

TAXREP 65/07

KEY TAX ISSUES FOR THE 2007 PRE-BUDGET REPORT

*Memorandum submitted in October 2007 by the
ICAEW Tax Faculty
to the Chancellor of the Exchequer*

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KEY TAX ISSUES FOR THE 2007 PRE-BUDGET REPORT

IMPROVING TAXPAYER SERVICES

- 1 We remain very concerned about the level of HMRC's customer service. We recognise that HMRC is in the process of a major reform programme aimed at improving services with less resources. However, as with any reform programme, if it is not matched with a review of the level of investment needed to support the service and effect improvements, problems may occur at the delivery stage. Reports and surveys of our members suggest very clearly that service levels have fallen in the recent past.
- 2 There appear to be a number of contributory factors, but the main problems centre around the closure of local offices, centralised processing and the increased reliance on call centres manned by less experienced personnel. The result of these appears to be that a considerable amount of time, and associated costs, is wasted in order to resolve issues. We would like to discuss with you how we can help work towards delivering a more efficient tax administration system that is truly customer focused and which benefits all the stakeholders.
- 3 Similarly, we have raised concerns about the serious delays experienced in registering new businesses for VAT. We recognise and appreciate the need to fight missing trader fraud and know that considerable efforts have been made to reduce the losses stemming from this. However, the measures taken to reduce fraud, together with the HMRC change programme, are having serious consequences for the rest of UK businesses and we would like to discuss with you how the situation can be improved.
- 4 In July 2007 we submitted a detailed memorandum to HM Revenue and Customs and HM Treasury on VAT registration delays. The paper set out a number of recommendations designed to improve the situation, covering both changes to the VAT rules and also operational improvements. We are working with senior HMRC personnel to tackle the delays but would welcome a commitment from Government recognising that delays in registering traders for VAT is causing serious problems and setting out an action plan for reducing these delays within a reasonable timescale.
- 5 The above examples highlight the need for the customer facing departments of HMRC to be treated as front-line departments and resourced accordingly. We welcome the desire of Government and HMRC to improve services to taxpayers, but to make real and lasting improvements in services requires sustained investment now.
- 6 We also welcome the recommendations in the report of the House of Commons Treasury Committee inquiry into the efficiency programme of the Chancellor's departments (HC 483-1, published on 23 July 2007). The Committee were concerned that indicators used by HMRC to measure the quality of its services are not adequate to assess the experience of service users and that HMRC should accord a high priority to working with users to put in place service quality measures that more accurately reflect the experience and needs of the users. The Committee also recommended that the measures should be published regularly and subject to external validation. We are keen to work with HMRC on developing these recommendations and putting them into practice.

7 Key policy recommendations

- HMRC's customer facing departments need to be recognised as a front-line service and resourced accordingly.
- An action plan and timetable needs to be prepared setting out detailed steps for reducing the current VAT registration delays. A senior HMRC person needs to be made responsible for delivering the plan.
- HMRC needs to work with its stakeholders to improve its services, working to develop service delivery indicators and robust means of measuring them.

A COMPETITIVE TAX SYSTEM

8 We fully support the Government's overall objective to ensure that the UK has a competitive tax regime. It is vital that the UK has a competitive tax system, not just in respect of headline rates of tax but also in relation to the structure of the business tax system and the relative ease with which business can be undertaken.

9 Turning to the taxation of foreign profits, we have said in the past that we think that an exemption system has considerable attractions over the UK's existing credit system. We therefore welcomed the consultation being undertaken by HM Treasury and HM Revenue & Customs on reforming the existing rules for taxing foreign profits. We consider that, overall, this part of the UK tax system is in need of improvement and we agree with the statement in paragraph B.4 of the partial impact assessment that 'maintaining the status quo is not an option'.

10 However, whilst we support in principle the adoption of an exemption system in the UK, much will depend upon the actual details of any such system. Currently the proposals in the document are at a 'high level' and the proposals really need to be set out in more detail before we can express a firm view as to whether the 'package of measures' will be good for business and will support a competitive UK tax regime. We have indicated in our submission to HM Treasury that we are looking forward to participating in the ongoing discussions on this important topic.

11 We are concerned about the current Controlled Companies proposals in this discussion document. We accept that any proposals need to be EC Treaty compliant, but the proposal to extend the regime to UK – UK companies seems likely to lead to an extremely onerous system in compliance terms.

12 We also have concerns about the interest relief provisions. We consider that the main focus should be on a commercially based test which could then work hand in hand with the new anti-avoidance proposals. We also consider that the current proposals could act in a capricious way and restrict interest relief for genuine commercial borrowings in the UK.

13 Key policy recommendations

- It is still too early to form a judgment about the current proposals for reform of the taxation of foreign profits. Currently the proposals are at a high level but the success of the proposals will depend upon how the precise details are developed.
- The proposals on this important topic need to be developed further in consultation with stakeholders. We look forward to participating in those discussions.

- We have particular concerns about the proposals in relation to controlled companies and interest relief and think that these proposals need to be reconsidered.

SMALL BUSINESS TAXATION

Review of small business taxation

14 We have previously welcomed the proposals in relation to improving links with large businesses, such as those outlined in the Varney Review. It is clear that Government is listening to, and acting upon, the concerns expressed by large businesses. We think this approach needs to now be taken a stage further and applied across the board to all businesses. In particular, there is a pressing need to review the needs of smaller businesses.

15 We recognise that there have been number of consultations and discussion papers on small business taxation, but progress on bringing this work to a satisfactory conclusion appears to have stalled. The challenges facing small businesses on tax issues are many and appear to be increasing, and we think it is all the more important that work in this area is reinvigorated.

Influence of tax on the trading vehicle

16 We believe that small and growing businesses should choose their trading vehicle for appropriate business reasons and not be influenced by tax. We remain concerned that a number of policies in recent years have encouraged small businesses to incorporate. These policies have created a number of distortions and anomalies and added considerable complexity to the tax system. The ICAEW believes that tax policy should be designed to encourage small businesses to grow and succeed regardless of their precise legal form, and that the system should allow for flexibility as commercial conditions change.

17 Many of the issues facing small businesses centre around a lack of certainty and clarity. We remain particularly concerned about problems in those areas which are governed largely by interpretation expressed in HMRC guidance and case law. The distinction between employed and self employed workers, for example, lacks certainty but mistakes can be very expensive: the tax consequences of unravelling a misclassification are likely to be complex and costly.

Costs and complexity of taking on new staff

18 We remain particularly concerned that the costs of complexity are acting as a disincentive to small businesses who are considering taking on new staff. Employing staff for the first time is one of the greatest administrative hurdles that businesses face, particularly where the employees will be paid above the PAYE/NIC thresholds. We think that these complexities are acting as a barrier to growth and that they need to be reduced, although we appreciate that there are many difficult policy issues that need to be addressed.

19 For example, the 21st century employment market is characterised by many people mixing employment and self employment, whilst others have multiple employments. These developments have put considerable strain on the PAYE system, which was introduced in the 1940s when most workers had only one employment. We think that there is a need to consider whether current working practices need new solutions.

Managed service companies

20 The Managed Service Companies (MSC) legislation, announced in the 2006 Pre Budget Report and now enacted in Finance Act 2007, is another illustration of the

difficulties produced in seeking to tackle some of these fundamental issues. We understand and have supported the underlying policy intentions of Government to tackle abuse in this area, but the fact remains that legislation such as this is used as a sticking plaster to patch over some of the problems rather than address some of the underlying causes.

21 A feature of the MSC rules is that the legislation is widely targeted and uncertain in scope and, in order for the legislation to work as intended, HMRC has had to publish lengthy guidance on how it plans to apply the law in practice. This is an increasingly common feature of the UK tax system, another recent example being the targeted anti-avoidance rule for capital gains tax in s 27, FA 2007. We think it is wrong in principle that HMRC has to make use of guidance in order to make up for underlying problems and uncertainty in the legislation. HMRC guidance has no legal force, can change without notice or warning, and is contrary to the principle that taxes and other legislative burdens should not be applied by legislation and dis-applied by guidance and concession.

Jones v Garnett

22 We also note the Ministerial statement published on 26 July 2007 in response to the House of Lords decision on 25 July 2007 in favour of the taxpayers in *Jones v Garnett* [2007] UKHL 35. Whilst we acknowledge that Government is free to make policy changes in this area if it deems it necessary, the policy options require careful consideration and we think it is vital that the Government consults fully and openly before introducing any changes in this field. We have consistently noted that small business taxation has suffered too much from 'short-term fixes' in recent years and a more thorough, considered review would be a better way forward.

Capital allowances for small businesses

23 The small business review also needs to consider the impact of the changes to the capital allowances regime announced in the 2007 Budget and partially enacted in Finance Act 2007. Whilst we understand that the 2% reduction in the main rate of corporation tax is intended to compensate large businesses for the abolition of Industrial Buildings Allowances (IBAs) and Agricultural Buildings Allowances (ABAs), this reasoning does not apply to companies paying the small companies rate of corporation tax because this is being increased in one per cent stages over a three-year period.

24 We remain concerned about the financial impact of these changes on small businesses and think that for small businesses there is a case for 'grandfathering' expenditure they incurred on IBAs and ABAs prior to 22 March 2007. We understand that that 95% of the value of IBAs and ABAs is claimed by large business, so if grandfathering is restricted to small businesses we think that the cost would be reasonable. Further, we do not think that such businesses find the compliance costs of making these claims excessive.

25 We will be making separate representations to HM Treasury shortly on the new Capital Allowances proposals.

26 Key Policy Recommendations

- The Pre-Budget Report should include a number of policy proposals to tackle the costs of tax administration at the smaller end of the economy. These proposals should include the following measures.
- There should be a consultation on how the tax collection systems for income tax and National Insurance could be streamlined to take into account modern working practices.

- There should be a consultation on how micro businesses and individuals may operate a simpler and more straightforward system of dealing with the tax affairs of taking on their first employees, including temporary employees and those with several jobs.
- The tax system should encourage businesses to grow regardless of their precise legal form and it should also allow for flexibility so that businesses can adopt whatever structure is right for commercial reasons without facing punitive tax charges.
- There should be open and detailed consultation on any proposals brought forward following the Ministerial statement on the *Jones v Garnett decision*.
- We recommend that small businesses which had been claiming IBAs and ABAs prior to 22 March 2007 should be allowed to continue to claim relief until the property is sold or its tax life has expired.

27 These policies would help to reduce the regressive costs of tax compliance for small enterprises, help stimulate employment at the smaller end of the economy and generate growth.

TAX SIMPLIFICATION

28 There is a wide recognition that the UK's tax system has become too complicated. We welcome the fact that these concerns appear to be shared by Government. We recognise that the system must reflect the complexity of the environment in which it operates and that there are many reasons why the UK tax system has become very complex. However, we think that action needs to be taken to simplify the system.

29 We have said in the past that there should be a commitment to simplification and that it needs to be undertaken in consultation with stakeholders. There should be an overarching committee tasked with developing an action plan to deliver tax simplification and then implementing it. Many of the complexity issues have already been discussed above, particularly in relation to small business taxation.

30 We believe that the Tax Law Rewrite (TLR) project has succeeded in emphasising just how complicated the UK tax system has become. Whilst we have, and continue, to welcome the valuable work on this project, given the pressing need for simplification we think that the TLR project should now be expanded to embrace the wider simplification agenda. We would be interested in exploring further how this might be achieved.

31 Key Policy Recommendations

- The Government should make a formal commitment to tax simplification.
- A steering committee, composed of all stakeholders, should be established tasked with preparing a tax simplification action plan.
- Consideration should be given to expanding the current Tax Law Rewrite Project to embrace a wider simplification agenda.

HMRC POWERS

Aligning HMRC's powers

32 One of the main aims underlying the Powers Review is to align powers across taxes. We agree it makes sense to align rules where doing so would bring clarity, consistency, efficiency and reduce costs for taxpayers and HMRC. In general it makes sense for rules to be aligned, **unless** there is a reason why they should not be.

33 However, the existing powers were developed separately to suit particular taxes or specific situations. Where a new tax has been introduced, that has been done in the context that Parliament was aware of how existing taxes operated and took a positive decision that an existing method of operation was inappropriate for the new tax. Therefore, to consider if and how tax rules should be aligned, the starting point must be a comparison of the different rules, an assessment of the reason for each difference, and a judgement as to whether that reason is still justified.

34 Our concern is that the Powers Review often does not provide this detailed analysis but rather proposes a blanket alignment of rules irrespective of whether such an alignment would achieve the objectives and whether it might have any detrimental effect for taxpayers.

Legislation v guidance

35 We are concerned by the increasing tendency for tax legislation to be framed in terms of broad and wide-ranging powers, with HMRC providing assurances that these powers will only be used in certain ways or in certain circumstances, and that these limits will be set out in non-statutory guidance. We have referred to this issue already in paragraph 21 above.

36 In the Powers context this is seen in the new Finance Act 2007 regime set out in s 97 and Schedule 24 for penalties for non-compliance, where the detailed application of the regime to particular circumstances is to be prescribed in HMRC staff guidance. Further instances are in the proposals in recent consultation documents on compliance checks and on tax payments and debt, where HMRC is, for example, seeking a power to have access to private residences which are used for business, and a power to attach assets such as bank accounts in order to collect tax debts without the need for a court order.

37 Our concern is whether this approach produces a fair result for the taxpayer. This depends firstly upon the guidance being clear and fit for the purpose, and secondly on HMRC staff following it and, where they are required to exercise judgement, doing so competently. Without in any way intending to criticise HMRC staff, inevitably things will go wrong sometimes. A further concern is that if the limits on powers are contained in non-statutory guidance, they will not be readily accessible to taxpayers other than specialists.

38 We strongly believe that if statutory powers are to be subject to limits or conditions, then these safeguards should also be spelled out in statute. If it is unclear how a power might be used, it must be better to first decide on best practice, and then legislate for both the power and accompanying safeguards.

Safeguards and rights

39 We are pleased to note that the Powers Review acknowledges the need for HMRC powers to be balanced by suitable safeguards for taxpayers. However, there is little discussion of taxpayer' rights, which in our view is a different concept to safeguards. 'Rights' is a wider and more robust concept than 'safeguards'. A taxpayer has rights

as part of his or her relationship with the State, and independent of any relationship with HMRC.

40 There is a need for a taxpayers' Bill of Rights or Charter. The OECD recommended in 2003 that the revenue authorities of OECD member countries should have a Bill of Rights or Charter to safeguard the taxpayer. The UK is a strong supporter of the OECD and as part of this we think that the UK should now use this as an opportunity to act on the OECD's recommendation. We would prefer to see a Bill of Rights rather than a Charter, as it will have statutory authority as compared to a non-statutory charter.

41 Key Policy Recommendations

- The current review of powers needs to make the case as to why alignment is desirable and whether the proposals will achieve their objectives in ways that are not detrimental to taxpayers.
- We are concerned about enacting legislation that is far too widely targeted but which is then cut down in scope by HMRC guidance. Legislation should be properly targeted at the outset and should be subject to full consultation with stakeholders.
- The Government should commit to introducing a taxpayers' Bill of Rights within a reasonable timescale.

GREEN TAXES

42 We understand and support the Government efforts to improve the environment and reduce emissions. We agree that there is a need to change behaviour, although we believe tax is only one of a number of policy options available, other options including permit trading and regulation. As a general principle, we are not in favour of using the tax system to encourage behavioural changes.

43 We think from a public perception viewpoint a green tax should have two aims. It should be seeking to change behaviour **and** the money raised should be used to help reduce emissions further, for example by investment in research or new technology to curb emissions.

44 Further, any green tax measures should be simple and straightforward. A survey in June 2007 by PricewaterhouseCoopers showed that 98% of businesses agreed that it is important to take measures to reduce the environmental impact of industry. However, over half of these companies said they were not confident about making what will be long-term investment decisions based on the current environmental tax and regulatory structure.

45 We think that there is a need to review the current green tax strategy so that any measures are simply to understand, will demonstrably influence behaviour and that all of the tax raised, or a substantial proportion of it, is ring-fenced and ploughed back into reducing emissions still further, for example through investment in low emissions plant or through further research.

46 Key Policy Recommendation

- There is a need to review the green taxes strategy so as to ensure that any green tax meets the necessary criteria, namely that the tax makes a demonstrable change in behaviour, that all or a substantial part of the tax

raised is used to help reduce emissions, and that any green tax is simple and straightforward that does not impose burdens on business.

PRIVATE EQUITY

- 47 The tax treatment of private equity has been a particularly controversial issue this year. The issues that have been raised by, for example, the Treasury Committee inquiry emphasise that the issues are much wider than just the tax treatment. We understand and recognise that the Government is concerned about certain aspects of the current tax regime for private equity. However, the tax issues themselves also impact more widely on the UK tax system and any changes made in this area are likely to affect many other areas.
- 48 We therefore think it is important that the Government consults more widely on any proposed changes to the tax system in the light of the private equity debate. We would be delighted to be part of that consultation process.
- 49 Key Policy Recommendation
- The Government needs to consult widely with stakeholders before making any changes to the taxation rules that impact on private equity so as to ensure that any rules are properly targeted, proportionate and do not have unintended consequences elsewhere.

FURTHER CONTACT

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