

## TAXREP 61/05

### LIBERALS DEMOCRATS TAX POLICY CONSULTATION PAPER

*Memorandum submitted in November 2005 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the Liberal Democrats in response to their tax policy consultation paper published in August 2005*

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### WHO WE ARE

- 1 The Tax Faculty is the focus for taxation within the Institute of Chartered Accountants in England & Wales (ICAEW), a Professional Body representing some 127,000 members with a Royal Charter obligation to act in the public interest. The Faculty is a centre for excellence and an authoritative voice for the Institute on taxation matters.

### GENERAL COMMENTS

- 2 We refer to your tax policy consultation paper published in August 2005. While tax policy is ultimately a political decision for the Government of the day, we have considerable interest in regard to implementation of UK tax policy and whether UK tax policy achieves its objectives and is 'fit for purpose' in encouraging growth and investment.
- 3 We are therefore pleased to contribute our comments on matters of a technical and policy effectiveness nature. Our comments are based on our strong belief that the tax system should be developed within a consistent framework and that the resulting tax system should satisfy key principles. These principles were established in our 1999 work entitled 'Towards a Better Tax System' and the resulting ten tenets are attached in Annex A.
- 4 We are pleased to note that many of the principles identified in your paper are similar to those contained within our ten tenets. We believe that your tax policy paper should reflect more clearly some of the principles that we have identified, as follows:
  - *Certainty*  
One of the key problems with the current UK tax system in practice is the lack of certainty. Many of the measures introduced in recent years have increased uncertainty.
  - *Properly targeted*  
Tax legislation, in particular anti-avoidance legislation, needs to be properly targeted.
  - *Statutory*  
We believe that parliament needs to undertake a review of the processes for enacting tax legislation. The lengthy Financer Bills and short timescales for enactment mean that parliamentary scrutiny of Finance Bills is not as high as we think it should be.
  - *Consultation*  
There should be a presumption that tax measures will be subject to proper consultation processes, both in terms of the policy itself and also its practical implementation.

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- 5 In addition to the areas you have considered, we believe that there is a need for:
- independent oversight of the development of e-services in order to improve e-services and provide a compelling business case to use e-services.
  - a new or updated Taxpayers' Charter/Bill of Rights to protect taxpayers' rights that balances the powers of the revenue authorities need with the rights of taxpayers.

## **SPECIFIC COMMENTS**

- 6 In the remainder of this document, we discuss:
1. Hypothecation
  2. Personal taxation
  3. Flat taxes
  4. Capital taxes
  5. Capital gains
  6. Property
  7. Decentralisation
  8. Environmental and indirect taxation
  9. Business taxation
  10. General Anti-Avoidance Rule.

### **1. Hypothecation**

- 7 In principle, we do not consider that hypothecation is desirable. This restricts the ability of the government of the day to raise money in the most efficient and desirable manner and to spend it where it is most needed. In practice, the concept of hypothecation of increases in tax is undermined by the fact that the baseline numbers for the spending commitments to which the hypothecated tax provides additional funds are variable.
- 8 Furthermore, the concept of hypothecation has been undermined by National Insurance Contributions, which were originally intended to be a hypothecated levy but are now income tax in all but name.
- 9 However, we think that there needs to be greater transparency as to how Government spends the money that it receives from taxpayers. As Chartered Accountants and business advisers, we believe that Government needs to put its expenditure plans onto a more business footing, with business plans prepared to support how it plans to spend taxpayers' money. Where the Government seeks additional revenues then the business case for them should be made clear and that business case should be subject to audit and proper accountability, with accounts prepared using generally accepted accounting principles and standards.

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## 2. Personal taxation – level and mechanics

- 10 The level of tax rates is a highly political matter; however, we believe that tax rates need to be competitive, and there is worldwide pressure to reduce tax rates rather than increase them. A 50% top rate would put the UK towards the top of the OECD table and might damage the perception of the UK as a competitive place in which to live and work.
- 11 The interaction of the income tax system with the national insurance rules and the tax credits rules leads to many distortions, high marginal rates for those on low incomes and considerable complexity and confusion in areas such as giving relief for childcare costs. This combines to create a system that lacks simplicity and certainty and has resulted in the lack of finality for recipients of state support. We therefore believe that there needs to be a thorough review of the system, with simplification as a key outcome.
- 12 We note the interest in moving from Council Tax to local income taxes. We would comment that the issues in moving to such a system should not be underestimated. Such a change could create considerable complexity (for example as both systems would need to accommodate the relief of losses) and would demand significant changes to the Pay As You Earn system. Furthermore, there would be considerable numbers of 'winners and losers' and the transition might need to be phased in over a long period in order to preserve legitimate expectations.

## 3. Flat taxes

- 13 Flat taxes are currently attracting much attention but the introduction of a flat tax raises many complications. The four major advantages put forward in favour of flat tax are that it:
- simplifies the tax system;
  - reduces top rates of tax;
  - stimulates growth; and
  - encourages compliance.
- 14 A completely flat tax, of the type considered by academics, could allow considerable scope to simplify the system. However, it would take a considerable political will to undertake the accompanying radical reform and simplification of the tax system and an acceptance of the need to complicate the benefits and spending regime to continue to provide the incentives that the government wishes to retain (such as for pension saving and charitable giving).
- 15 In respect of rates, given the competitive pressures on UK plc, it would be likely that the level of any flat-rate tax would have to be pitched towards the lower end of the scale, in the hope that its simplicity and the attractive rate would encourage taxpayers to become more productive and compliant, thus increasing the overall tax take.
- 16 However, we believe that adopting a flat tax is likely to introduce a considerable short-term risk that revenue flows will fall short of expectations. For example, the Adam Smith Institute estimates that a personal allowance of £12,000 with a flat rate of 22% thereafter would benefit all, and the lower paid greater proportionately, ignoring the

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negative effect caused by the loss of tax credits currently built into the system. Even ignoring the tax credits, such an option would be likely to create an estimated £50 billion shortfall in government revenues, equating to about 12.5% of the current total tax take and more than a third of income tax revenue of £140 billion.

- 17 For taxpayers, a flat-rate tax is likely to be popular if all taxpayers could see there was a clear benefit to them. However, if it is designed to be revenue neutral, there will be winners and losers and it would be unpopular with many taxpayers, particularly middle income earners, and could cause hardship for many. There would need to be a lengthy transitional period to move into such a system.
- 18 The final perceived advantages of stimulating growth and encouraging compliance are difficult to prove. The majority of the countries that have introduced flat tax have tax systems and economies which are very different from the UK and it is perhaps unrealistic to compare them. Undoubtedly in many of the old Eastern European countries, where there was not a market economy and individuals were not part of the tax system, a low and flat tax system does encourage individuals to join the tax system, but that does not mean to say that such a system would work in the UK.
- 19 If a flat tax was to be introduced, the precise model would be a policy question, but it would be essential to keep the system as simple as possible. The suggestions in paragraph 3.4.3 of the document appear to add complications and lose much of the benefit of simplicity.
- 20 Another alternative would be to simplify the existing structure and seek to reduce rates, but at the same time restrict existing reliefs. This approach would appear a lower risk option than moving to a flat-rate tax.

## 4. Inheritance tax

- 21 The Inheritance Tax system contains a number of distortions and anomalies. For example, with the 100% reliefs for business and agricultural property, together with the rise in house prices, the burden in relative terms falls on those who own relatively modest residential properties. Furthermore the rate of IHT, being 40%, is relatively high.
- 22 We believe that there is the need for reform or abolition. The yield from Inheritance Tax is low and is paid by only a small percentage of estates. To that extent, it could be abolished without serious consequences for the Government's revenue.
- 23 Some countries have a wealth tax and any comprehensive review of capital taxation should include consideration of the advantages and disadvantages of a wealth tax.

## 5. Capital gains

- 24 Similar comments apply to capital gains tax as for inheritance tax. The system has become vastly complicated in recent years, and CGT receipts appear to be out of proportion to the complexity involved.

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- 25 Although this might suggest CGT should be abolished, this would result in behavioural changes and a return to the income v capital boundary debates that existed prior the introduction of capital gains tax. There is a risk that abolition would result in a narrowing of the tax base.
- 26 Accordingly, we think that what is required is a radical simplification of CGT, perhaps coupled with a review of rates and thresholds. Given the often close interaction between IHT and CGT, similar rates would appear appropriate.

## **6. Property**

- 27 The paper suggests that the intention would be to replace Council Tax with a local income tax. That being so, we cannot see why there would be a need to have a further tax based on domestic property values which would be the exact equivalent to Council Tax.

## **7. Decentralisation**

- 28 We do not have a policy position on Decentralisation, but consider that it is important that there is transparency and proper accounting by national and local government. There is a danger that any changes to the existing system will merely be seen as another way to raise taxes, with the national government continuing to take its share and more taxes being paid to local government. Such local taxes might exacerbate regional differences and tensions and result in further transfers to ease such pressures, largely negating the idea of decentralisation.

## **8. Environmental and indirect taxation**

- 29 In principle, we believe that the prime purpose of the tax system should be to raise revenue rather than influence behaviour. Tax incentives should be used when it can be clearly demonstrated that the incentives are properly targeted and encourage behaviour which is in the interest of society at large. It is important to ensure that such incentives can be demonstrated to work and achieve their objectives.
- 30 In some cases, environmental objectives may be better achieved by specific grants rather than through the tax system. The advantages of grants are that they can be targeted and are more clearly identified with the investment rather than being swallowed up in the capital allowances computation. Many businesses would prefer to receive a cash grant shortly after the investment rather than have to wait to obtain a reduction in either the corporation or income tax liability. A cash grant will also be preferable where the business does not make taxable profits.

## **9. Business taxation**

- 31 We recommend that a strategic review of corporation tax and its role in attracting investment is undertaken. The review would need to include the rates of tax, investment incentives such as capital allowances and whether it can be made simpler. We believe that the corporation tax computation should start with the accounting profit rather than be based on cash flows, but the move to fair value and international standards is throwing up

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a number of issues that need to be addressed if this approach is to remain the starting point.

- 32 We are concerned that the Finance Bill cycle does not allow time for proper consultation, debate and scrutiny of tax legislation, with the result that highly complicated and poorly drafted legislation is passed. We have argued in the past that many of the tax proposals should be brought out of the annual Finance Bill and included in a separate Bill with adequate built in for full consultation on the detail of tax reforms.
- 33 There is also a need for the tax system to foster smaller businesses and help them grow. Small businesses are faced with a complex choice as to what business structure to adopt, often making that choice on the basis of tax reasons rather than for commercial reasons. Policy developments in recent years have now accentuated historical differences to the point where the taxation systems for companies and unincorporated businesses have almost parted company. We believe that there needs to be a comprehensive review of the tax regimes for smaller businesses in order to provide for flexibility and to foster growth. This review should consider whether a difference in the two taxation systems is justified.
- 34 We also believe that there is a need to reduce the payroll/PAYE burdens placed on small businesses but we think that this should be achieved through structural reform rather than the state setting up its own payroll bureau.

## **10. General Anti-Avoidance Rule**

- 35 We have objected to this in the past, principally on the grounds of certainty. In theory, a GAAR could provide an opportunity to simplify the system and abolish complex legislation. However, in practice we understand that the government would wish to use a GAAR in addition to other detailed anti-avoidance provisions, thus introducing further uncertainty into the system without any compensating simplicity. Should a GAAR be introduced, we believe that a pre-transaction clearance system would be essential feature but that the net effect would still be an increase in uncertainty.

FJH

16 November 2005

## 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](http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_43160,MNXI_43160).