

TAXREP 44/03

KEY ISSUES FOR THE PRE-BUDGET REPORT

Text of a letter submitted in December 2003 to the Chancellor of the Exchequer by the President of the Institute of Chartered Accountants in England & Wales to the Consultation Document published in August 2003

CONTENTS

	Paragraphs
INTRODUCTION	1
SUMMARY OF KEY ISSUES	2 – 7
DETAILED COMMENTS	
Pensions	8 - 13
Taxation of small businesses	14 - 16
Residence and domicile	17 - 19
Improved services to taxpayers	20 - 24
Corporation tax reform	25 - 27
Challenges under EU and Human Rights laws	28 - 30
CONCLUSION	31

Tax Representation

Tax Representation

KEY ISSUES FOR THE PRE-BUDGET REPORT

INTRODUCTION

- 1 In advance of the Pre-Budget Report scheduled for 10 December, we believe that there are a number of key issues which should be addressed in order to ensure that UK plc remains an attractive place in which to work and invest. We have summarised these in the section below and this is followed by our detailed comments on each issue.

SUMMARY OF KEY ISSUES

Pensions

- 2 The Government needs to provide real incentives for taxpayers to save for their old age. The proposal for a new lifetime limit on the fund should be dropped in favour of a contribution based limit.

Taxation of small businesses – the so-called ‘Husband and Wife’ tax

- 3 Urgent action needs to be taken to address the considerable uncertainty caused by the Revenue seeking to apply section 660A to small incorporated businesses.

Residence and domicile

- 4 We are happy to support a statutory definition of residence and ordinary residence but do not think that the rules on domicile should be changed without first a comprehensive analysis of the economic impact on the UK.

Improved services to taxpayers

- 5 We believe that much more needs to be done to make the revenue departments more customer focussed and to be more innovative in improving the existing systems.

Corporation tax reform

- 6 The Government should proceed with the proposals for schedular and trading versus investment company reform. However, the proposal to tax gains and losses on capital assets as income should be dropped.

Challenges under EU and Human Rights laws

- 7 We are concerned that parts of the UK tax code are highly vulnerable to challenges under not only the EU treaty but also on Human Rights grounds. The UK Government needs to work with our EU partners to amend the EU treaty and laws as well as ensuring that UK law complies with our EU treaty obligations.

DETAILED COMMENTS

Pensions

- 8 We are increasingly concerned that fewer and fewer citizens are saving enough for their retirement. Many of the current problems in the pension market stem from the removal of repayment of tax credits on pension funds back in 1997.

Tax Representation

- 9 The Government needs urgently to reinvigorate long-term saving and pension provision. Although we appreciate that the Government has published proposals aimed at making pension savings more attractive, we believe that much more needs to be done to encourage pension provision and saving in its widest sense. The Government proposals include many good suggestions but also some major disincentives.
- 10 As we noted in our earlier representation on these proposals (published as TAXREP 11/03), although the proposals to sweep away the existing tax regimes and remove limits are welcome, the fact is that few citizens use up their full entitlement under the existing rules. The proposals by themselves are therefore unlikely to encourage pension saving. The Government needs to provide real incentives for those on lower and middle incomes to save for a pension. Such incentives could include, for example, matching the taxpayers' pension contribution or even restoring repayable tax credits for pension funds. It will of course be necessary to ensure that any incentives are only available for long term pension savings. Government also needs to encourage flexible pension arrangements that are easily portable between jobs without penalty.
- 11 The proposal to have a cap which is linked to contributions and investment growth is wrong in principle as it will discourage long term saving. It is also likely to be unfair as taxpayers could be faced with tax charges due to circumstances beyond their control. The investment limits should be by reference to the contributions made to the fund.
- 12 Even if the above proposal is not accepted, the currently proposed £1.4m lifetime cap needs to be indexed by reference to earnings growth rather than inflation. If it is not, more and more citizens will come up against the limit in the future and this will discourage pension provision.
- 13 We urge the Government to reconsider this limit and the proposal to link it to earnings.
- Taxation of small businesses**
- 14 Whilst the Government has made a number of welcome steps to encourage enterprise, we are concerned that these initiatives will be stifled by the Revenue's use of the settlement legislation to attack the so-called 'husband and wife' companies. We have previously expressed our concerns at the Inland Revenue's apparent change of policy in this area, our most recent comments (by way of a joint letter from the other representative bodies) were published as TAXREP 42/03.
- 15 This appears to contradict previous assurances given in Parliament at the time that the rules were introduced that they would not be applied to impose a greater tax burden on married couples as a result of an outright gift of assets. The Government has encouraged businesses to incorporate by providing incentives to companies which are not available to businesses that are unincorporated such as partnerships and sole traders. Many incorporated businesses have shares held by a husband and wife. It now appears that this straightforward structure is being subjected to challenge with the Inland Revenue seeking to reallocate the dividends paid by the company to the other spouse going back six years and seek tax and interest. Not only is the Inland Revenue's approach in respect of ordinary shares questionable in law, it is damaging confidence in a vital sector of the economy by creating uncertainty: just how are taxpayers meant complete their tax returns?

Tax Representation

- 16 Given the need to resolve the uncertainty, we think that you should announce that the Government will stand by what was said in Parliament when the settlement rules were introduced and that the Revenue will cease applying the legislation in the way they are presently seeking to do. Secondly, we think that the Revenue need to work with the professional bodies to produce some clear examples of common situations that ordinary taxpayers are likely to come across showing where the dividing line falls between arrangements that are and are not settlements under section 660A.

Residence and domicile

- 17 We remain concerned that the proposals for reform of the residence and domicile rules could have serious consequences for UK plc. We published our views on the earlier consultation paper as TAXREP 26/03.

- 18 In principle we support the idea of formulating a statutory test of residence and ordinary residence. This could be by reference to the US type model based upon physical presence over a number of years. However, it is vital that any proposed test is first put out to consultation rather than merely imposed.

- 19 We have major concerns about the proposal to change the domicile rules which could have the effect of driving investment and business out of the UK. We have said in the past that it is essential that before any changes are made to the domicile rules, a full economic analysis of the likely effect of those changes is prepared. Without such an analysis, any changes may turn out to be counter productive and merely reduce the tax take in UK plc.

Improved services to taxpayers

- 20 In the summer you announced a Treasury review of the Inland Revenue and Customs and Excise with one of the key aims to address how service delivery could be improved. We recently submitted our views on this consultation as TAXREP 39/03. The first thing we should say is that whilst in theory a merger between the Inland Revenue and Customs and Excise may appear logical, it is likely to take many years for any benefits to outweigh the costs. We suggest that the transfer to the Revenue of the Contributions Agency should be objectively assessed before any further mergers are considered. We believe that there are many more pressing issues that need to be resolved. The introduction of Tax Credits has shown that insufficient attention is given at the policy stage to the practical issues of implementation and how any problems will be overcome. This also happened when self assessment was introduced. There is an urgent need as part of policy formulation for direct input from senior staff with operational expertise and sufficient time needs to be spent on getting the operational side right.

- 21 Turning to improving taxpayer services, we believe that much more needs to be done to make the revenue departments more customer focussed and to be more innovative in improving the existing systems. Often the problem is one of perception. For example, the UK currently has a 'penalty' culture in relation to submission of tax returns – in other words 'if you do not send in your tax return by the due date and do not have a reasonable excuse, we will fine you £100'. No business would normally treat its customers in such a fashion. The US has a system of 'filing extensions' in return for a fee: the effect is largely the same as the UK system but the perception is totally different.

Tax Representation

- 22 The Revenue complains that too many income tax returns are submitted at the end of January: providing taxpayers with a realistic financial incentive for early filing would cure that.
- 23 More radical steps should be taken to make life easier for straightforward compliant taxpayers where the risk of tax loss is low. For such taxpayers, possible improvements in service delivery include both a shorter return and a 'pre-populated' return. This return would be filled out with tax information which is already on the Revenue's computer, such as employment and UK investment income. Assuming that the taxpayer had no other sources of income (which will often be the case), the taxpayer would then only need to check the return and then sign and return it.
- 24 Whilst we also support the move to electronic filing, we remain concerned that the Government needs to have a consistent approach on electronic filing issues which make life easier for taxpayers and their agents. For example, in order to deal electronically with Customs and Excise a taxpayer needs to buy a digital certificate but this is not required in order to submit an income tax return to the Inland Revenue. Email is now a very widely-used means of communication but taxpayers and their agents are only able to communicate with a very small number of Inland Revenue departments in this way. There are specific barriers to agent use of electronic filing methods and the government's targets will not be met unless these are addressed. While a number of government e-services initiatives claim to be "joined up" they are in fact fragmented and inconsistent. There needs to be one consistent approach to the provision of electronic services across all of the revenue departments.
- Corporation tax reform**
- 25 The Government needs to start making some decisions on corporation tax reform. As we stated in our response to the consultation paper (published as TAXREP 40/03), the consultation process has been very valuable and we support reform of the rules to bring the UK business tax regime up-to-date and also to ensure that it is competitive. We think that you now need to move forward on reforming the arcane schedular system and bringing the taxation of income into a single pot. This should produce welcome simplification. We accept that this needs to be balanced against the costs of providing relief for past losses. In addition, we think that you should take the opportunity to abolish the distinction between trading and investment companies, an historic distinction which is not recognised in most other countries' tax systems and has no place in the modern international business world.
- 26 The Government also needs to take steps to ensure that the UK tax system is well prepared to cope with the move to International Accounting Standards. In a review which we undertook of the tax implications of moving to IAS (published as TAXREP 27/03), we identified a number of areas where changes may be needed, for example, with the proposals to move to a mark to market basis for non-financial assets. We think it would also be helpful if the Government confirmed the fundamental policy that the UK tax rules will start from the accounting profit.
- 27 The UK Government also needs to consider the long-term competitiveness of UK plc. We are now faced with a situation where, for example, Ireland has a corporation tax rate of only 12.5% as compared to our full rate of 30%. Many other EU countries are reducing their headline rates of corporation tax below the UK rate. Whilst we accept that relatively

Tax Representation

few companies pay UK corporation tax at the full rate, it is vital to consider whether the rates of UK corporation tax need to be reduced so as not to price UK plc out of the market. We also consider this issue below in respect of EU treaty issues.

Challenges under EU and Human Rights laws

- 28 We are becoming increasingly concerned that various parts of the UK tax code are highly vulnerable to challenges under both the EU treaty but also under the Human Rights Act. This is an issue both in respect of long-standing tax rules, for example the corporation tax loss relief rules, but also in respect of rules introduced as recently as this year's Finance Act, for example the measures to deal with VAT Carousel fraud set out in sections 17 and 18. We set out these concerns in our representations on the Finance Bill (published as TAXREP 14/03) and in our evidence to the House of Lords Select Committee which examined the Finance Bill (published as TAXREP 16/03)
- 29 We appreciate that these issues are not straightforward and that measures originally designed to provide relief for UK to UK transactions are vulnerable to the charge that they are discriminatory. However, we are concerned that the Government's response will be to 'level down' the playing field, for example the suggestion in the corporation tax reform consultation paper referred to earlier is that UK to UK transactions should be subject to transfer pricing rules. This proposal would result in major increases in compliance costs with little or no advantages for UK plc. Given that most EU countries have similar problems and that corporate revenues are under threat throughout the EU, the right place to address this issue may well be at the EU level through a change in the EU Treaty.
- 30 At the UK level, we urge you to consider reforms which would make the UK a more attractive location for conducting international business rather than merely increasing the existing regulatory burden on UK companies. For example, the exemption for gains on substantial shareholdings introduced in 2002 is a valuable new relief but it is still relatively unattractive when compared to, for example, the Dutch participation exemption.

Conclusion

- 31 We believe that consideration should be given to announcing positive developments in each of the above areas we have outlined. We believe that such changes will help to ensure that the UK remains an attractive and competitive place in which to work and invest and that tax burdens are reasonable and not unduly onerous.

FH

2 December 2003