Tax Representation

ICAEW TAX FACULTY

TAXREP 34/08

BUDGET MEASURES AND LOW-INCOME HOUSEHOLDS

Comments submitted on 14 May 2008 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales to the Treasury Committee of the House of Commons in response to the call for evidence on Budget Measures and Low-Income Households issued on 30 April 2008.

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BUDGET MEASURES AND LOW-INCOME HOUSEHOLDS

INTRODUCTION

1. In this document we present the written evidence of the Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) in response to the Treasury Committee's call for evidence for its enquiry into *Budget Measures and Low-Income Households*.

2. We are pleased to have the opportunity to respond to this consultation. We would be happy to discuss any aspect of our comments with the Committee. Please contact Frank Haskew, Head of the Tax Faculty, at frank.haskew@icaew.com or +44 (0)20 7920 8618. Please copy any emails to taxfac@icaew.com.

3. Information about the Tax Faculty and the ICAEW is given in Annex A. We have also set out, in Annex B, the Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals to change the tax system.

EXECUTIVE SUMMARY

4. The 10% starting rate which is retained for savings is not simple or easy for people to understand and calculate. It also presents practical difficulties in that taxpayers who are entitled to a refund (because 10% tax applies to their savings income) will have to make a claim for it. The compensation measures announced by the Chancellor so far will not alter these intrinsic difficulties with the operation of the 10% rate.

5. Therefore, in the interests of simplicity, we do not think that the 10% rate should be retained in this limited way just for savings income. If the Government decides to abolish it, this will create further losers, and careful consideration and consultation is needed before anything is done.

6. For 2008/09 we recommend that HMRC takes practical steps to make people aware of the possibility of claiming back tax if the 10% rate applies and to identify those likely to be affected.

7. There are two aspects to compensating those who have lost out from the changes to the 10% rate: compensation for those on low incomes who are financially disadvantaged by the tax changes in the 2008/09 tax year; and longer-term changes, to ensure that these groups are not disadvantaged in future.

8. As a general principle we think anomalies and inequalities in the tax system should be addressed via changes to the tax system, and not via the benefits system.

9. The tax credits system is not appropriate for delivering one-off compensation for those who have lost out from the changes to the 10% rate.

10. In the longer term, we strongly recommend that tax credits should be extended to people who need support but who do not currently qualify for credits. This would involve changing the age and working hours criteria.

11. We also recommend that the Government does much more to encourage take-up of tax credits by those who are eligible but do not claim, and to find out why people do not claim.

12. We do not think that either the Winter Fuel Allowance mechanism or the National Minimum Wage (NMW) is a suitable route via which to compensate people for anomalies or inequities in the tax system.

13. The burden of an increase in the NMW falls not on the Government but on the employer, who has to pay not just the increased wage but also the associated employer's NIC. This is likely to be received extremely badly by employers.

14. We can accept the increase in the personal allowance as a pragmatic solution for 2008/09. However, we are concerned that it does not fully compensate those on the lowest incomes. This will have to be addressed in any further proposals for 2008/09 or future years.

15. The Chancellor's announcement said nothing about NIC. The increase in the personal allowance means that this is no longer aligned with the primary threshold for NIC It seems likely that the change in the higher rate threshold for income tax will also have an impact on the Class 1 NIC upper earnings threshold since the Government's stated aim is to align the two. We are concerned that this announcement will have far-reaching consequences for the wider tax system which need to be properly analysed and consulted upon.

16. The burden of implementing this proposed change mid year for employees will fall on employers. We are concerned that the cost implications of this should be investigated fully before the change is implemented

17. There was no consultation on the changes to the 10% rate or the other measures in the 2007 Budget 'package'. We strongly recommend that when developing new tax policy, and certainly before implementing it, the Government consults with all relevant stakeholders at an early stage.

DETAILED COMMENTS

The 10% rate – from 6 April 2008

18. The changes to the 10% rate of income tax were announced as part of a package of measures affecting personal allowances, tax rates, National Insurance contributions (NIC) and tax credits, announced in the 2007 Budget. Paragraph 5.5 of the 2007 Red Book stated:

    5.5 The Government will simplify the tax system by removing the starting rate and cutting the basic rate of income tax from 22 pence to 20 pence from April 2008, creating a simpler structure of two rates: a 20 pence basic rate and a 40 pence higher rate. This is the lowest basic or standard rate of income tax for over 75 years. To continue to reward saving, the Government will maintain the existing ten pence rate of tax for savings income, which is identified separately in the income tax system.

19. From 6 April 2008, therefore, the 10% starting rate of income tax has been retained just for savings income which falls within a band (£2,320 for 2008/09) above the personal allowance. While this decision might be a reasonable one in policy terms, the retention of the 10% rate for savings income does little to simplify the system and it does not achieve a simpler two-rate tax system. In order to work out his or her tax a taxpayer will need to understand what is meant by savings income, understand the order in which types of income are taxed, and work out how much if any savings income falls within the 10% band.

20. Furthermore, the benefit of the 10% will not be given automatically. If a taxpayer has overpaid because 20% tax has been deducted from savings income but some of it is taxable at 10%, he or she must claim a repayment from HMRC. So, in order to end up paying the right amount of tax the taxpayer will need to be aware of the new 10% rate rules and how these will apply, know that a claim is needed, and understand how to make one. Many taxpayers on low incomes, particularly older people, are likely to struggle with this, and lose out on the refunds due to them.

21. Measuring the 10% starting rate for savings against our Ten Tenets (Annex B), the rules certainly fail tenets 2 and 3 – that tax should be simple and easy to calculate and collect (or claim back). The compensation measures announced by the Chancellor so far (in his letter to the Treasury committee of 23 April and statement to the House on 13 May) will not alter these intrinsic difficulties with the operation of the 10% rate.

22. Therefore, in the interests of simplicity, we do not think that the 10% rate should be retained in this limited way just for savings income. However, abolishing it will create further losers, and careful consideration and consultation is needed before anything is done.

23. For 2008/09, from a practical point of view, we should like to see HM Revenue & Customs (HMRC) doing as much as possible to make people aware of the possibility of claiming back tax if the 10% rate applies to their income. So far, HMRC has published some quite helpful guidance on its website, but unrepresented taxpayers are unlikely to know that this exists. In due course HMRC should produce some targeted publicity and support, possibly on the lines of its previous Tax Back initiative. We should also like HMRC to use its databases to identify those likely to be affected, but we do not know if this will be possible.

Winners and losers

24. The winners and losers from the 2007 Budget changes have been identified by many commentators and were discussed in the Treasury Committee's own enquiry into the 2007 Budget but we will recap on the categories.

25. Those who can benefit from the higher personal allowances or claim tax credits (particularly child tax credit) will be better off under the total 'package' for 2008/09. So will those whose income is sufficiently high for the 2% drop in the basic rate of income tax to outweigh the loss of the 10% rate.

26. Those who will be worse off fall broadly into three groups:

- People who are not eligible for tax credits.
- People who, though eligible for tax credits, do not claim them.
- Early retirees under the age of 65 who do not benefit from the enhanced age allowances available to people of 65 and over, particularly women pensioners aged 60 to 64.

27. The first group – those not eligible for tax credits – includes:

- Younger workers (under the age of 25) who do not have children (unless the worker is disabled, in which case they can claim if they are 16 or over).
- Those who do not work enough hours to qualify.
    - Those who work less than 16 hours a week are not entitled to working tax credit (WTC), though may be entitled to child tax credit (CTC) if they have children.
    - Workers without children must work at least 30 hours a week to get WTC.
    - But if the worker is disabled, or aged 50 or more and starting work after a period on benefits, they must work at least 16 hours a week.

  This group is likely to include part-time workers or those with an illness or disability who are trying to get into work.
- Migrant workers who are in the UK on condition that they do not have recourse to public funds.

28. The ICAEW is not in a position to quantify the winners and losers in each category.

Compensation and future changes

29. The Government has indicated its intention of helping those who have lost out as a result of the changes to the 10% rate.

30. In our view there are two aspects to this:

- Compensation for those on low incomes who are financially disadvantaged by the tax changes in the 2008/09 tax year.
- Longer-term changes, to ensure that these groups are not disadvantaged in future.

31. The Chancellor's letter of 23 April 2008 to the Treasury Committee indicates that the Government is looking at three routes for delivering compensation and support: tax credits, the winter fuel allowance mechanism, and the NMW. On 13 May 2008 he announced that to provide compensation for 2008/09 the Government would increase the personal allowance by £600. We discuss each of these below.

32. As a general principle we think anomalies and inequalities in the tax system should be addressed via changes to the tax system, and not via the benefits system. This is because in reality we do not have an integrated tax and benefits system in the UK. Tax is assessed on the individual and (broadly speaking)

applies in the same way to everyone, whereas tax credits and benefits are targeted at specific groups of people and in many cases are assessed on the household rather than the individual.

Tax credits

33. The tax credits system is not appropriate for delivering one-off compensation for those who have lost out from the changes to the 10% rate, because:

- To do that, tax credits would have to be extended to include those people who are not currently eligible, which would require changes to both the legislation and the computer system.
- Any compensation delivered via this route would not reach those who are eligible but do not claim tax credits.
- The tax credits system is not designed to deliver one-off payments.
- Changes or claims generally cannot be backdated beyond three months.

34. In the longer term, we strongly recommend that tax credits should be extended to people who need support but who do not currently qualify for WTC:

- School or college leavers, aged under 25, who are starting out in their careers and need some short-term help.
- Part-time workers, especially those who are unable to work as much as 16 hours a week because they have an illness or are disabled but are trying to move off benefits and get back to work.

35. We appreciate that reducing the age and working hours criteria would be expensive measures (though we are not in a position to quantify them) but they would enable the Government to support low-income groups who are re-entering workplace or entering it for the first time.

36. We also recommend that the Government does much more to encourage take-up of tax credits by those who are eligible but do not claim, and to find out why people do not claim. Take-up is particularly poor for households who do not have qualifying children and are therefore eligible just for WTC.

37. At the Treasury Committee's enquiry into the 2007 Budget, the Government indicated that it was seeking to boost the number of WTC claimants. However, we are not aware of any major initiatives to achieve this, and take-up rates have not improved markedly. The estimated take-up of WTC for families without children in 2005/06 is 22%, according to figures published by HMRC in 2008. At the time of last year's Committee enquiry the figure quoted was 19%.

38. The Government should also look at the interaction between the benefits and tax/tax credits systems for those on low incomes who are endeavouring to get into work, as there may be disincentives such as the loss of passported benefits.

Winter Fuel Allowance mechanism

39. The Chancellor's letter of 23 April refers to 'using the mechanism that already exists to pay the Winter Fuel Allowance'. It is not clear whether this envisages paying an enhanced Winter Fuel Allowance, or simply using the Winter Fuel Allowance database to deliver a one-off payment.

40. Either way, it seems an inappropriate route to compensate pensioners for a tax loss. It is hard to see how it can be used to pay targeted compensation.

41. The Winter Fuel Allowance is paid to those aged 60 and over and is not means tested. Therefore, an increase in the allowance will benefit a lot of pensioners besides those who have lost out from the tax rate changes – in particular, pensioners who are already getting the benefit of the enhanced personal tax age allowance. But it will not compensate those under 60 who have retired early.

National Minimum Wage (NMW)

42. This also seems an odd route to suggest if the intention is to deliver targeted compensation.

43. An increase in NMW would benefit younger workers who cannot get WTC. But it is hard to see how the NMW rate could be increased just for this group. An increase in NMW for younger workers would presumably require a knock-on increase in the main NMW rate.

44. A worker will pay tax at 20% and NIC at 11% on any increased wage. In addition, if he or she is a tax credit claimant, tax credits will be reduced at the 39% taper rate. This produces a marginal rate of 70%, leaving the worker with just 30% of the increase. This hardly seems a cost-efficient way to deliver compensation.

45. The burden of an increase in the NMW falls not on the Government but on the employer, who has to pay not just the increased wage but also the associated employer's NIC. The level of the NMW should be set in order to ensure that low-paid workers receive a fair and adequate wage and not to compensate them for anomalies or inequities in the tax system. This is likely to be received extremely badly by employers, especially the small and medium-sized businesses that many of our members represent.

Personal allowances

46. The Chancellor announced on 13 May 2008 that compensation for the 'losers' in 2008/09 would be delivered by increasing the basic personal allowance by £600, to £6,035. This will save basic rate taxpayers £120 and in particular will help pensioners aged 60 to 64 who do not benefit from the age allowance.

47. In our view this is a pragmatic solution for 2008/09. It is clear that it would be impossible, even with huge Government time and effort, to identify each and every 'loser' in order to quantify their loss under the 2008/09 package of measures and then pay them precise compensation. Therefore, a quick and simple solution seems best, and increasing the personal allowance fits the bill. We welcome the

fact that this measure provides compensation via the tax system rather than by attempting to use the benefits or NMW systems.

48. The Chancellor has stated that this measure will fully compensate 4.2m households and take 600,000 out of tax altogether. He also says that 1.1m households will see their loss halved. The measure is an expensive one because it is not targeted, and is based on an average loss which the Chancellor has set at £120. It therefore benefits those basic rate taxpayers who would not have lost from the changes to the 10% rate. On the other hand, the taxpayers who will not be fully compensated are those on the lowest incomes.

49. For example, a person with pension income of £8,000 a year (and no other taxable income) would have paid tax in 2007/08 of £343; with a personal allowance of £5,435 their tax liability for 2008/09 would have been £513 (ie an increase of £170); with the new personal allowance it will be £393. Thus even after the changes announced on 13 May, this person will pay £50 more tax in 2008/09 compared to the year before, due to the loss of the 10% rate on earnings.

50. The Chancellor indicates in his 13 May statement that ‘for future years our aim is to continue the same level of support for those on lower incomes’ and there will be proposals at the Pre-Budget Report. The proposals will need to address the situation of those on lower incomes who have lost by more than the average figure.

51. The Chancellor’s announcement said nothing about NIC. For some years now the primary threshold for NIC has been aligned with the personal allowance. However, we now have a personal allowance for 2008/09 which is £600 higher than the NIC primary threshold. We should be interested to know how the Government proposes to proceed for 2009/10 if this increased level of personal allowance is maintained. Raising the primary threshold to align it with the personal allowance would be a very expensive measure.

52. It seems likely that the change in the higher rate threshold for income tax will also have an impact on the Class 1 NIC upper earnings threshold since the Government’s stated aim is to align the two. We are concerned that this announcement will have far-reaching consequences for the wider tax system which need to be properly analysed and consulted upon.

53. The burden of implementing this proposed change mid year for employees will fall on employers. We are concerned that the cost implications of this should be investigated fully before the change is implemented.

The consultation process

54. We should like to make some general comments about the need for effective consultation on major tax policy changes before they are announced or implemented.

55. The changes to the 10% tax rate were announced at the 2007 Budget and the winners and losers were identified by various bodies, including the Treasury Committee, shortly afterwards. However, this did not attract a huge amount of attention at the time and the matter has only been discussed and debated in

recent weeks, following the Budget 2008 announcement of the tax rate bands for 2008/09 and the publication of the Finance Bill. There has been no consultation or discussion with representative bodies.

56. The result has been the recent announcement of some policy changes which, we imagine, have been developed at rather short notice, and a certain amount of misinformation in the press which may have alarmed people unnecessarily. This is not the best way to develop good tax policy or announce it.

57. We strongly recommend that when developing new tax policy, and certainly before implementing it, the Government consults with all relevant stakeholders at an early stage. We trust that this will be done in any respect of any further changes to tax rates, personal allowances, tax credits and related matters which may be announced at the Pre-Budget Report this autumn.

Jane Moore
14 May 2008

ANNEX A

THE ICAEW AND THE TAX FACULTY: WHO WE ARE

1. 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.

2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. 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.

3. 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.

4. To find our more about the Tax Faculty and ICAEW including how to become a member, please call us on +44 (0)20 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

ANNEX B

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).