



## FINANCE BILL 2011 – WRITTEN EVIDENCE TO THE HOUSE OF LORDS SUB-COMMITTEE

Comments on the Finance (No 3) Bill 2011 submitted on 9 May 2011 to the House of Lords Select Finance Bill Sub-Committee by the Tax Faculty of the Institute of Chartered Accountants in England and Wales

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## INTRODUCTION

1. We welcome the opportunity to present written and oral evidence to the Sub-Committee. Our comments below reflect the three areas that the Sub-Committee has identified for review, namely:
  - the government's new approach to tax policy making;
  - corporation tax reform and its implications for growth and tax competitiveness; and
  - anti-avoidance measures and disguised remuneration.
2. Information about the Tax Faculty and the ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's ten tenets for a better tax system, by which we benchmark proposals to change the tax system.

## WHO WE ARE

3. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
4. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.
5. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions 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 Institute who pay an additional subscription, and a free weekly newswire.

## THE GOVERNMENT'S NEW APPROACH TO TAX POLICY MAKING

### ***The tax consultation framework***

6. The government published *Tax Policy Making: a new approach* in June 2010 and, following a period of consultation, in which the Tax Faculty participated, the government published its *Tax Consultation Framework*<sup>1</sup> in March 2011.
7. The Framework sets out five stages to the development and implementation of tax policy which are:
  - Stage 1 Setting out objectives and identifying options.
  - Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.
  - Stage 3 Drafting legislation to effect the proposed change.
  - Stage 4 Implementing and monitoring the change.
  - Stage 5 Reviewing and evaluating the change.

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<sup>1</sup> Tax Consultation Framework, see <http://www.hmrc.gov.uk/consultations/tax-consultation-framework.pdf>

8. We welcome the new Tax Consultaton Framework which we believe should lead to better tax policy development and implementation in the UK.
9. In order to ensure that that is the case we also believe that there should be some independent oversight to determine whether the government has complied with the framework year on year.

#### ***Principles to underpin the tax system***

10. We have, for a number of years, believed that there should be clear, and agreed, principles to underpin the tax system. We, therefore, welcome the fact that the government has now also set out the principles that it believes should underpin the UK tax system.
11. The tax principles were spelt out in the Chancellor's Budget Speech on 23 March 2011 and in large measure reflect the Tax Faculty's own principles that we identified in 1999 should underpin a good tax system (the Ten Tenets). The Government's principles are that:
  - taxes should be efficient and support growth;
  - they should be certain and predictable;
  - they should be simple to understand and easy to comply with; and
  - our tax system should be fair, reward work, support aspiration and ask the most from those who can most afford it.
12. These principles are also consistent with those contained in the report of the Treasury Select Committee Inquiry into the principles of tax policy published on 15 March 2011.
13. We believe that when evaluating future tax changes these principles should be used to test any new proposals.
14. We also welcome the introduction of the new Tax Information and Impact Notes (TIINs) which accompany all new draft tax clauses and believe that TIINs should assess the particular measures by reference to the agreed tax principles. In relation to the TIINs we remain concerned that the figures, and costings, used in these Notes are not always realistic and they may underestimate the costs incurred by businesses in implementing changes.

#### ***The new timetable for developing specific new taxation measures***

15. We note that under the new timetable potential new tax policy measures will be announced at the time of the Budget, in March or April, for consultation over the period running up to the November or December Autumn Statement. This corresponds to Stages 1 to 3 of the new Tax Consultation Framework.
16. At the time of the Autumn Statement draft clauses will be published, Stage 3, as happened in December 2010. After a period of further consultation those draft clauses will then be published in the following year's Finance Bill as happened this year with the publication of Finance (No 3) Bill on 31 March 2011.
17. We share with other bodies the belief that if the House of Lords is to play an appropriate part in the formulation of better tax policy, then there is also a role for it during the new consultation period from March/April to November/December.

#### ***Efficiency of the tax system***

18. There will be little benefit in having better tax policy formulation if the tax system is not administered efficiently. In our view HMRC's poor service standards is one of the single biggest barriers to improving the efficiency of the UK tax system.
19. Given the further cuts in HMRC's budget following the spending review, there are serious questions about whether HMRC's current efficiencies can be delivered, let alone deliver on

the further proposals outlined in the March 2011 Budget, for example improved administration of IR35 and the move to Real Time Information in PAYE.

20. We are very disappointed that paragraph 3.69 of the Overview of Tax Legislation and Rates published in the Budget pack confirms that the Government is proceeding with its plans to make it compulsory for businesses to use a new online Registration Wizard for corporation tax, income tax self assessment/class 2 NICs, PAYE and VAT as part of the 'One Click' programme which is currently being developed.
21. Although we expect consultation this summer, implementation between August 2012 and 2013 seems to have already been decided. The Tax Faculty is concerned that the mandation aspect of this is being pushed ahead too quickly and, in particular, that not all areas of the UK will have the necessary access to high speed broadband. Mandating online registration by businesses may actually deter new businesses from taking on their first employee or even from starting up, thus hindering the growth agenda.
22. In spite of this rush to mandation, HMRC has yet to roll out robust and reliable methods whereby taxpayers and agents can communicate electronically with HMRC. This has to be addressed as a matter of urgency, and is all the more important given that taxpayers are continuing to experience great difficulty in communicating with HMRC, whether it is by post or the telephone. This is not good enough. In short, we cannot stress enough the need for HMRC to improve its efficiency and offer a proper suite of electronic services.

## **CORPORATION TAX REFORM AND ITS IMPLICATIONS FOR GROWTH AND TAX COMPETITIVENESS**

### ***General comments***

23. The proposed reductions in the main rate of corporation tax set out a clear strategy for making the UK's corporation tax system more competitive and provide businesses with certainty. We welcome the stability and certainty this will bring to business planning.
24. The possibility of a differential rate in Northern Ireland is more controversial. The review of this area will need to consider all the available options for encouraging growth and investment in Northern Ireland, including for example whether it might be better to designate Northern Ireland as one of the new enterprise zones.

### ***R & D tax credits***

25. In principle we support the Government's drive to increase R & D spending in the UK. In the Budget the Government proposed to increase R & D tax credit for small and medium sized companies from the current level of 175% to 200% from 1 April 2011 and 225% the following year. We welcome the proposed abolition of the rule limiting the amount of repayable credit to the amount of PAYE and NIC paid and the minimum expenditure requirement. The practical consequences of these changes need careful consideration.
26. Many smaller companies do not have the financial resources to undertake significant levels of R & D. Further, one of the problems with this area remains the correct identification of the boundary between what does and does not qualify as R & D. In practice, we suspect that much of the activity of smaller firms in this area is in innovation in its widest sense, for example improving existing products and processes, but these activities are unlikely to satisfy the definition of R & D. We recognise that this area may be constrained by EU law considerations but nevertheless we believe that further work is needed to examine whether R & D tax relief meets the needs of smaller companies which undertake innovative activity.

### ***Enterprise Investment Scheme***

27. It is proposed that the current limits that apply to the Enterprise Investment Scheme (EIS) will be increased, subject to State Aid agreement. We welcome these announcements: the EIS was once attractive to equity investors in small and growing companies but, in 2007, the then

Government scaled back the reliefs substantially on the grounds that the schemes did not comply with EU State Aid rules. We said at the time that the proposed reductions in the reliefs were likely to kill interest in the schemes and, further, that HM Treasury had not produced compelling evidence that the schemes did breach EU State Aid rules. We raised these points repeatedly during the passage of the 2007 Finance Bill through Parliament but to no avail. Our understanding is that, as we feared, EIS is now rarely used and that a potentially important source of funding for growth businesses has been turned off.

28. It now appears that the Government will be reversing most of the reductions in the qualifying conditions and restore them to levels which appear to be very similar to what they were before the 2007 changes. It appears remarkable that, four years on, the unpublished concerns of HM Treasury about whether these schemes complied with EU rules are no longer considered a problem. It would be helpful for the UK to have a clearer statement from the EU about exactly how EU State Aid rules are applied in practice.
29. Given the Government's clear focus on the growth agenda, we recommend that there is a complete review of all investment reliefs to identify whether they can be made more effective in raising growth capital for UK companies and the costs and benefits of possible options.

#### ***Enterprise zones***

30. The Chancellor has announced the creation of 21 enterprise zones. The Chancellor has stated that the zones will benefit from 100% rates relief and superfast broadband and that he will consider the scope for enhanced capital allowances in zones where there is a strong focus on high value manufacturing.
31. Enterprise zones have been tried before – such zones were established in the 1980s to encourage regeneration. The principal tax relief on offer then was 100% allowances on buildings in the zone. Although these were successful in regenerating some areas (for example Canary Wharf), in later years such schemes were often characterised by prepackaged investment schemes often backed by non-recourse loans, but with the downturn in the property market many investors still lost money. It appears that for the new enterprise zones to work, local authority support will be essential and this aspect of the proposals needs to be clarified and encouraged.
32. The proposed new investment schemes would appear to avoid the less satisfactory aspects of the 1980s schemes and have a clearer focus on manufacturing. However, the rules will increase the complexity of the tax system where the tax treatment will depend upon where the activity is located.
33. In a similar manner to the 1980s schemes, we think it is important that any tax reliefs in the new zones should be time limited, although we recognise that this does not improve stability.

#### ***Entrepreneurs' relief***

34. Capital gains tax has been subject to numerous policy changes since it was introduced in 1965. The FA 1998 changes to CGT were designed to encourage growing businesses and later changes provided further encouragement to entrepreneurs. However, the FA 2008 changes and the introduction of an 18% flat-rate marked a major reversal of earlier policy. The move to the flat-rate also saw the introduction of entrepreneurs' relief (ER), which was modelled on retirement relief, a valuable relief that had been a feature of the UK tax system from the introduction of CGT in 1965 until 1998, when it was phased out in favour of taper relief.
35. This complicated set of events and policy changes has been further exacerbated by the increase in the CGT flat-rate to 28% on 22 June 2010 and an increase in the limit for ER from £2m to £5m. In this Budget, the ER limit was raised again, from £5m to £10m. This increase is likely to encourage entrepreneurs to start and continue to grow businesses,

although ER itself has reintroduced many of the uncertainties that surrounded the availability of retirement relief.

36. In order to encourage growth, entrepreneurs need to be encouraged to grow, sell and reinvest in businesses. The history of changes to the CGT rules highlighted above show that in this key area the UK tax system lacks stability and certainty: entrepreneurs do not often know at the outset whether they will be eligible for ER and even if they do qualify they do not know whether the tax rules will have changed by the time they realise their investment.
37. As part of the growth agenda, we believe that the Government should review the CGT system and particularly ER to see whether they meet the needs of the growth agenda and whether any further changes are needed to encourage entrepreneurs. Once decided, then the Government should commit to making no further changes for the life of this Parliament.

#### ***Statutory residence test***

38. We welcome the Government's proposal to consult on a statutory residence test which is something we have advocated for some years and have contributed to the working party that has been examining this.
39. We believe that it is essential to have a statutory residence test so that taxpayers have certainty as to their tax position. The recent court cases on residence have highlighted just how uncertain are the UK rules and this uncertainty does little to encourage investment and growth in the UK.
40. In accordance with the principles identified by the Chancellor, it is essential that any residence rule is simple and clear and is based on objective measures that are framed to encourage growth. Any such measure should be internationally competitive and therefore framed in similar terms to the residence rules of territories that are our principal trading partners.

### **ANTI AVOIDANCE MEASURES AND DISGUISED REMUNERATION**

#### **General comments**

41. We have stated consistently that the right approach to counter tax motivated behaviour that is considered unacceptable is through properly targeted anti-avoidance legislation.
42. It is a question for Government to decide as to what is the most effective approach to counter identified avoidance while at the same time keeping costs and admin burdens on businesses to a minimum and not affecting those taxpayers claiming the reliefs for what are considered to be acceptable reasons. In other words, any measures should be properly targeted, proportionate and not stifle the UK's competitiveness and growth agenda. We recognise that this is a difficult balancing act and that it may not always be possible to reconcile these often conflicting policy aims.
43. In 2004 the Government introduced the Disclosure of Tax Avoidance Scheme (DOTAS) rules. These rules provide HMRC with an early warning of tax avoidance schemes and an opportunity to determine quickly if action is needed. We worked with HMRC to ensure that the disclosure rules worked as intended while ensuring that they do not impose too great a burden on taxpayers or render the UK uncompetitive. We believe that these rules have been successful and that they have helped to reduce the incidence of aggressive tax avoidance schemes. We continue to help HMRC as they refine the DOTAS rules in the light of experience.
44. The OECD in 2009 recommended that revenue authorities move towards enhanced co-operation with advisers and revenue authorities and a greater reliance on risk assessment - we supported and contributed to the work that led to that report. It is clearly important that governments address this problem at an international level.

45. Although not part of the Finance Bill itself, the paper Tackling Tax Avoidance makes a number of sensible recommendations. We have welcomed previously the new Protocol on unscheduled announcement of changes to tax law which reiterates the fundamental principle that any tax changes should be made prospectively and not retrospectively.

***The anti-avoidance provisions***

***Clause 26 and Schedule 2, Employer income provided through third parties***

46. These provisions are a matter of major concern and we have set out our comments on this in more detail below.

***Clause 27 and Schedule 3, Tainted charity donations***

47. These provisions are designed to replace an existing set of highly burdensome anti-avoidance provisions – namely the substantial donor provisions introduced in the Finance Act 2006. The underlying policy purpose of both sets of rules is to prevent the abuse of the generous tax reliefs for charitable gifts where donors and charities are linked and the donor or a connected person obtains a benefit as a result of the donation.
48. At the time the FA 2006 rules were introduced, we expressed concern that the rules are widely drafted and would impose considerable burdens on charities. At the time HMRC undertook to keep this legislation under review and continue to work with the sector to establish whether the objective has been achieved in a way that does not cause unnecessary and disproportionate cost to charities.
49. Experience showed that the 2006 provisions were extremely burdensome to apply in practice and we therefore welcome the fact that HMRC listened to the many representations made by the sector and have now brought forward new rules to counter abuse in this area while hopefully reducing the admin burdens on charities.
50. There are concerns that the new rules are also very burdensome and there should be further consultation in this area before any new rules are introduced. However, on balance it appears that the new rules are considered to be an improvement on the 2006 rules. We therefore recommend that the operation of the new rules be kept under review by HMRC and in consultation with the charitable sector to ensure that these rules do not also prove to be disproportionately burdensome.
51. Clauses 28 to 34 are designed to counter identified avoidance schemes and we are not aware of particular problems with the operation of the provisions.

***Clause 26 and Schedule 2, Employer income provided through third parties***

52. We support the policy purpose behind these measures, namely abuse of Employee Benefit Trusts (EBT) and Employer Funded Retirement Benefit Schemes (EFRBS). It is entirely right that the Government should seek to counter tax avoidance in this area so as to prevent employees receiving what is in substance employment income (for example by way of loans that it is not intended will ever be repaid) without paying tax and NIC on that income.
53. As we have said above it is important that any such measures are properly targeted, proportionate and as far as possible do not hinder growth. While we recognise that HMRC have consulted extensively and have been willing to listen to, and act on, the concerns that have been raised, these rules continue to be a cause for major concern. We do not think that the rules are properly targeted and proportionate and that the extra burdens they will put on employers will stifle growth and damage the UK's competitiveness.
54. Although we welcome the fact that extensive changes have been made to the draft clauses published in December 2010, the legislation in the Finance Bill has more than doubled and is now over 50 pages long. We are very concerned at the resulting complexity of the new rules.

They are now so complicated that they will be almost impossible for taxpayers, their advisers and HMRC staff to understand and use them properly. Given that the new rules could be in point where, say, a business is looking to second employees to the UK, these rules are likely to damage the UK as an attractive place to live and work.

55. These measures do not support the Government's stated commitment to simplifying the tax system nor to the ambitions set out in the HM Treasury/BIS paper The Plan for Growth. We have seen the written evidence already submitted to this Committee, in particular that provided by the Law Society (we refer particularly to para 14) and the Chartered Institute of Taxation, and we endorse all the points that they have made. It is not possible to do justice to all the points raised: the legislation is just too complex to understand and uses expressions which lead to considerable uncertainty.
56. In any event, we do not think that this Committee is the right forum for such detailed and exhaustive consideration: instead we believe that these measures need to be subject to detailed consideration and debate in the Finance Bill Committee stages, as was recommended by the Treasury Select Committee in its report on the Budget. We therefore recommend that this Committee supports this recommendation.

FJH/IKY May 2011

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**Further contact**

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

The tax system should be:

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

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see <http://www.icaew.com/~media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide-4-99-towards-a-better-tax-system.ashx> ).