ICAEW
REPRESENTATION 40/19

THE IMPACT OF BUSINESS RATES ON BUSINESS INQUIRY

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ICAEW welcomes the opportunity to comment on the impact of business rates on business inquiry published by Treasury Committee on 1 February 2019, a copy of which is available from this link.

Business property is an important source of revenue for the UK government. It supports the provision of local services. Yet the current system is complicated and unfair. It discourages productive business investment and holds back the economy. Action is urgently needed to address pressures in the system and ensure a sustainable basis for local finance. Government needs to ensure that the right incentives are in place to support business growth and the prosperity that generates across society. We make some suggestions in the pages that follow.

This response of 2 April 2019 has been prepared by ICAEW's Tax and Business and Management faculties. Internationally recognised as a source of expertise, the Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business.

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KEY POINTS

1. Public debate about the level of taxation on business is heavily focused on corporation tax. However, property tax – or business rates - accounts for a significant source of government income from business. It is now the third-largest tax borne by the largest businesses in the FTSE 100, yet remains largely unrelated to sales or profits. PwC's Total Tax Contribution survey of the 100 Group found that in 2017 business rates accounted for 19% of taxes paid by the FTSE 100.
2. Business rates are widely considered to be unfair, disproportionate and unproductive. We propose three measures for government to consider:
   - link rates more closely with market rents (para 18);
   - have more frequent revaluations (para 19); and
   - provide greater transparency, eg as to how valuations are arrived at (para 20).

Fairness

3. Business rates have been very successful at generating tax revenue, having outpaced wider economic growth over the past decade. This has been in part down to the pegging of rates to the RPI - a mechanism which has now been altered to the CPI. They have also grown with property development.
4. Proper consideration of the impact and fairness of business rates is now urgently needed. Although reliefs were introduced in 2016, particularly for the smallest businesses, for many other businesses business rates continue to be a growing burden. There are now significant concerns being raised.
5. Business rates are not distributed equally among businesses. They are paid predominantly by businesses that intensively use property, for example, in retail, hospitality or manufacturing. They do not scale with profitability or hardship. As a fixed cost, they become proportionately more onerous as profitability declines and can cause significant problems in an economic downturn. The stability of rates revenue through the cycle has clearly been attractive to government historically, but we suggest the committee consider whether this is sustainable with rates being a major business tax.
6. The current system is even unfair and unpredictable within a single business. Rateable values can be hard to estimate, can differ significantly as a percentage of turnover even between similar units, and can diverge materially from the rental actually paid. That makes the cost hard to forecast. Appeals can take a long time to conclude, tying up cash flow over this period.
7. The digital economy is steadily shifting value away from bricks and mortar and into the virtual space. This creates a two-pronged problem: threatening the revenue stream generated from business rates, and putting even greater pressure and responsibility on those paying them.
8. In some sectors, for example telecoms, there can be major differences in valuation techniques between infrastructure on the central list and that on local lists. That can lead to major differences in rates as a proportion of activity between entities in the same sector. It can act as a disincentive to productive activity, such as investment in key infrastructure.
9. The revaluation system can also produce winners and losers, even when there has been no underlying change in a business's operations or profitability. All of these problems can lead to inherently unfair results.

Reforming the System

10. Government has direct control over the policy levers affecting business rates, and therefore has the power to address the problems. Our 2018 thought leadership report, Business rates: maintain, demolish, rebuild or refurbish? examines the issues with the current system in more detail and considers some of the solutions that have been suggested. We attach a copy for the committee's reference. That report explores in detail the issues with business rates; our policy suggestions are set out in this written evidence, which proposes a framework that government might adopt in evaluating reform.

11. Business rates generated £29bn for the exchequer in 2016/17. Combined with council tax and stamp duty, property is the basis for a substantial element of government revenues; indeed the UK's reliance on property taxes is the highest in the OECD. Given this high figure, even a small proportion of revenues would be difficult to replace from other sources. Inevitably this is likely to mean that property taxes will remain at the heart of UK tax policy. Rates link local activity with revenues for local services, a historical link that is intuitively equitable. But this does not necessarily tie the UK to the inflexibility and economic disincentives that these taxes currently entail. Government can focus both on maximising the effectiveness of property taxes as a source of revenue and minimising the disincentives to business and economic growth that these taxes currently entail. On both counts the current system needs to be improved.

12. The issues with business rates are many, complex and politically charged. It is unrealistic to suggest there are simple solutions to them and, no doubt, the submissions received will contain a wealth of suggestions that the committee will need to consider and weigh up their relative merits. There are a number of reports in this area, which we suggest the committee seek out if they have not already been provided as evidence (our own thought leadership report includes useful links to a number of sources). These reports set out a number of elements of the system that could work better and which the committee should investigate.

13. It is inevitable that businesses will pay some tax as a result of their activities and that they will pay some taxes locally. It is not inevitable that paying tax disrupts and distracts management or that it acts as a disincentive to productive investment. Income taxes (including corporation tax) follow productive activity and the generation of profits, consumption taxes take a proportionate share of activity. Business rates do not work like that. They can turn a profitable opportunity into an unprofitable one – and mean that potentially productive activity is not pursued. They can turn a solvent business into an insolvent one. This problem has grown as rates have grown as a proportion of the economy. There are three major issues which might each be addressed by the government. These are set out below.

14. **Uncertain**: Rateable values are often inconsistent with the rent actually paid. That makes it very difficult for businesses to assess what their rates liability might be, particularly for new premises. They may be able to renegotiate rents with a landlord but there is no certainty whether or when this is then reflected in rates. Appeals are uncertain in success and timing and can be costly. Unfortunately, uncertainty has been compounded in recent years by the failure to deliver consistent revaluations.

15. **Disproportionate**: The mathematical 'gearing' described above means that as a fixed cost, business rates become proportionately greater for more marginal trading locations. In the most marginal they militate against businesses establishing or continuing and may prevent investments from being made. Equally, the levying of tax on fixtures and fittings makes the business case for investment in improvements or plant intensive businesses more difficult to make. Again this becomes more of an issue where the business case is marginal. In both

cases a more flexible system could encourage more economic activity (and potentially more tax).

16. **Unproductive**: Business rates retention was intended to give an incentive to local authorities to encourage and expedite development. These have been blunted by the tariffs and top-ups system as well as the failure to roll-out 100% rates retention, which reduce incentives in local authorities that might have the greatest development opportunities. It is clearly essential that government maintains an adequate funding formula to supplement the local authorities that need it, but they might examine whether this mechanism needs to be combined with incentives that would make the whole pie bigger.

17. On this basis we propose three measures for government to consider which are set out in the paragraphs below. In each of these areas it is important that policy decisions are based on empirical research. ICAEW is actively engaged with academic research and can help connect government with researchers in this area.

18. **Clearer link with rent**: Many of the problems business face with rates are linked to the lack of certainty around how much they need to pay, the complexity of calculating it, the unfairness where similar hereditaments pay disproportionate levels of rates, and the difficulty of appealing. These issues could be addressed if there was a clearer and more timely link between market rents and rates. As we set out in paragraph 19, technology should be able to enable this.

19. **More timely data**: Government consulted in 2016 on more delivering more frequent and regularly spaced revaluations and agreed then to conduct three yearly revaluations. It is important that this is carried out as planned. The summary of responses suggests that there was little support for the alternative options of self-assessment or a formula, with the former being onerous for business and the latter potentially unfair. We agree with this conclusion. However, over the medium term we believe that government must be able to do better than revaluations every three years. It was announced in 2016 that local authority business rate systems will be linked to HMRC digital tax accounts by 2022. By 2022 HMRC should have much better data capabilities as a result of the roll-out of digital tax systems. It should be possible to use these data capabilities to enable more timely maintenance of valuations, perhaps involving a degree of automation. The end objective should be to make it more certain what businesses will pay in relation to their rent.

20. **Greater transparency**: Better information about the calculation of rateable values could help make the system easier to navigate and fairer. The government could investigate whether the VOA might make available more comprehensive information about assessments, perhaps including a summary showing how a valuation was calculated. They might include with this information any evidence of market rents to support their assessment.

ANSWERS TO SPECIFIC QUESTIONS

The impact of changes in Business Rates policy since 2017 on businesses, in particular:

- ***the changes in reliefs and allowances;***
- ***the ability of businesses to pay;***
- ***the relationship between Business Rates and the behaviours it drives in business.***

21. See paragraphs 3 to 9.

How the current Business Rate system measures up against the pillars of good tax policy:

- ***fair;***
- ***supports growth and encourage competition;***
- ***provides certainty; and,***
- ***coherent.***

22. **Fair**: As we explain in paragraphs 3 to 9, business rates are not distributed evenly across the economy, in accordance with ability to pay or even equitably spread inside a sector or between different properties of a single business. They therefore score lowly for fairness. A core element of the system is its link between physical presence and consumption of local services. This is a fair principle. The solutions we explore below could make the system fairer while still maintaining the link to payment for local services.

23. **Supports growth and encourage competition**: The 2011 Mirrlees review concluded that business rates were economically sub-optimal as they acted as a disincentive to productive activity from happening in the first place. From an accounting perspective this is easy to illustrate; to invest in a project, businesses would typically look at whether the cash-flows generated would exceed the cost of investment. Business rates are a fixed cost and in some cases could make the difference between an acceptable and an unacceptable investment. Corporate taxes also reduce cash-flows, but only generally in proportion to profits, so are in effect a marginal cost.

24. **Provides certainty**: In theory business rates should score well on this pillar. Based on rental values they should be transparent both at a point in time and as the market moves. Unfortunately some of the strongest criticisms of the current system relate to its failure to deliver certainty. Partly this has been due historically to delays in revaluations. We welcome the steps government has already taken to more frequent revaluations. It is important that three yearly revaluations are delivered and sustained. But even at the point of valuation, the rateable value might not equate to the rent paid. Appeals are time consuming, costly and uncertain. New technology could enable the government to do better. Big data, better database connectivity and AI must all have the potential to make the valuations process more efficient and more responsive. The Netherlands have recently adopted annual valuations for all properties.

25. **Coherent**: The current system for property taxes is not coherent. We have repeatedly called for a comprehensive review of how property is taxed as well as the level of taxes borne by business. This has become more urgent as the proportion of business tax represented by property has grown. Clearly property will remain an attractive base for business and domestic taxation, but the interaction of incentives and disincentives within the tax system certainly needs attention. One example is the use of capital allowances to incentivize investment in plant while business rates act as a disincentive on those same investments. Another example is that while other taxes are designed to flex with activity to give a level of protection to businesses in a downturn, rates might act to hasten failure.

26. **Competitive**: In addition to the four pillars we suggest that competitiveness is also an issue. While competitiveness is more commonly associated with corporation tax, the digital economy means that businesses have greater flexibility around location. The high levels of property tax in the UK could act as a disincentive for businesses to develop a physical presence in the UK and thereby hinder growth as they look to invest elsewhere.

27. We make suggestions in paragraphs 18 to 20 that might help address these factors.

The economic justification for a property-based business tax:
The impact of Business Rates on rental prices

28. Both rent and rates are fixed costs that will be considered in assessing whether the returns on an investment in establishing, expanding or continuing with a business make it worthwhile. They both have to be paid and if in combination they are too high then a business cannot operate. But although in theory rates should merely mirror rents, in practice rents are more likely to be more responsive to local market conditions – subject to lease obligations and the credit risk of the lessee. Landlords will adjust rents in accordance with the lease terms, potentially annually and as and when vacancies occur. Rates increase annually but are also revalued periodically. As was seen in 2017 this can cause real problems. The step increase in rates in London, the South-East and other parts of the UK meant that the combined fixed cost base (including rent) for some businesses suddenly became too much for them to sustain. Equally in some areas lessees had been able to secure rent reductions due to local conditions but had to wait a long time before this was reflected in rates.
29. These are not the only issues. There are a number of reasons why rateable values might be out of kilter with rents or might not adjust on a timely basis. Rents are often not as simple as the headline lease amount. The economic return to the landlord is affected by factors such as: variability in collections over time, for example due to rent free periods; the aggregate amount paid by all tenants in the block; and service charges. The complexity and time taken to appeal make adjustments to reflect market rent difficult and costly.
30. This is a remarkable range of issues for something that should be straightforward. Tax is a cost of doing business. It does not need to be opaque or disruptive.

The impact of Business Rates on property prices

31. We do not have any evidence on this point.

Alternatives to property-based business taxes, ie. the proposed digital services tax

32. We welcome the inclusion of this point in the current inquiry. It appears that the OECD proposals for a digital tax have momentum behind them and the UK government has proposed its own digital services tax due to take effect from April 2020. The digital services tax is not an online sales tax, it is targeted at 'digital businesses that are considered to derive significant value from the participation of their users'. These taxes are aimed primarily at securing corporate tax revenues in relation to the creation of value not directly attributable to a permanent establishment due to the virtual nature of its activities. It is proposed that the UK digital services tax will have a high threshold - the business must generate more than £500 million in global annual revenues from in scope business activities and more than £25 million must be linked to the participation of UK users.
33. Clearly government has identified the digital services tax as a source of incremental revenues, but for the system to be fair the objectives and revenues for this tax need to be evaluated alongside the reform of business property taxes. Although we appreciate that the threshold for the UK digital services tax is high, nevertheless some retailers with an online and offline presence could be at risk of a double charge. That cannot be equitable.
34. One problem with the current business rates system is that it does not reflect profitability; it can therefore act as a disincentive for businesses to establish in marginal locations and might even precipitate business failure. These issues might be addressed if there was greater flexibility for businesses where rates are material to profitability. The government should be able to collect more information about business activity through its making tax digital programme and should therefore have greater capabilities to assess where in the

economy rates are a particular burden. In these areas it might even be possible to link some flexibility in rates to activity levels.

The problems associated with property-based business taxes

35. In paragraphs 14 to 16 we explain why we believe the current business rates system is uncertain, disproportionate and unproductive. We explain the problems this causes and suggest some areas that government focus on in resolving them.

The impact of changes (proposed and actual) of Business Rates on Local Authorities and Councils, and the High Street.

36. Businesses welcome the reliefs that government has provided since 2016, they have gone some way to slow the pace of increase in a tax that had grown inexorably up to that point. Nevertheless, they do not resolve the underlying issues with the system. We suggest that further reform is necessary. In considering what might be done government may wish to take account of the factors we set out in paragraphs 14 to 16.