

## TAXREP 53/05

### NATIONAL INSURANCE CONTRIBUTIONS BILL 2005

*Memorandum submitted in October 2005 by the Tax Faculty of the  
Institute of Chartered Accountants in England and Wales  
to the Paymaster General*

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# Tax Representation

## NATIONAL INSURANCE CONTRIBUTIONS BILL 2005

### INTRODUCTION

1. We comment in this memorandum on the National Insurance Contributions Bill published on 11 October 2005 at <http://www.publications.parliament.uk/pa/cm200506/cmbills/053/2006053.htm>. We also include recommendations concerning the secondary legislation and comment on the Frequently Asked Questions published on 11 October by HMRC at [www.hmrc.gov.uk/employers/faqs-nicbill05.htm](http://www.hmrc.gov.uk/employers/faqs-nicbill05.htm).
2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A.

### KEY POINT SUMMARY

3. Our concerns are:
  - Retrospective legislation is not a satisfactory solution; not only does it make for uncertainty for employers but there is a real probability that it is ultra vires European Law;
  - Draft secondary legislation should be subject to consultation;
  - The draft secondary legislation should come into effect when the Bill does, subject to receiving proper Parliamentary scrutiny;
  - There should be a right of recovery of retrospective primary NIC by employers from employees;
  - Additional primary NIC not recovered by the employer from the employee should not result in any taxable benefit;
  - All additional amounts of NIC that are borne by the employer should qualify for tax relief in the hands of the employer for the relevant years; and
  - Amounts of NIC overpaid should be repaid without the need for a claim to be submitted.

### GENERAL COMMENTS

4. Whilst we understand the Government's concern to counter avoidance, we remain convinced that retrospective legislation is not the answer, as it fails the fundamental principle of certainty. When retrospective legislation was first proposed by the Paymaster General in her statement on 2 December 2004, we wrote to her on 10 February 2005 expressing our concern with this proposal (TAXREP 8/05) and on 14 March 2005 made representations on the draft legislation published on 3 February 2005 (TAXREP 13/05).
5. Certainty is one of our ten fundamental principles underpinning a good taxation system (see our Ten Tenets for a Better Tax System outlined in Annex B). Our comments on the undesirability of retrospective legislation apply as much to this Bill as they did when we responded to the statement of December 2004 and the draft legislation on 3 February (now incorporated in Finance Act 2005).
6. We have reproduced those comments in Annexes C and D respectively. Whilst in the body of this memorandum we concentrate on detailed comments on the Bill and

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HMRC's FAQs, we consider that in the context of this Bill the following extracts from the ECJ case *Stichting Goed Wonen* (C-76/02 of 17.4.05) have particular relevance:

Para 32: 'The principles of the protection of legitimate expectation and legal certainty form a part of the Community legal order. They must accordingly be observed ... by the Member States'.

Para 33: 'Although in general the principle of legal certainty precludes a Community measure from taking effect from a point in time before its publication, it may exceptionally be otherwise where the purpose to be achieved so demands and where the legitimate expectations of those concerned are duly respected'.

We do not think that anyone reading the Paymaster General's 2 December 2004 Statement could have expected the content of this Bill.

7. The draft secondary legislation should be exposed for comment.
8. The secondary legislation that is proposed by this Bill should come into effect on the same date that this Bill becomes law, or as soon as possible subject to allowing sufficient time for proper scrutiny by Parliament.
9. We consider that there should be a right of recovery of retrospective primary NIC by employers from employees.
10. We would welcome confirmation that:
  - Additional primary NIC will be recoverable from the employee;
  - where additional primary NIC is not recovered by the employer from the employee, no taxable benefit will arise; and
  - all additional amounts of NIC that are paid by the employer will qualify for tax relief in the hands of the employer for the relevant years, including amounts that could have been recovered from the employee but which the contemplated secondary legislation might not permit.

## DETAILED COMMENTS ON THE BILL

### *Power to make provision in consequence of retrospective tax legislation*

#### **Clause 1: Earnings: power to make provision in consequence of retrospective tax legislation: Great Britain**

##### ***Subsection (1)***

##### *New section 4B*

11. In new subsection (8), we would welcome confirmation that, where the earnings for a period and hence the NIC liability are revised to a lower figure, amounts of NIC overpaid will be repaid without the need for a claim to be submitted.

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12. In new subsection (9) we would welcome clarification in the Bill and Explanatory Notes of the meaning of ‘original determination’. Does it refer simply to the amount of earnings on which the employer originally determined that he would pay NIC, or to Decisions made by Officers of the Board of HMRC under section 8, Social Security Contributions (Transfer of Functions, etc.) Act 1999 or to judgements of a Tribunal or Court? We consider that it should not refer to Court and Tribunal decisions, as the Government should not seek to erode the authority and independence of the Courts and Tribunals by overruling retrospectively their judgements. As noted in TAXREP 8/05, it would also mean that there would be no legal certainty. We believe that certainty is one of the fundamental requirements of a good tax system (see our Ten Tenets for a Better Tax System in Annex B) and its absence is likely to contravene European Community, and hence national, law.

## *New section 4C*

13. In subsection (6), a similar comment about the meaning of ‘determined’ applies as to subsection (9) of new section 4B supra.
14. We welcome the provision in subsection (7) under which where there is a reduction in NIC liability for a year, accrued benefit entitlement will not be affected.

## ***Subsection (2)***

## *Amended section 176*

15. New subsection (2A) provides that a draft statutory instrument can apply retrospectively for up to twelve months before the date it is laid. Twelve months’ limbo between the primary and secondary legislation being laid is too long. Employers need to know what the NIC rules will be, and government will presumably want any additional NIC to be accounted for as early as possible. Accordingly, we consider that the statutory instrument should be made at the same time as the primary legislation, or as soon as possible thereafter, subject to democratic requirements, in particular proper Parliamentary scrutiny.
16. Under these provisions, it appears likely that the intention is that additional primary NIC liability cannot be reclaimed by employers from employees. If this is the case we consider it to be a penalty in respect of an action which was legitimate at the time it was undertaken. We consider that the legislation should make it possible for the employers to recover the primary NIC from employees, especially if we are correct in our understanding that the employees’ contributions records are to be amended – where the level of earnings make it appropriate – to take into account the additional primary NIC paid.

## **Clause 2: Earnings: power to make provision in consequence of retrospective tax legislation: Northern Ireland**

17. Where appropriate, our comments on Clause 1 refer mutatis mutandis to Clause 2.

## *Agreements and joint elections*

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## **Clause 5: Agreements and joint elections: Great Britain**

18. We would welcome clarification in the Bill of the meaning of new sub-paragraphs 3A(2A)(b) and 3B(7B)(b). As presently drafted, it is not clear that the legislation achieves the desired effect which is explained clearly in paragraphs 58 and 59 of the Explanatory Notes.
19. We suggest that for the avoidance of doubt the following should be added at the end of the changes in Clauses 5(2) and (3): ‘where the earnings on which the contributions arise were paid before the coming into force of the regulations in question’.

## **Clause 6: Agreements and joint elections: Northern Ireland**

20. Our comments on Clause 5 refer mutatis mutandis to Clause 6.

## **COMMENTS ON THE FREQUENTLY ASKED QUESTIONS**

### **Question 2**

21. The final sentence of the first paragraph of the Answer to Question 2 states that ‘It should secure total tax and NICs yield of £200m in 2004-05 and £500m per annum thereafter for essential public services’.
22. We would welcome clarification of the methodology underlying these figures. On what basis have they been calculated? What statistics do they include? To what extent do they include estimates? What objective research was carried out? How up to date are they? Apart from the methodology behind the figures, how much is tax and how much is NIC? We would have thought that if the strategy of the government to discourage what it considers undesirable avoidance succeeds, then the amount of avoidance would fall over time.
23. We also consider that it is inappropriate to include emotive phrases such as ‘for essential public services’ in a frequently asked questions guidance note which would be more effective if it confined itself to being an objective explanation of why the measures are considered necessary.

### **Question 6**

24. Following a retrospective change in legislation such as this, we consider that in the regulations ‘the new time limits’ will need to be at least three months in order to provide sufficient time for employers to make in an orderly manner the necessary changes to systems and procedures and to actually obtain, complete and lodge the appropriate returns.

PCB  
26.10.05

## ICAEW AND THE TAX FACULTY: WHO WE ARE

The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations 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 ICAEW who pay an additional subscription.

### 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).

## RETROSPECTIVE LEGISLATION

### **Text of a letter dated 10.2.05 from the Tax Faculty to the Paymaster General - Tackling Avoidance: Employment-related Securities (published as TAXREP 8/05)**

We refer to the announcements made in the 2004 Pre-Budget Report (PBR) in respect of the above and the press release, draft legislation and explanatory notes published on 3 February 2005 implementing the proposals set out in the Technical Note accompanying the PBR.

We are considering the draft legislation and will be responding shortly. In advance of those comments, however, we would like to put on record our concerns about the written statement you made to the House of Commons on 2 December 2004. This is to the effect that the Government may in future resort to retrospective legislation in relation to what it considers to be unreasonable tax avoidance schemes involving employment income.

The relevant paragraph of your December statement is reproduced below:

*'I am therefore giving notice of our intention to deal with any arrangements that emerge in future designed to frustrate our intention that employers and employees should pay the proper amount of tax and NICs on the rewards of employment. Where we become aware of arrangements which attempt to frustrate this intention we will introduce legislation to close them down, where necessary from today.'*

As we have stated in the past, we fully appreciate and understand the Government's need to take action against tax avoidance of the sort set out in your statement (which for the sake of clarity we have referred to below as 'unreasonable tax avoidance'). However, we believe that unreasonable tax avoidance should be countered by way of properly targeted anti-avoidance legislation. It seems to us that the basic principle behind the disclosure of tax avoidance schemes rules introduced in the Finance Act 2004 was to achieve exactly that: namely to enable the Government to act quickly and close down unreasonable tax avoidance schemes by introducing properly targeted anti-avoidance legislation. We support that approach wholeheartedly.

However, we are now concerned that, even before the FA 2004 rules have been given time to bed down properly and their success measured, taxpayers face the prospect of targeted legislation introduced with retrospective effect. Although we appreciate that retrospective legislation may have some superficial attraction in countering unreasonable tax avoidance, we are opposed to it in principle, for the following reasons.

- It fails the test of certainty. We believe that certainty should be one of the fundamental principles of a good tax system as set out in our Ten Tenets for a Better Tax System (see Appendix 1). Taxpayers are entitled to assume that any actions they take will be taxed in accordance with the law in existence at the time that the action is entered into. In relation to countering tax avoidance,



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the current practice of making a specific announcement that a scheme will be blocked from that day, even if draft legislation follows in due course, is well understood and is reasonably certain in its effect. This practice follows closely the guidelines agreed by the Government in the Parliamentary debate about the 1978 Finance Bill (the so-called *Rees rules*) where it was agreed that any warning about prospective retrospective legislation must be clear in form. We do not think that the announcement made on 2 December 2004 meets the required standard of certainty as set out in the Rees rules.

- The legal basis for retrospective legislation is now questionable, particularly in the wider context of EU and Human Rights laws. Emerging EU case law provides that the state cannot retrospectively remove a right without a transitional period (the so-called legitimate expectation right as found in *Marks-and-Spencer v C&E Commrs (C-62/00)*). If there is no transitional period, then the removal of the right will be illegal under EU law if it interferes with an EC treaty freedom and the state will be liable in damages. We accept that the extent of the legitimate expectation right has yet to be determined precisely in cases where tax avoidance may be an issue, but in our view emerging ECJ decisions suggest that the introduction of retrospective legislation relying on the statement made on 2 December 2005 would still fail the legitimate expectation right, thus making such legislation illegal under EU law.
- Retrospective legislation has the potential to undermine the credibility of the UK tax system in the eyes of taxpayers. We believe that, by and large, the UK's tax system has a high degree of credibility: the tax rules are obeyed and taxpayer compliance and honesty are good. The new tax avoidance disclosure rules, for example, appear to be working well in identifying schemes at an early stage: they are reasonably certain and we believe that taxpayers and their agents are complying with them. However, if credibility in the system is undermined, it may have very undesirable consequences. For example it may lead to poorer compliance, potentially leading into non-compliance and possibly to evasion.

Put shortly, although we understand the Government's desire to counter unreasonable avoidance, for the above reasons we do not think that the introduction of retrospective legislation has a place in UK taxation. We are also concerned that it will damage inward investment into the UK. We urge the Government to ensure that any legislation it proposes does not have a retrospective element and for confirmation that it will adhere to this principal in the future.

We wish to emphasise that our above comments should not be read as condoning or supporting unreasonable tax avoidance. This is a very difficult area and the proposal raises serious issues. Indeed, we see that this has also been recognised by the Treasury Committee's report on the 2004 Pre-Budget Report, which was published on 27 January 2005. Paragraph 95 of the report noted the serious issues raised by retrospective legislation and the fact that the rules are likely to be challenged in the Courts. The Committee, however, stopped short of recommending that the Government rethink this aspect of the proposals, proposing instead that:

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*The Inland Revenue should, without jeopardising their position, publish a paper setting out their thinking on the principles which will guide the way they implement this announcement.*

We welcome the opportunity to work with the Government in trying to reach some fundamental principles which minimise unreasonable tax avoidance whilst respecting the right of taxpayers to plan their affairs within the law and ensuring legislation is never retrospective. We think that this approach would be in the best interests of Government, taxpayers and their advisers.

## EMPLOYEE SECURITIES: ANTI-AVOIDANCE

**Text of a memorandum (TAXREP 13/05) submitted on 14 March 2005 in response to an invitation to comment on draft legislation issued in February 2005 by the Inland Revenue**

### INTRODUCTION

1. We welcome the opportunity to comment on the draft legislation to amend Part 7, Income Tax (Earnings and Pensions) Act 2003 ('ITEPA') with explanatory notes published on 3 February and on the Revenue's website at <http://www.inlandrevenue.gov.uk/pbr2004/draft-schedule.pdf> (draft legislation) and <http://www.inlandrevenue.gov.uk/pbr2004/en-clause204.pdf> (explanatory notes).

### KEY POINT SUMMARY

2. The legislative provisions here are very wide. We anticipate that the Revenue will attempt to limit the scope of the law in order not to frustrate the underlying existing objective that employers should be able to incentivise employees by offering them shares in their (employer) company. Applying the law by reference to guidance is an example of taxing by law but untaxing by concession. As noted in our letter dated 10 February to the Paymaster General (TAXREP 8/05), we consider that tax law needs *inter alia* to be certain. The proposals as they stand are not certain and do not comply with the Tax Faculty's Ten Tenets for a Better Tax System (reproduced in the Annex). In this case, the risks for employers and employees of being considered to be the wrong side of the avoidance line are so great as to make it likely that commercial incentive arrangements of the type that it is government policy to encourage will not be entered into.

### WHO WE ARE

3. The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
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## GENERAL COMMENTS

6. We are concerned that this legislation goes further than is necessary to curb the avoidance at which it is apparently targeted. It creates uncertainty for companies and will distort commercial practice by preventing them from introducing share incentive arrangements that do not involve that avoidance.
7. Many of the provisions create new income tax charges where the avoidance of tax or national insurance contributions is one of the main purposes of the arrangements in question. We are concerned that this is a highly subjective test and employers will not be prepared to rely on published guidance and concessions by the Inland Revenue.
8. For example, an employer may establish a restricted share scheme involving forfeitable shares. His aim would be to allow employees to choose between paying income tax on the unrestricted value of the award at the outset and then enjoying capital gains tax treatment for future growth (in effect, normally subject to taper relief which reduces the effective rate of tax to 10%), or, if the employee prefers, paying no income tax at the outset but suffering a charge on the market value of the shares on the date when the risk of forfeiture lifts.
9. No employer is likely to establish a forfeitable share scheme without regard to the tax treatment and the choice open to employees. We do not see by reference to the draft legislation how it can be argued that one of the main purposes of this scheme is not to enable the employee to avoid either the income tax charge at the date of the award or the income tax charge when the risk of forfeiture lifts. Accordingly, the employee must be deemed to make the election in all cases and all of the legislation dealing with later chargeable events is otiose.
10. We expect that the Revenue intends that guidance will be published to indicate that the legislation will not be applied in that way, and that provided an income tax charge arises on one or other of the relevant occasions in the circumstances described above, the new provisions will not apply. This is not good enough. If the law does not clearly remove the charge in the above circumstances we do not accept that taxpayers should have to rely on a concession by the Revenue to avoid it.
11. We are also aware of the Revenue's view of the meaning of the 'main benefit' test in the tax avoidance disclosure guidance. We assume that similar principles will apply here but in view of the importance of this matter more detailed provisions are needed to make the boundaries clear. In any event, we do not accept that it is sufficient to leave the relief from these new tax charges to be dealt with in published guidance only. The tax avoidance disclosure regulations involve a maximum penalty of £5,000. Here we are dealing with a potential liability of PAYE at up to 40%, employer NIC at 12.8%, employee NIC of up to 11%, a section 222 ITEPA charge of another 40% on the tax, a class 1A NIC charge and interest and penalties on top of that. In some circumstances, such as where the company in question is a subsidiary, the employer would also be denied a corporation tax deduction under Schedule 23 Finance Act 2003 by virtue of paragraph 4(3) Schedule 23. In other words, if the

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employer makes an incorrect judgement on the main purpose, the main benefit of the arrangement goes to the Revenue.

## DETAILED COMMENTS

12. We have the following further comments on specific provisions.
13. We do not accept that it is reasonable for redeemable securities to be brought into the restricted securities regime with retrospective effect.
14. The new tax charges imposed by section 446UA will result in double taxation. First, there appears to be no allowance of the amount of this charge in the base cost for capital gains tax. Secondly, once the tax has been paid, the employee may 'make good' the amount of the notional loan, for example by paying up the outstanding part of the subscription price of the shares, but will obtain no credit for the tax paid (s.446U and s.446UA).
15. The extension of the scope of section 447 is unreasonable. Where a sole trader incorporates his business and thus receives "employment related securities", and subsequently decides to pay a dividend on those shares in order to avoid a national insurance charge, he may be taxed both under s.447 and under the dividend rules.