



## ICAEW TAX FACULTY REPRESENTATION

### TAXREP 2/11

### TREASURY COMMITTEE INQUIRY INTO THE FUNDAMENTAL PRINCIPLES OF TAX POLICY

*Memorandum submitted on 14 January 2011 to the Treasury Select Committee by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to the invitation published on 24 November 2010 to provide written evidence on a number of questions concerning tax policy.*

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# TREASURY COMMITTEE INQUIRY INTO THE FUNDAMENTAL PRINCIPLES OF TAX POLICY

## INTRODUCTION

1. The Treasury Committee launched an Inquiry on 24 November 2010 into the fundamental principles of tax policy. The call for evidence refers to the publication of recent detailed reports into the fundamentals of tax policy by both the OECD and Institute for Fiscal Studies (IFS). Reference is also made to the publication of the list of over 1,000 tax reliefs published by the Office for Tax Simplification (OTS).
2. The Committee has invited written evidence on the following five questions:
  1. What are the key principles which should underlie tax policy?
  2. How can tax policy best support growth?
  3. To what extent should the tax system be structured to support other specific policy goals?
  4. How much account should be taken of the ease and efficiency with which a particular tax can be imposed and collected?
  5. Are there aspects of the current tax system which are particularly distorting?
3. We have set out below our comments on these questions. As part of our response to question 1, we have also set out some comments on the OECD and IFS reports and, in our response to question 2, we have also referred to the work of the OTS.

## WHO WE ARE

4. The Institute of Chartered Accountants in England and Wales (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, ICAEW provides leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide. The Tax Faculty is the focus for tax within ICAEW.

## EXECUTIVE SUMMARY

### *Question 1 What are the key principles that should underlie tax policy?*

5. In 1999 we identified ten principles that provide a framework for evaluating the tax system and we have used them subsequently to evaluate tax policy changes. Our key principles are that the tax system should be: certain in operation with changes kept to a minimum; simple and understandable; easy to collect and to calculate; fair and reasonable; statutorily based, properly targeted and subject to parliamentary scrutiny and proper consultation; it should be regularly reviewed and competitive so as to encourage investment.
6. A good tax system also needs to be administered efficiently and effectively. This is subject to a separate Treasury Sub-Committee Inquiry but we are very

concerned that HMRC's efficiency and effectiveness have fallen and that they need to be improved.

7. The OECD and IFS Mirrlees reviews are valuable contributions to the debate on what is the best tax policy. Tax policy should be broadly based with reasonable tax rates and reliefs kept to a minimum. The OCED suggest moving towards increasing taxes on consumption and residential property taxes and reducing income taxes and corporation tax, but in the current climate we do not think this would be right approach for the UK.

*Question 2 How can tax policy best support growth?*

8. The tax system should be competitive, fair and reasonable and not subject to constant change. Tax policy should be decided at an early stage and major changes kept to a minimum.
9. There should be a review of the tax and administrative burdens on businesses that hinder growth by reference to the life cycle of a business and the pressure points that arise.

*Question 3 To what extent should the tax system be structured to support other specific policy goals?*

10. The tax system should be designed to raise revenue efficiently to fund spending requirements. Using the tax system to support other policy goals is at best problematic and may result in unexpected behavioural changes and prejudice revenue flows.
11. Where specific policies are adopted in order to change behaviours, there should be post implementation cost/benefits reviews and greater use made of 'sunset' clauses.

*Question 4 How much account should be taken of the ease and efficiency with which a particular tax can be imposed and collected?*

12. Ease and efficiency of collection are an important part of the design process and there should be greater consultation at an earlier stage into the likely admin burdens and compliance costs incurred by taxpayers, their advisers and HMRC.
13. Tax policy changes should be evaluated against specific cost/benefit criteria and if the policy fails the criteria it should be rejected or modified.

*Question 5 Are there aspects of the current tax system which are particularly distorting?*

14. There have always been distortions in the tax system and we have identified a number of the more important ones. Most of these distortions are not new. Many of them are also interrelated and resolving them is likely to be politically sensitive.

**QUESTION 1 - WHAT ARE THE KEY PRINCIPLES WHICH SHOULD UNDERLIE TAX POLICY?**

15. Since its foundation in the early 1990s the ICAEW Tax Faculty has been at the forefront of the debate to improve the UK tax system and the way UK tax policy is developed. As part of this work, in 1999 the Tax Faculty identified ten principles (the Ten Tenets) that should underpin a good tax system. These are set out in Appendix 1.
16. We have used the Ten Tenets in the intervening period to evaluate subsequent policy changes and we believe that they continue to offer an appropriate

framework to assess the overall tax system and to evaluate individual tax policies.

17. We have set out below what we consider are the key principles (tenets) of a better tax system and the necessary processes (see our comments at para 23 below) that we believe need to be in place to ensure that such a system can be maintained and developed.

#### **Key principles of a better tax system**

18. A key principle underlying tax policy is that it should be **certain**. The importance of this principle is confirmed consistently in feedback from members and businesses. Taxpayers in general and businesses in particular need to know where they stand and make plans for the future, with a clear understanding of the tax consequences which will result from their decisions. Clear and certain tax laws minimise the likelihood that taxpayers and the revenue authority will become involved in disputes about the tax effects of transactions and the need to resort to the appeals system.
19. The tax system needs to be designed to be as **simple** as possible while achieving its various objectives. It also needs to be **fair and reasonable**. The maintenance of a proper balance between these two tenets can most obviously be a source of tension: if the system is too simple (for example a flat-rate of tax rather than a more progressive system of rates) it may not be generally perceived as fair and reasonable but on the other hand a tax system that seeks to ensure that all taxpayers are treated fairly will inevitably result in greater complexity.
20. Tax law also should be **properly targeted** so that it can best achieve the underlying policy objective. We also believe that tax policy should be **constant**, in other words tax policy should be set and then not be subject to constant changes every subsequent year.
21. The purpose of the tax system is to raise money for government expenditure in the most efficient way. We do not think that the tax system is best suited to encouraging changes in behaviour. Such changes often result in considerably increased complexity but may have little impact upon behavioural change - an example being the rates of capital allowances, where business's investment timescales are not likely to be influenced by regular changes to the rates. Conversely, changes to encourage behaviour may have adverse effects, for example the policy behind the introduction of the 0% rate of corporation tax was to encourage companies to reinvest and grow but the absolute tax saving resulted in considerable numbers of businesses incorporating solely to save tax, with the result that the policy had to be changed.
22. Finally we believe that tax needs to be **easy to collect and to calculate**. It should be relatively easy for the majority of taxpayers to understand and calculate their tax liability without the need for external assistance.

#### **Processes**

23. The formulation of tax policy and resultant legislation needs to be **subject to proper consultation** and it needs to be **statutory** i.e. enacted by statute and subject to proper Parliamentary scrutiny. It also needs to be **constant** so that changes to the underlying rules are kept to the necessary minimum but it is also important that there are **regular reviews** so that when the economic and commercial reality changes the law can be suitably updated.

24. We have set out our detailed comments on appropriate processes in Appendix 2.

### **The need for a competitive tax system**

25. The current Government has as its aim to create the most competitive tax system amongst the G20 countries. In a globalised world where businesses in particular have real choices as to where they operate, the UK needs to provide a tax system which is attractive for businesses which already operate in the UK and which encourages future inward investment. However, a balance needs to be struck between a sufficiently attractive tax regime and the need to protect the UK tax base while ensuring that businesses make a fair and reasonable contribution to the public finances.

26. The UK is currently coming towards the end of a major review of the way in which it taxes international business. The final part of this process is an interim amendment of the existing CFC (Controlled Foreign Company) legislation, in FA 2011, with a recasting of the rules in FA 2012. This is coupled with a change to the taxation of foreign branches to be completed in FA 2011. It would be appropriate to review these changes in the light of the move towards a more territorial approach to UK taxation in order to determine what aspects of the current, and proposed, legislation are crucial to maintaining the competitiveness of the UK tax system.

### **The administration of the tax system**

27. However good the tax system is in design, in order to deliver its potential benefits it needs to be administered efficiently. We have been extremely concerned in recent years by the drop in service standards and efficiency of HMRC. This is a major concern of our members. At the end of 2010 we published the results of a member survey<sup>1</sup> that sets out the concerns in detail.

28. In December 2010 we submitted written evidence to the continuing Treasury Sub-Committee Inquiry into HMRC's efficiency and effectiveness. In view of the critical importance of this aspect of the tax system we would be happy to assist the Sub-Committee further with that Inquiry.

### **The OECD and Mirrlees review**

29. The OECD and Mirrlees reviews are valuable contributions to the debate on what is the best tax policy. These detailed and comprehensive reviews are written primarily from a macro economic standpoint and we will be studying them and their conclusions in more detail over the coming months.

30. As professional accountants closely involved in advising on tax and the proper operation of the tax system, we also believe it is vital to ensure that whatever tax policies are adopted, they are designed to be efficient and that they work properly in accordance with the ten tenets referred to above.

31. As a general principle, we believe that tax policy should aim to be broadly based, that rates are kept reasonable and that the number of reliefs is kept to a minimum needed to ensure that it operates fairly.

32. We agree with the view expressed in the Mirrlees Review that the tax system should be considered as a whole with the benefit system, seek neutrality, and

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<sup>1</sup> See

[http://www.icaew.com/index.cfm/route/175054/icaew\\_ga/Faculties/Tax/Publications\\_and\\_technical\\_guidance/TAXREP\\_43\\_10/TAXREP\\_43\\_10/pdf](http://www.icaew.com/index.cfm/route/175054/icaew_ga/Faculties/Tax/Publications_and_technical_guidance/TAXREP_43_10/TAXREP_43_10/pdf)

achieve progressivity as efficiently as possible. We also agree with the OECD that the tax system should distort economic incentives as little as possible.

33. The OCED report suggests moving towards increasing taxes on consumption and residential property taxes and less from income taxes and corporation tax. The 22 June 2010 Budget 'Red Book' shows that Council Tax, Business rates and VAT combined raised £131bn (23%) of total revenue and that stamp duty land tax raised a further £5.8bn. In contrast, income tax, NIC and corporation tax raised £292bn or about 53% of total revenues. Our initial conclusion is that, even if such a move was desirable economically and let alone whether it would be politically acceptable, it would involve a major rebalancing of the UK tax system which would take time to achieve and risks introducing considerable distortions and behavioural changes.
34. Ultimately, the relative proportions of tax raised from the various sectors of the economy are policy questions for the government of the day to decide. In the current fiscal climate, we believe that the overriding need is not to rebalance the tax system but to ensure that existing revenue flows are stable and not put at risk.

## **QUESTION 2 - HOW CAN TAX POLICY BEST SUPPORT GROWTH?**

35. As noted above, a key requirement of businesses is that they want certainty year on year. In relation to the tax system, this suggests a competitive but fair and reasonable system which is not subject to constant change. Tax policy and rates should be set at an early stage in the Parliamentary cycle and thereafter major changes in tax policy should be kept to a minimum.
36. The government is pursuing a growth agenda and we believe that there is a need to review the tax and administrative burdens on businesses that hinder growth. Such a review could be integrated with the work of the Office for Tax Simplification (OTS). The call for evidence referred to the work of the OTS and the identification of over 1,000 tax reliefs – this work is proving valuable but there is a need for a more detailed review of where are the real pressure points in the tax system.
37. One approach would be to review the burdens by reference to important events and decisions that businesses are required to make, for example: starting a business and adopting the most appropriate business structure; taking on your first employee(s); registering for VAT; buying capital equipment; raising external finance; selling internationally etc. The precise burdens at each stage should be identified and quantified and consideration given to how the burdens could be reduced.
38. We also believe there needs to be a clearer recognition that the policy approach needs to recognise that there is a significant difference between micro, SME and large businesses.

## **QUESTION 3 - TO WHAT EXTENT SHOULD THE TAX SYSTEM BE STRUCTURED TO SUPPORT OTHER SPECIFIC POLICY GOALS?**

39. As noted above the overriding aim of the tax system should be to raise revenue efficiently to fund the government's spending requirements. This requires a stable and reliable tax system that produces a predictable flow of revenues within the limitations of forecasting error and the stage in the economic cycle. In our experience, supporting other policy goals is at best problematic and often results in unexpected behavioural changes that may prejudice revenue flows, for

example by encouraging tax avoidance. It will often be more efficient to achieve other policy goals by different means that can be better targeted, for example the use of government grants.

40. There would be merit in examining the UK rules for capital allowances and the extent to which the system should, or should not, be used to encourage behaviour. There are competing pressures to encourage UK business to invest in additional productive capacity while at the same time achieving other policy objectives, such as encouraging innovation and addressing the Government's environmental goals.
41. Where specific policies are adopted in order to change behaviours, there should be post implementation reviews to consider whether the policy outcomes have been achieved and whether the benefits outweigh the costs (i.e. revenue foregone).
42. In order to instil this discipline into the tax policy making process, greater consideration should be given to the use of 'sunset' clauses. These would operate so that after a fixed period of time, say five years, a particular measure will lapse unless Parliament extended it but that should only be done if a clear and positive case is first made for the retention of the particular provision.
43. We recognise that this approach conflicts somewhat with our tenets about the need for certainty and for the system to be constant. The two approaches can be reconciled by ensuring that the time limitation is stated at the outset and that the measure is not changed once it has been introduced.

#### **QUESTION 4 - HOW MUCH ACCOUNT SHOULD BE TAKEN OF THE EASE AND EFFICIENCY WITH WHICH A PARTICULAR TAX CAN BE IMPOSED AND COLLECTED?**

44. As mentioned above one of our ten principles is that tax should be easy to collect and to calculate. It follows that the ease and efficiency with which a tax can be collected is a very important part of the design process and needs to be considered in detail at the design stage and before tax policy decisions are made. There should be greater consultation at an earlier stage into the likely admin burdens and compliance costs of proposed measures.
45. While impact assessments seek to assess this efficiency, we are not convinced that the figures and costings used to compute the assessments are always realistic and they tend to underestimate the costs incurred by businesses in implementing changes. Further, the approach only takes account of cost incurred by businesses rather than taxpayers as a whole.
46. We believe it would be worthwhile when evaluating tax policy changes to develop a minimum cost/benefit ratio that compares expected tax revenues with the costs of compliance. This should include costs incurred by taxpayers, their advisers and HMRC and it should cover all taxpayers not just businesses. If the proposed tax policy change fails to meet the minimum standards then it should either be rejected or amended so as to ensure that it does meet the test.

#### **QUESTION 5 - ARE THERE ASPECTS OF THE CURRENT TAX SYSTEM WHICH ARE PARTICULARLY DISTORTING?**

47. There have always been distortions in the tax system but resolving them is often politically sensitive. Areas of the tax system where there are particular distortions include:

- the taxation of smaller businesses with particular reference to different taxes paid by an employee, the self employed and a person operating through a company, where all undertake similar work ;
  - the general interaction between the income tax and national insurance rules and in particular the higher taxation of earned rather than unearned income because of the impact of national insurance on the former;
  - the difficulty in determining whether a person is employed or self employed for tax purposes and the different definitions applied for non tax purposes;
  - the 22% difference between the top rate of income tax and the CGT rate favours capital returns although we appreciate that the current Government has reduced this from 32%;
  - the impact of higher marginal rates of tax, for example the withdrawal of personal allowances for income over £100,000 results in a marginal income tax rate of 60% on income between £100,000 and £113,000, when either side of this band the rate is 40%;
  - liability to tax depends upon residence but the UK continues to have unclear residence rules based largely on out of date case law; and
  - VAT Low Value Consignment Relief, in particular in relation to goods despatched from the Channel Islands which enables goods to be sold in the UK VAT-free.
48. Most of these distortions are not new and have been with us in some form for many years. Many of them are also interrelated so policy changes in one area are likely to have repercussions in other areas that need to be factored in to any decision making process.

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## THE ICAEW 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=118111>

### The processes that need to be in place to create and maintain a Better Tax System

1. In formulating tax policy there needs to be appropriate Parliamentary scrutiny and outside experts need to be involved. There should be proper time for consultation and a clear timetable – the proposals of the current Government are a considerable improvement and should lead to improved tax legislation in the longer term but it will require sustained effort and processes to be locked-in for the future. We therefore believe that the approach should be enshrined in a binding code so that a future government will be held to account. There should also be external monitoring of how the government of the day has complied with the code and we suggest that there should be a periodic review of new legislation, either by the Treasury Committee or some other suitable oversight body.
2. It is also worth considering whether the House of Lords could be given a role in examining and improving Finance Bill measures without undermining the long established principle that the House of Commons should be the arbiter on Money Bills. The deliberative process should be carried out in collaboration with those who have to operate and actually run the systems, including agents and the professional bodies. There is an argument for disengaging many of the measures, particularly those of a technical nature, from the traditional Finance Bill timetable and putting such measures through a separate process. The current Government approach demonstrates that such an approach should be possible and has resulted in improved opportunities for scrutiny.
3. Drafting of tax law should be clear, properly targeted and generally included in primary legislation. It is particularly important that anti-avoidance measures are properly targeted and are not 'catch all' measures whose scope is then cut down by HMRC guidance. This is not a satisfactory approach for a number of reasons. First, following the 2005 House of Lords decision in the *Wilkinson* case ([2005] UKHL 30) this approach is legally doubtful. Second, such guidance cannot be relied upon and may be changed at any time so is of little practical help in the event of a dispute.
4. It is important that tax law is subject to proper Parliamentary scrutiny. It is for this reason that we believe substantive tax legislation should be set out in primary tax legislation and not in secondary tax legislation where the level of detailed Parliamentary scrutiny is lower. There has been a tendency in recent years to include within the primary law powers for the executive to in effect rewrite the tax legislation by way of secondary legislation. It is reasonable for Parliament to delegate minor and administrative measures to the executive but not otherwise. We believe that as a matter of principle any changes to tax law which are not merely administrative should be put through the Finance Bill process and subject to proper Parliamentary scrutiny. Such principles and practice could be set out in a binding code and again subject to a review process.
5. Our proposals above are designed to ensure that substantive tax law is subject to proper scrutiny through the Finance Bill process. Whether this approach is adopted or not, we believe that more generally there is a need for greater scrutiny of Statutory Instruments. The number of tax related Statutory Instruments has grown considerably over the years and Parliament needs to be satisfied that they are subject to a thorough review.

6. The role played by guidance is an important consideration. It should not be used as a support for inadequate primary legislation but it clearly has a role in helping taxpayers and their advisers better understand what legislation means in practice and, as a result, guidance can help to create the required certainty. We believe that there should be a presumption that all guidance is consulted on before it is finalised and published.
7. It is also clear that a proper understanding of tax legislation and the manner in which it will be implemented require any guidance to be produced at the time that the proposals are being debated and before they are enacted. Again, the Government appreciates the need for this approach and we believe that it needs to be enshrined in a code so as to ensure that it is followed in the future. There should also be consultation with interested parties on that guidance so as to ensure that it is clear and correctly reflects the primary and secondary legislation which it explains.