THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

**TAXREP 27/10**

# THE EMERGENCY BUDGET 2010

***A memorandum dated 2 June 2010 from ICAEW Tax Faculty to the Chancellor of the Exchequer setting out the key issues to be considered ahead of the 2010 Emergency Budget to be held on 22 June 2010.***

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# THE EMERGENCY BUDGET 2010

## INTRODUCTION

1. In this document we present the comments of the Tax Faculty of The Institute of Chartered Accountants in England and Wales (ICAEW) ahead of the forthcoming Emergency Budget scheduled for 22 June 2010.

2. We would be happy to discuss any aspect of our comments and to take part in any further consultations on this area.

3. Information about the Tax Faculty and 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

4. ICAEW 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 135,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

5. 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.

6. The Tax Faculty is the focus for tax within ICAEW. 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.

## KEY POINTS SUMMARY

7. Difficult decisions will have to be taken on public spending and tax, but the key to balancing the books lies in economic growth and for this the Government needs to support the private sector and provide a competitive tax system.

8. We support the establishment of the Office for Budget Responsibility and would welcome the opportunity to contribute to its work.

9. The UK tax system is suffering from a crisis of confidence and we would like to work in partnership with Government and HMRC on a 'restoring trust' agenda.

10. We welcome the proposed Office for Tax Simplification and look forward to contributing to its simplification programme.

11. We support and will contribute to the development of a long-term tax strategy for large businesses and believe that a study should be undertaken of the UK's competitiveness and how it may be improved.

12. We welcome, and would like to participate in, the proposed review of small business taxation including consideration of IR35.

13. HMRC should work in partnership with the tax profession to agree a set of service targets and ensure that service problems are identified and resolved.

14. Before any changes are made to the CGT rules there should be a period of consultation and a number of policy options considered.

15. As part of the tax simplification programme, the Government should consult on how best tax avoidance can be minimised further.

16. There should be consultation on what changes are needed to the furnished holiday lettings regime so that it is EU treaty compliant and meets the Government's objectives.

17. Changes to the rules on non-domiciled taxpayers should only be made after full consultation and the 2008 rules should be simplified where possible.

## TACKLING THE BUDGET DEFICIT

18. The success of the coalition government will be measured on its ability to cut the deficit while securing the economic recovery. This will require difficult, but necessary, decisions to be taken on public spending and tax. However, we think that the government must look to encouraging economic growth as the key element in balancing the books. This will require a spirit of partnership between business and government. Business will need to play an essential role in filling the gap left by reduced investment in the public sector. In order to allow this to happen, government needs to provide the conditions to support sustainable economic growth and provide a competitive tax system.

### Office of Budget Responsibility

19. ICAEW welcomes the creation of an Office for Budget Responsibility, which we proposed in our manifesto 'Going for Growth'. It is important that this office is able to provide an economic forecast independent of the Chancellor that will give credibility to the Budget process. We would be happy to assist the Government in establishing and contributing to this Office.

### The size of the challenge

20. It is important to understand the challenge the UK economy faces. The £6.2 billion of savings announced from Whitehall spending in 2010/11 mark an important start in tackling the deficit, but represent a fraction of the public sector savings that will need to be made to reassure the financial markets and give confidence to business. The statistics below demonstrate the size of the challenge.

    - The UK Budget deficit for 2010 is the largest among G20 nations. As at April 2010 overall public sector debt in the UK is estimated at £893 billion; it was £890 billion at the end of the 2009/10 financial year. The deficit is expected to reach 74% of GDP by 2010/11.

- Government interest payments totalled £32.2 billion over the 2009/10 financial year; 2.3% of national income over the same period but 6.8% of current tax receipts.

- Public spending has grown in both absolute terms and at 53% of GDP is higher then both the Eurozone and the United States. This spending is now out of line with tax revenues.

- The public sector workforce expanded in the recession (Q1 2008- Q4 2009) while on average there was a 5% reduction in the private sector workforce for the same period.

## RESTORING CONFIDENCE IN THE TAX SYSTEM

21. We are concerned that the UK tax system is suffering from a crisis of confidence. In order for this to be restored, all stakeholders involved in the tax system must work in partnership to identify the problems and create solutions to restore confidence.

22. In 1999 we identified ten principles which we believe should provide the framework for good tax system. These are set out in the Appendix.

23. **Policy recommendations**

    - Government should concentrate initially on a small number of key priorities. These should include:

        - setting a clear framework for tax simplification and associated improvements to the formulation of tax policy;
        - considering how HMRC's service standards can be improved given lower budgets; and
        - a new approach between taxpayers, their advisers and those who administer the tax system to work in partnership to restore trust and confidence.

## IMPROVING TAX LAW

### Tax simplification

24. We welcome the Government's commitment to tax simplification and the establishment of an Office for Tax Simplification (OTS).

25. The UK has one of the longest tax codes in the world and this puts the UK at a competitive disadvantage to other countries. In practice simplification is harder to achieve: it is a large task and inevitably there will be winners and losers. We would be delighted to participate in this agenda and contributing to the OTS.

26. As a general principle, we believe that tax simplification should focus around reducing rates and simplifying tax reliefs: the Government proposal to reduce the rate of corporation tax and simplifying reliefs and allowances therefore appears to be a step in the right direction. It is important to ensure that tax simplification measures include suitable transitional provisions to protect legitimate expectations.

27. The formulation of tax law needs to be improved. The Finance Bill process should adhere to a set timetable and new procedures should be introduced to improve the

quality of tax law and provide greater clarity and certainty. We welcome the commitment in the Coalition Agreement to give the public an opportunity to comment on proposed legislation online, and a dedicated 'public reading day' within a Bill's committee stage. We think that the Government should go further and consider using the skills of the House of Lords to improve the detail of tax legislation (accepting that the House of Commons has supremacy on deciding tax policy) and for the Finance Bill Committee to invite bodies such as ICAEW to attend evidence hearings.

28. Consultation – whether formal or informal - should start at an early stage so that government policy objectives can be achieved in a way that minimises any unintended or damaging consequences. Consultation should take place when the policy options and technical details are still being discussed. There may be times when consultation is not practical, eg the need to counter tax avoidance schemes, but this should be the exception rather than the rule.

29. A key principle of taxation is that taxpayers have certainty. In order to ensure that taxpayers have certainty before the start of the tax year, government should commit to introducing a clear timetable for the annual Finance Bill process. Tax changes should be announced in sufficient detail that taxpayers understand their position by the start of the year. If this is not possible, any tax changes should apply prospectively and not retrospectively.

30. **Policy recommendations**

- We support the establishment of the Office of Tax Simplification and we would be delighted to assist on developing and implementing its work programme.
- The Budget cycle should be fixed. The Pre-Budget Report (PBR) should be held no later than the end of November. The Budget should be held no later than the end of February and the Finance Bill should be published before 31 March.
- Except in extenuating circumstances, for example to tackle identified tax avoidance schemes, tax changes should be announced only at the PBR or Budget.
- Government should commit formally to improving tax policy formulation by consulting with key stakeholders on proposed tax policy changes. This should be undertaken as a matter of course unless there are exceptional circumstances.
- Consultation should take place before major policy decisions are made. This process should include detailed, accurate and realistic analysis of the practical considerations and the costs of implementation. Adequate time should be allowed for consultation responses to be analysed and changes to be considered.

**Restoring trust and confidence**

31. A 'trust gap' has developed between taxpayers and their advisers on the one hand and tax policymakers and HM Revenue & Customs on the other. A number of factors have contributed to this. For example, we have been concerned for some time that the balance between HMRC's powers and taxpayers' rights and safeguards has shifted too far towards HMRC and that new burdens and obligations have been introduced or proposed, for example to tackle fraud and poor work, that will be intrusive and are more likely to punish those who commit minor misdemeanours rather than catching those involved in fraud etc.

32. This trust gap has been generally recognised on both sides and it is essential that we all work in partnership to reduce it if the Coalition Government's ambitions on civil liberties are to be realised. As part of the Government's programme 'to reverse the substantial erosion of civil liberties and roll back state intrusion' there needs to be a review of the HMRC powers project generally and in particular the detailed proposals that were contained in the 'Working with tax agents' consultation.

33. We have always said that any problems in this area need to be considered jointly with the profession so that solutions are developed in partnership. It is essential that fraudsters and those involved in tax evasion are rooted out and that poor standards of work are addressed. HMRC needs to trust the overwhelming majority of agents who do good work and agents need to have trust in HMRC and its processes and systems. Without this mutual trust there is a very real danger that the vital working relationship between agents and HMRC will be undermined and that as a result compliance will be adversely affected. We believe that there is an opportunity for all parties to work in partnership to develop joint standards of behaviour and professionalism.

34. We would be delighted to continue our work with HMRC on a 'restoring trust' agenda and more generally adopting a more collaborative approach to identifying and resolving problems, ensuring that those who abuse the tax system are dealt with appropriately and to raising standards and professionalism across the whole tax profession.

35. **Policy recommendations**

- A review of the HMRC powers project should be undertaken with particular reference to the detailed proposals that were contained in the 'Working with tax agents' consultation.

- HMRC should work in partnership with the professional bodies on a 'restoring trust' agenda and more generally adopt a collaborative approach to problem solving.

## BUSINESS TAX POLICY

### Large businesses

36. Complexity and frequent change in the tax system makes it difficult for businesses to plan with certainty. We welcome the Government's commitment to a clear plan for corporation tax.

37. Evidence from the 100 Group – representing finance directors of Britain's largest companies, predominantly from the FTSE 100 – suggests that competitiveness is being undermined by high levels of frequently changing and complex taxation. There is particular concern about the impact of 'last minute' tax changes enacted without consultation.

38. We welcome the Government's commitment to ensure that the UK remains an attractive location for businesses and the proposed review and reform of the UK's controlled foreign companies (CFC) rules. We would be happy to contribute to the CFC review.

39. Although we appreciate that some studies have shown that the UK remains an attractive business location, others show the opposite and we remain concerned that the UK has lost competitiveness. Although relatively few companies have decided to relocate to other jurisdictions, we know that many of the UK FTSE companies now examine this issue regularly and would consider relocating if the circumstances are right.

40. Whilst the attractiveness of the UK as the base depends upon many factors, tax issues are crucial and key factors in any assessment include not just headline rates but complexity, certainty and ease of administration. We would commend to the Chancellor the idea of launching an independent study to assess the relative importance of these issues to multinational businesses, where the UK stands relative to other jurisdictions and make recommendations for improving the UK's competitiveness. The study should report back in the 2010 PBR.

41. **Policy recommendations**

- We support the development of a long-term tax strategy for large businesses and would like to contribute to developing the strategy.

- An independent study should be undertaken into the UK's competitiveness as compared to other jurisdictions and how it might be improved.

**Smaller businesses**

42. An issue which we highlighted in our 2009 PBR document is the difference between the tax treatment of incorporated and unincorporated businesses. ICAEW appreciates that there have always been some differences in treatment but, in recent years, the differences have grown rather than reduced and this is now becoming a critical issue.

43. From April 2010 we have an effective top rate of tax (income tax and NIC) of 51% (and higher effective marginal rates for income of £100,000 to £112,950) as compared to a current maximum corporation tax rate of 28% (and more likely only 21%) and a flat rate capital gains tax of 18%. We are concerned that the combined effect of the increases in the rate of income tax and NIC in 2010 and 2011 will increase the gap between the effective tax/NIC rates on employment income as compared to dividend income, further encouraging small businesses to operate through companies.

44. HM Treasury and HMRC need to work with stakeholders to reform the business tax system as it affects smaller businesses. We support the wholesale review of small business taxation and that this should include a review of measures such as IR 35. The review should consider how the differences between the income tax/NIC treatment of incorporated and unincorporated businesses could be reduced.

45. **Policy recommendation**

- We support the proposed review of small business taxation with specific reference to IR 35 and how the differences between the tax treatment of incorporated and unincorporated businesses can be minimised.

**DOING MORE WITH LESS: HMRC SERVICE STANDARDS**

46. We are very concerned that the 'Change programme' at HMRC has resulted in a significant decline in the standards of services that taxpayers have a right to expect. We appreciate that HMRC has made progress in some areas and is operating against a background of extremely challenging budget cuts.

47. Members continue to report problems across a range of HMRC's activities, including:

- significant numbers of errors in PAYE coding notices which appear to be exacerbated by the coming online of the new NIC and PAYE service;

- continued problems in making contact with HMRC to resolve issues due to the reliance on telephone contact, with calls not being answered or returned promptly;

- difficulties in resolving problems first time with HMRC's contact centre staff;

- long delays in dealing with post, including the processing of paper returns, tax repayment requests and VAT registrations which are subject to further checks even though they do not appear to be high risk;

- that when things go wrong, HMRC needs to communicate earlier with taxpayers and agents.

48. Given that budgets are likely to get tighter, HMRC will be asked to 'do more with less'. We think that there is scope for HMRC to work in partnership with tax agents to identify how the problem areas can be addressed and what steps can be taken to make things easier.

49. In 2007 we recommended that HMRC should work with the professions to develop a better set of service delivery indicators that had the confidence of stakeholders. Similar recommendations were made by the Treasury Committee (HC 483-1, published on 23 July 2007). We believe that a set of reliable and meaningful service measures would be of public benefit, help improve agent confidence and drive improvements in service standards. For example, the NAO report into HMRC's handling of telephone enquiries earlier this year suggests that 35% are avoidable because they are made to HMRC as a result of HMRC errors or delays. Greater emphasis needs to be placed on ensuring that HMRC gets it right first time, thereby reducing the need for contact afterwards. We believe that in order to reduce errors and ensure that processing is right first time there is a need for more staff training and supervision and better IT and procedures.

50. We believe that there are a number of improvements that can be made but recognise that they will require further investment in IT systems. Most taxpayers now use email to communicate, but HMRC still relies on the telephone and post. Handling large numbers of letters promptly needs large numbers of staff, which in some offices is no longer possible. HMRC has been trialling the use of email and 'shared workspace' solutions but progress is very slow, with security issues being cited as the reason for a lack of progress. Given HMRC's drive to compulsory electronic filing, HMRC needs to prioritise the development of email/shared workspace solutions.

51. In addition to greater use of email, HMRC should develop Internet-based technology which allows tax agents to 'self serve', thereby giving agents the opportunity to deal with issues and reducing pressure on HMRC's frontline resources. We have suggested previously that in appropriate circumstances agents could be given the ability to 'self-serve' PAYE coding notices. We understand that there will be a pilot scheme later this year and we urge that greater consideration is given to such ideas.

52. We have said previously that we would not call for a deferral of the implementation dates for iXBRL filing of company tax returns as long as the software market delivered appropriate and effective products well ahead of the deadline for mandation. We will continue to monitor this but our position remains that implementation should not impose new burdens for businesses, particularly smaller businesses.

53. **Policy recommendations**

- HMRC should work in partnership with the professions to develop a better set of service delivery indicators that have the confidence of stakeholders.

- Greater emphasis needs to be placed on ensuring that HMRC gets it right first time, thereby reducing the need for contact afterwards.

- HMRC needs to prioritise the development of email/shared workspace solutions.

- HMRC should develop Internet-based technology which allows tax agents to 'self serve'.

## COMMENTS ON SPECIFIC PROPOSALS IN THE COALITION AGREEMENT

***We will seek ways of taxing non-business capital gains at rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities.***

54. Capital gains tax was introduced in 1965 and since that time has undergone a succession of policy changes which can be summarised as follows:

1965 – 1982 CGT charged at a flat rate of 30% with no relief for inflation but with retirement relief
1982 – 1987 CGT charged at flat rate of 30% with relief for inflation and retirement
1987 – 1998 CGT charged at marginal rate (max 40%) with relief for inflation and retirement
1998 – 2008 CGT charged at marginal rate (max 40%) with inflation relief abolished in favour of taper relief with separate scales for business and non-business assets by reference to the holding period of the asset
2008 CGT charged at flat rate of 18%, with new entrepreneur's relief based on the retirement relief rules

55. This does not take account of considerable changes in the rules within those regimes, for example:

- the various changes to retirement relief up to 1998; and
- the reduction in the 10-year holding period to claim maximum business asset taper relief which was introduced in 1998, first to four years (from 2000) and later to two years (from 2002).

56. This chopping and changing of CGT policy does little to engender confidence in the tax system and does not provide taxpayers with long-term certainty. Further, as noted above, there is now a 32% difference between the CGT rate (18%) and the highest rate of income tax (50%), which does not appear to be sustainable in the longer-term.

57. Although tax rates are a matter for the Government to decide, we would point out that under the 1987 to 1998 regime, the top rate of CGT was only ever 40% and this was after giving relief for inflation. Further, there have been a number of studies which suggest that the new 50% tax rate may reduce rather than increase tax revenues.

58. We can appreciate why the Government is considering another change to the CGT regime. However, if the CGT regime is to be changed again, there should be full

consultation before any changes are made and a number of possible policy options should be tabled for consideration. We would be happy to discuss with you possible options for reform. If the CGT rate is once again to be set by reference to the rates of income tax, it will be important to ensure that the tax rate is perceived to be fair and reasonable and does not discourage long-term saving. We also agree that it is reasonable to have a more favourable rate for entrepreneurs who have built businesses over a period of time – this has been a feature of CGT in some form or other since the tax was first introduced 45 years ago.

59. **Policy recommendations**

- If CGT is to be reformed again there should be a period of consultation and a number of policy options proposed for consideration. If CGT is to be aligned more closely with income tax rates, consideration should be given to exactly what would be a fair and reasonable top rate and whether relief for inflation should be restored.

- There should be a more favourable rate for entrepreneurs who have built businesses over a period of time.

***We will make every effort to tackle tax avoidance, including detailed development of Liberal Democrat proposals***

60. It is right that the Coalition Government should make every effort to tackle tax avoidance. We have stated consistently that this should be done through properly targeted tax avoidance legislation. We have also been involved actively in the development of the disclosure of tax avoidance (DOTAS) rules.

61. We recognise the competing pressures between the need for a simple tax code and one that does not give scope for tax avoidance.

62. **Policy recommendations**

- We would like to participate in discussions about how tax avoidance can be minimised. Possible ideas, which could be tied in with the tax simplification programme, include:

    - consideration of a new general anti avoidance provision to replace numerous existing provisions; and

    - further strengthening of the DOTAS rules to ensure that HMRC has advance warning of all tax avoidance schemes and that promoters cannot ignore the rules.

***We will take measures to fulfil our EU treaty obligations in regard to the taxation of holiday letting that do not penalise UK-based businesses.***

63. In the 2009 Budget the then Chancellor announced his intention to abolish the furnished holiday letting (FHL) regime although the measure was later dropped from the 2010 Finance Bill.

64. The problem with the proposal to withdraw this relief is that it would take us back 26 years and reopen problem areas in the taxation of letting income that have been largely removed by the 1984 rules. A return to the pre-1984 rules will result in a considerable

increase in complexity and uncertainty and could damage the growth of holiday homes in tourist areas.

65. We suggest that the right approach is a compromise: namely that the FHL regime is kept, thus providing certainty and stability, but that the available tax reliefs are reviewed and where considered necessary scaled back, depending on which reliefs Government is most concerned about. Indeed, some concerns that the Government has about the scheme may be reduced if the rules were applied consistently: for example loss relief should not usually be an issue given that to come within the FHL rules the letting of the property must be 'on a commercial basis with a view to the realisation of profits'.

66. We have prepared a more detailed briefing on this issue which we are happy to share with the Government. We would welcome further discussions about how the FHL scheme could be retained in an amended form so as to ensure that it is compliant with EU rules.

67. **Policy recommendations**

- The FHL regime should be retained but the available tax reliefs and conditions attached to the relief should be reviewed to address the concerns about EU treaty compliance.

- Greater emphasis should be placed on ensuring that FHL claims meet the conditions for claiming the relief.

***We will review the taxation of non-domiciled individuals***

68. We participated in the 2008 changes to the rules on domicile. That consultation and the subsequent rules were highly unsatisfactory and the FA 2008 rules remain far too complicated and difficult to apply in practice. For example, the CGT rules on transactions denominated in foreign exchange can lead to highly complicated (indeed almost impossible) calculations which may yield little or no tax.

69. We believe that there is a clear need to simplify the existing rules and ensure that taxpayers can self assess with confidence and accuracy. We would be happy to discuss this issue further with the Government in order to understand the policy objectives and how they might be achieved. Again, subject to a better understanding of the policy objectives, we would be happy to prepare a briefing on the issues and how they might be resolved.

70. **Policy recommendations**

- Any changes to the tax rules for non-domiciled taxpayers should only be made after full consultation.

- The existing rules introduced in 2008 should be simplified to ensure that taxpayers can self assess with confidence and accuracy.

FJH
2 June 2010

## APPENDIX 1

## 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/index.cfm?route=128518).