complication of having to identify which losses are used first. In practice, however, we suspect that the majority of these losses are in relation to failed trades which have been discontinued, in which case relief will never be available for the losses and no streaming calculations will be necessary.
- 41 In respect of future losses, we have already concluded that capital assets not already within one of the special income regimes (in practice real property) should remain subject to the CGT rules. If so then we see no difficulty in allowing complete pooling of income losses, apart from the overriding question of affordability. There would certainly be some revenue cost mainly in respect of the wider relief for losses carried forward, as discussed below, but this is a direct consequence of the greater neutrality and simplification which the reformed system is aiming to achieve.
- 42 If, contrary to our recommendation, capital gains are assimilated into income, and the schedular system is also abandoned, then logically post-commencement capital losses should be available to offset against profits from whatever source. Any other alternatives, such as are suggested in paragraph 4.23, would fail to deliver the neutrality and the significant simplification which are claimed as the reasons for assimilating capital gains into income in the first place. Given that losses on most corporate shareholdings would now be disallowed under the substantial shareholdings rules, and losses on intellectual property are dealt with under the new rules set out in the Finance Act 2002, the only substantial losses which would be brought into the income regime under this alternative are likely to be those on property disposals.
- 43 In respect of possible intermediate options for reform of the schedular system, such as those set out in paragraph 4.17, the proposed reforms do not appear to offer the benefit of real simplification. However if complete abolition of the schedular system is eventually decided to be impracticable the "minimalist approach" of completely aligning Schedule A with Schedule D Case I for computational and loss relief purposes would have some merit.

Are there any other options for reform which have not been identified in this chapter?

- 44 The opportunity should also be taken to undertake other reforms. One example is the 'wholly and exclusively' test. This frequently causes problems in practice but we question whether the rule is needed. If a company incurs expenditure, should it not be taken that the expenditure was incurred for the purposes of the business and is therefore deductible? If there is an element of private benefit, then this will be picked up as a benefit in kind on the employee concerned. That being so, there seems no reason for a deduction to be either denied or apportioned at the corporate level.

How should the accumulated income losses at commencement day be treated?

- 45 As noted above, these should be streamed and set off in accordance with the existing rules.

If affordability were an issue, what might be acceptable ways of limiting the potential cost to the Exchequer?

- 46 If losses pre-commencement are streamed, then the reform should not lead to additional revenue costs to the Exchequer in respect of those losses.
- 47 In respect of losses post-commencement, according to the figures in paragraph 4.14, there are estimated losses for the year to 31 March 2001 of £80bn, of which about £15bn to £17bn will be carried forward trading losses under Schedule D Case I. (Although the consultation document refers also to Case III there is no such thing as a Case III loss.) We take these figures as broadly indicative of the losses likely to arise in future years, and the amount likely to be utilised if the present regime continues.

48 If Case I losses are being carried forward this implies that there were no current-year profits against which they could be set, and consequently the proposed reform would make no difference to the amount of relief obtained in the current year. The reform would however certainly increase the prospects of these losses being used in the future. At a 30% tax rate the maximum revenue cost would be about £5bn, a substantial sum as compared to the corporation tax receipts according to the Budget 2002 Red Book of £33bn. However that figure has to be reduced to the extent that the losses would have been used against future profits even under the existing regime, and also to the extent that they will not be used, for want of future profits, even under the new regime. It should also be discounted to reflect the time value of the average delay in obtaining relief. We suspect that in many cases these losses may never be used even under the new regime, in which case there is no Exchequer cost. It would assist the debate on this issue if further work was undertaken to quantify the likely real cost of giving unrestricted loss relief. It would then be possible to assess with greater certainty the affordability of the proposal.

- 49 Ultimately, the amount of relief given is a policy decision for the Government.

The treatment of trading and investment companies

What are the practical effects of the existing boundaries (both at corporate and shareholder levels) between trading and investment companies?

- 50 The boundary between trading and investment is historic and does not necessarily reflect the reality of business today. Further, this boundary is not one which is generally recognised in other jurisdictions, although of course other jurisdictions often draw their own boundaries, for example between active and passive income.
- 51 This boundary has a number of practical effects. For example, the existing rules discriminate against companies which have a mixture of both trading and investment activities. In practice, many companies will have, to a greater or lesser extent, a mixture of such activities, and the tax system should not create distortions by establishing boundaries which are in many ways artificial and which create uncertainties. In order to minimise these uncertainties, the decision is often made to isolate investment activities into a separate company, for example a property holding company. However, that decision will often result in increased administrative and compliance costs.
- 52 There are many examples of the tax legislation treating trading companies, and their shareholders, more favourably than investment companies. Some of these may be justifiable as a matter of policy; others less so. But if distinctions of this sort are to be drawn we believe that they should at least be precisely targeted to match specific policy objectives, rather than relying on the blunt instrument of the historical distinction between trading and investment.
- 53 Apart from the distinction between trading and investment companies, a distinction is drawn for some purposes (such as capital gains rollover relief) between trading and other activities. This distinction also fails to accord with present day business reality. The distinction, if any, should be between business and non-business activities.

In particular, what problems do the current boundaries and rules cause? How are business decisions, including choice of investment, affected?

- 54 We have referred above to the practical problem caused by drawing a boundary between trading and investment companies. The boundary causes particular problems where the activity might be either a trading or investment activity. Problems also arise if the intention or use of property changes. The result is that business decisions will be affected (to a greater or lesser extent) by the tax treatment rather than the real needs of the business.
- 55 The fact that there are different criteria for deductibility as a trading expense and as a management expense, even though the underlying policy is much the same, is an additional source of complexity and, potentially, of unnecessary disputes.
- 56 The investment/trading company boundary is one part of the wider issue of whether the boundaries drawn around various tax provisions are appropriate and whether they could

be rationalised and made consistent. The UK tax system generally draws three main boundaries, namely:

- Qualifying trading companies, for the purposes of various reliefs;
- Non-qualifying trading companies; and
- Investment companies.

57 The boundary between the first two of the above is not consistent across the various tax provisions. For example, there are different definitions of a qualifying company for the purposes of the CGT taper relief, EIS, VCTs, IHT business property relief etc. It would be a significant simplification if these various definitions could be standardised and applied consistently, unless there are clear policy reasons for drawing a different line in each case – which on the face of it there are not. We accept that this reform goes wider than the proposals under consideration but rationalisation and simplification of these boundaries is a logical extension of rationalising or eliminating the trading/investment company boundary – and should take place even if no other reforms to the corporate tax system are implemented.

If the current boundaries are considered to be no longer appropriate how should these be changed and why?

58 As mentioned above, we believe that in the interests of simplification, the number of boundaries should be reduced to a minimum. In principle, we do not see why there should be a boundary between trading and investment companies. A more suitable boundary, if one is needed at all, might be between personal investment companies and all other companies carrying on a business. We also believe that the boundaries should be clearer than they are at present i.e. there should be a definition of “trading company” which is common across all the legislation.

Do views on where the boundaries should be moved differ according to the relief, or other situation, being considered?

59 Whilst there may be situations where a different boundary is required, these should be kept to a minimum. It is not always easy to understand the policy purpose behind boundaries drawn in slightly different places and this provides an opportunity to consider whether many of the existing boundaries which have been drawn are justified.

As regards the detailed computation of profits, how might any alignment of the rules be best achieved?

60 The starting point should be to tax the profits of the company as calculated using generally accepted accounting principles though obviously for investment income, as for trading income, some adjustments would still be necessary. In particular UK dividend income would need to be excluded, and the appropriate adjustments made in respect of capital assets.

Conclusion

What do respondents see as the relative priorities of the three proposals for reform set out in this document? How would investment and other business decisions be affected by different options?

- 61 A reform of the schedular system and the boundary between trading and investment companies appear logical candidates for reform and these changes can be more easily made. Accordingly, these should be priorities for reform. The two are so closely related that they should ideally be implemented together, but if that is not possible the reform of the schedular system logically comes first.

Would real simplification result from each of the proposals?

- 62 As mentioned above, there is a danger that 'simplification' measures turn out to be just as complicated as the measures they are designed to replace, if not more so. We do not think that assimilating gains on capital assets into income would result in real simplification: it would merely result in a different system that was just as complicated.
- 63 On the other hand, rationalisation of the schedular system, elimination of the distinction between trading and investment companies, and a reconsideration of the various other boundaries do offer scope for simplification. The position of existing investment companies could be adversely affected, particularly if the relief for excess management expenses is assimilated to that for trading losses without at the same time abolishing the schedular system, and transitional provisions would be needed to ensure that existing expectations were preserved. We would not like any changes to the corporation tax regime to be so hedged about with anti-avoidance rules and restrictions that it becomes more complicated than the system which it replaces.

What compliance cost savings can be identified?

- 64 A rationalisation of the schedular system and existing boundaries could result in significant savings in compliance costs. The rationalisation should also reduce Revenue costs and enable resources to be moved into other areas where there are higher risks of loss of revenue.

Are there any aspects of any of the proposals that raise particular issues for different sized companies?

- 65 As mentioned above, it is important to keep in mind that burdens on companies such as record-keeping are proportionately more onerous for smaller companies than for larger companies. Our experience as business advisers is that burdens on smaller companies are a major disincentive to enterprise. Consequently any genuine simplification is likely to be of proportionately greater benefit to smaller companies. Conversely any reform which attempts to simplify the principles behind the tax system but, when it comes to practical implementation, actually increases record-keeping and compliance requirements would hit smaller companies hardest.

Are there any particular types of business that might be affected differently or need special consideration?

- 66 We refer to the comments already made above. Property investment and portfolio investment companies are likely to be particularly affected.

Do respondents agree that considering the taxation of groups on a consolidated basis would be a subsequent step to the present proposals?

- 67 We believe that this should be reviewed, although opinion is divided as to whether a consolidated return such as that in the US, let alone taxation on the basis of consolidated accounts, offers real simplification benefits. However, one useful administrative simplification would be to include the results of group companies on one return, although this should be optional and not compulsory.

Are there any other issues that the Government should consider as part of this review?

- 68 As noted above, we think that a review should be undertaken of whether, for example, the 'wholly and exclusively' rule is still appropriate. In addition, the Government should consider a review of the many boundaries for business tax reliefs to see whether they can be rationalised.

C HOW SHOULD COMPANIES BE TAXED?

- 69 This consultation raises a wider question as to how businesses should be taxed. We think that this should be the starting point for the debate. For example we are concerned at the differences that now exist between the taxation of companies and unincorporated businesses. The difference between the two has grown steadily since 1998 and this proposal will, in effect, result in a complete divorce between the two systems. We remain unconvinced that this is a development to be encouraged, not least because we believe it creates anomalies and will result in unfairness. On the other hand it also creates opportunities for exploitation.
- 70 The Government has moved to this two-tier system with little if any debate about whether this is right in principle. We are not convinced that it is. If the Government believes that businesses should operate within a corporate structure, then we would appreciate the opportunity to debate the issue rather than the Government apparently attempting to influence this development through piecemeal changes to the UK tax system.

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THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.