



## **Budget 2006 Representations of the Chartered Institute of Taxation**

This year, instead of submitting detailed technical representations, the Chartered Institute of Taxation has decided to concentrate on three main areas of concern. These are areas which we see as fundamental in our continuing relationship with HMRC, and we regard them as important enough to isolate in this way, possibly to the detriment of other areas on which we might have wished to make detailed representations. We would welcome the opportunity to discuss these areas of concern.

### **Consulting and listening**

We would like to congratulate HMRC on the quality of their consultation process relating to the new pensions simplification regime. We have found this responsive, with the Government side prepared to listen and willing to make changes in response to what they have heard. Where this has not been possible, we have understood the reasons why.

In contrast, we might refer to tax credits. The recent parliamentary statements, the many written questions and the Government debates on tax credits have all led us to look back at comments we have made as the tax credits consultation process has progressed. Our files on tax credit consultations are thick (!), but we have gone back to comments we have made as long ago as July 2001 and the first consultation document "Supporting families, making work pay and tackling poverty", running up to more recent comments on forms, newsletters and guidance in 2004 and overpayments in 2005. Recurring themes, which seem to presage recent issues, are concerns about:

- the practical effects of the new system;
- complexity;
- the ability of HMRC satisfactorily to deliver this major change within a relatively short time frame;
- communications to claimants on overpayments; and
- the cause and recovery of overpayments.

By way of evidence, we attach an Appendix that contains extracts from some of our older comments and some of the (former) Inland Revenue's responses (Appendix A). More recent comments (summarised in the combined tax credits co-ordinating group's Issues Log) are more readily called to mind, and so are not included.

We think the contrast between these two consultation processes (and we could cite others on both sides of the divide, as evidenced by our research project in 2003), both on matters affecting millions of taxpayers, highlights the need for HMRC to review the way in which they consult outside bodies and the way in which they train staff to initiate and carry forward consultations generally. It is also causing us to review the time and effort we put into consultations with our limited resources. We see little benefit in continuing consultations where the consultees are not listened to or where the consultations are self-evidently 'window dressing'.

### **International competitiveness**

The UK has been a relatively favourable European country in which to do business in recent times, thanks to its framework of laws and its relatively business-friendly economic policies. As far as tax is concerned, the restrictions on double taxation relief in FA 2000 have tended to undermine the UK's competitive position, but the introduction of the relief for substantial shareholdings in 2002 has improved it.

We believe that there is a real danger that the UK's competitive position is being further undermined by a flood of complex, ill thought out tax legislation that purports to counteract tax avoidance but, in practice, will go much further than that.

For example, no other European country has all of the following:

- a disclosure regime;
- general anti-arbitrage legislation; and
- a plethora of mini-GAARs.

We believe it would be useful to carry out a detailed review of the tax systems of other developed countries to determine, as objectively as possible, the UK's competitive position.

We have commented in previous years on the way in which poorly drafted tax legislation is rushed through Parliament with little or no scrutiny. This year's first Finance Act was an extreme example (we accept that the second Act has been better but the process has still been far from ideal).

For example, the boundary between debt and equity has been adjusted asymmetrically with no proper review of the distinction between the two. The issue was given 'some' thought in 1996, but was put in the 'too difficult' box. Such a fundamental change should have been based on a thorough review of the financial structures currently adopted by companies and groups, followed by proper consultation. That review and consultation are now overdue.

The arbitrage rules give the impression that the UK is seizing the opportunity to collect additional tax where the rules of another jurisdiction appear to give some relief or advantage which the UK Government conveniently describes as avoidance.

There needs to be an exclusion for inbound investment.

There should also be a statutory clearance procedure.

Changes affecting private equity structures are likely to cause investments to migrate out of the UK. The Government should now undertake the consultation that should have preceded any change in the law.

There needs to be a thorough review of this complex legislation, so that correcting amendments can be made in the 2006 Finance Bill. There should also be proper consultation on any further changes to the structure of the tax system before such changes appear in a Finance Bill. A copy of our representations on the relevant provisions of the May 2005 Finance Bill is attached as Appendix B.

Generally, the Government seems keen to apply the label 'avoidance' to any measure it wishes to force through regardless of its merit, and the label 'evader' to anyone opposing it. There is a fundamental lack of clarity, in many areas, as to the economic transactions that the Government wishes to tax, and wishes not to tax. In the absence of such clarity, taxpayers cannot know whether HMRC will see their behaviour as acceptable or not. In the circumstances, we can understand why objective bystanders obtain the impression that the Government would like to have complete discretion over how much tax a particular individual or company should pay. Comments about paying the 'right' or 'proper' amount of tax create the impression of arbitrariness, and do nothing to improve the confidence of overseas investors in the UK's tax system and tax authority, nor does the attachment of the 'avoidance' label to transactions that do not amount to avoidance.

It is understood that the Government is reconsidering the imposition of a General Anti-Avoidance Rule (GAAR). For the reasons advanced when this was last considered, we think it is inappropriate. We would add the further reason that there is no common understanding of what is, and what is not, avoidance – as evidenced by recent tax changes and recent Ministerial and other comments. Further comments are set out below.

Finally, the Government needs to make further efforts to secure the compliance of the UK's tax system with the EC Treaty. For example:

1. Amendments to the group relief legislation would appear to be required, assuming that the ECJ follows the Advocate General's Opinion in the *Marks & Spencer* case.
2. Moreover, we continue to believe that the exclusion of the Irish Republic from the Excluded Countries lists in the CFC legislation is contrary to the Treaty.

## **GAAR Issues**

The case for a GAAR in the UK was considered at length in the late 1990s. The conclusion reached was to reject a GAAR, because of both the uncertainty that it would introduce into the tax system and the resources that would be needed within the tax authorities to make the necessary clearance mechanism run efficiently.

In raising this issue, we are not calling for a GAAR. However, we do have to question whether recent and current developments of the UK's tax system are pointing in this direction almost on a back-door basis. Reviewing 2005's Finance Bills, with their understandable volume of anti-avoidance legislation, does seem to show that that legislation splits into two distinct categories:

1. Carefully targeted anti-avoidance measures, blocking particular schemes or loopholes – for example for measures on CFCs, DTR and Options.
2. Wide-ranging measures that seem to attack particular areas and have overtones of 'mini-GAARs' – for example, the measures on arbitrage, shares treated as loan relationships and aspects of the employee securities measures.

The concern with the latter type of changes is their wide-ranging nature. Whilst it is understandable that the Government wishes to take action across a broad area, the result is legislation that lacks clarity, direction and proper safeguards. It is notable that in the Finance Bill debates there were regular calls for clearance mechanisms. They were rejected by Ministers on the basis that such mechanisms were unnecessary as the target of the measures was clear. However, the very fact that there were such repeated calls does suggest that to most professional commentators the measures are not well targeted and their ambit is uncertain. It seems we are heading for a system where the authorities have areas where they have the benefits of a GAAR on their side without the necessity of supporting the taxpayer and adviser appropriately.

We think it is appropriate to have a discussion on the direction of development of the tax law in this country. All parties involved must surely acknowledge that the ever-growing accretion of tax law is not sustainable; there is a need to manage the process more efficiently, in a way that could lead to provisions being retired rather than continually built on. We would refer to our recent paper 'Taxed by Law: untaxed by concession' in this respect (added as Appendix C to this submission for ease of reference).

In this context it is perhaps worth pointing to the plans of the Tax Law Rewrite Project to start work on corporation tax. Should this be a catalyst for a review of the way tax law is framed before the existing law is simply rewritten?

The Chartered Institute of Taxation  
14 July 2005

**Appendix A****Extract of some CIOT comments and Inland Revenue responses (when given) on tax credits****Introduction to the response to the New Tax Credits Consultative Document, July 2001, 'Supporting families, making work pay and tackling poverty'**

"The CIOT is glad to be able to respond to this document and contribute to the debate on the operation of New Tax Credits. We recognise this as a fundamental change in the UK personal tax system, affecting many taxpayers including those not currently affected by 'old' working families type tax credits. It is difficult to be certain of the depth of the change as this consultation document does not contain any details of rates and thresholds. We look forward to the publication of rates and thresholds as soon as possible and suggest that further consultation may then be appropriate.

"We are concerned that the many practical effects of the new system have not been fully dealt with and our detailed response seeks to highlight these rather than to comment on the policies behind the rules. However, it is our view that while the proposed tax credits would work in a perfect world where people have stable relationships and are open and honest about their income and assets, in the real world the proposals could involve enormous administrative cost, invite fraud, discourage marriage and disincentivise second earners from entering the labour market. We think more work is necessary to address these issues.

"We are also very concerned about complexity, particularly for this lower income sector of society. An alternative would be a much simpler system of higher personal allowances, including reliefs for those with children, based on the tax system. Under this system people would retain more of their own earnings rather than giving with one hand and receiving with the other. Those who had no income or whose gross earnings were inadequate would be fewer in number and could be dealt with separately, thus minimising the number of people for whom means-tested complexity would be required. The administrative savings together with adjustments to tax bands would help to cover the costs of giving the higher personal allowances to a wider population. We realise that more detailed work would be necessary to consider all the ramifications of raising the tax-free threshold but we think this would be time well spent. At present the Government is imposing a minimum wage, then recovering part of it in taxes and national insurance, and then returning it in the form of credits. This seems a nonsense.

"Having said this, we realise that some policy decisions have already been made, and thus in discussing the document we have only commented on policy where it seems to us that the logic supporting it is questionable or where it seems manifestly unfair.

"Our other area of general concern is the time limit for introducing the credits. We are under the impression that the various sections of the new amalgamated Inland Revenue are not yet in the position where they can adequately link their administrative systems and 'talk' to one another. To make these new tax credits work and to supply the necessary 'customer services' to the claimants we think more progress is needed in this area.

“We also understand that in order to meet the deadline of 6 April 2003 legislation will be prepared in draft this autumn. If this is the case, this timescale leaves no time for you to consider the many points raised through this extensive consultation process. It would thus become a mere paper exercise for those of us who have contributed time and resources to making comments with an expectation that they will be considered and if appropriate taken into account. We should be grateful for assurances that our concerns in this area are unfounded. In summary we thus do not see 6 April 2003 as a feasible operative date and suggest that the credits should not actually go on-line until 6 April 2004.

“Before looking at the specific paragraphs of the consultation document we should like to make some comments on what we see as the five big themes:

1. The unit of assessment
2. The period of assessment
3. Alignment and integration with tax (and National Insurance)
4. Marginal tax rates and work incentives
5. Administrative ease”.

*We received no response to this paper.*

**Comments on the Tax Credits (Income Thresholds and Determinations of Rates) Regulations 2002 sent to the Tax Credits Policy team 26 July 2002 prior to the House of Commons debate on various tax credit regulations**

“This is the first version of these regulations and we think it is a great pity that they have not been the subject of any consultation. Our main concern (apart from their complexity) is how the computational aspects of Regulations 7 and 8 will work in practice. Both these regulations take the income of a tax year and, if necessary, split that income on a time basis. Whilst this is simple it is going to produce a lot of unfairness and some strange results at year ends if a claimant’s circumstances change on any date other than 6 April.

“Take the example of a couple where one party is working 16 hours and only earning £10,000 a year. They have one child. Their yearly entitlement to tax credits is as follows:

Basic element	1,525
Couples element	1,500
Family element	545
Child element	1,445
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Max credits	5,015

“Their income exceeds the threshold (£5,060) by £4,940 so their credits are reduced by 37% of this figure, £1,829. Net payable credits £3,186.

“If the other member of the couple gets a job, say on 5 October, and starts to earn say £30,000, the joint income of the couple for the tax year becomes £25,000 (30,000 x 6/12 plus 10,000) and the couple will lose entitlement to all credits except the family element of £545. But for the first six months of the tax year their income was only £5,000 (10,000 x 6/12) and they would have been paid credits of £1,593 (3,186 x 6/12).

“When they get sent their end of year notice under section 17 of the Tax Credits Act, because their total income for the year is averaged out, they will be notified of an overpayment of credits of at least £1,320 (1,593 less half the family element, £273, which remains payable).

“These credits are only recoverable because of the averaging of the income over the year. If the calculations were done on an actual basis, they would show that they were still entitled to the £1,593 whilst their income was £5,000 (10,000 x 6/12) and then only £273 for the remaining six months of the year when their income was £20,000 (10,000 x 6/12 plus 30,000 x 6/12).

**“Apart from the fact that this appears manifestly unfair claimants are not going to realise that getting a job part way through the tax year can result in the recovery of tax credits for a period when their income was low.**

“There are similar problems for people moving from larger incomes to smaller ones during a tax year when the averaging rule will mean that they will not be entitled to credits until after 5 April (see example 2 below). This is not a responsive system.”

*We highlighted these anomalies in a letter to Maeve Sherlock at the Treasury on 20 February 2003, when we were appealing for a reconsideration of the three month rule and the annual measure of income as it produced the need for protective claims. She replied in general terms on 26 March 2003 saying no change was possible.*

**Extract from a letter commenting on a draft of the WTC2 Guide to Tax Credits sent in November 2002**

“Also we note whilst there are two examples of material changes in income (6 and 8) both of these claimants conveniently take on their new jobs at the start of the tax year so there is no illustration of the anomalies we have highlighted previously where there are substantial changes of income in-year. Since the latter are going to be the more likely occurrence we think examples like these should be included.”

*There are still no examples in the WTC2 showing the effects of an in-year income change with the possibility of an overpayment arising.*

**Extract from comments on the Spring 2004 edition of Tax Credit Update sent in January 2004 and the leaflet TC820**

“We have done our best to provide you with some comments on this draft (we hope it is a draft and can be changed - it looks to be in a very final form). But we have to say that this type of consultation is actually worse than no consultation. Monday was the first day most recipients were likely to see the draft of the leaflet and you requested comments within the next 48 hours! The flyer came later, giving less than 48 hours, and this is without taking into account the time needed to circulate the papers within organisations. This is also, of course, the time of year when tax advisers are most busy, dealing with clients' tax returns.

“It does appear to us that earlier drafts must have been available and since you specifically said at the consultation meeting last October that you would consult on this newsletter in the future and consider how ‘future versions of this product could be improved’ we find all of this most frustrating.

“The comments we can make in the time available are:

1. We were most surprised to see no reference to under or over-payments in the ‘What happens next’ Table and were relieved to discover that this is covered by the flyer. We think, however, that some mention of under and over-payments needs to be in the Table on page 2. This could be done by extending the sentence ‘We’ll send you a statement to finalise your 2003/04 award, which will tell you whether the amount we paid you during the year was correct’ (part 5).
2. We were also surprised to find that none of the examples had an overpayment. Surely this will not be that uncommon? Examples, which tell claimants that they will get a notice telling them that they have received the correct amount of credits, are hardly illuminating.

“We are concerned that we are still not getting the message across that initial tax credit awards are always provisional because they are based on last year’s income. Your bullet points in the flyer are interesting in this context. What exactly do you mean by “Your initial award was not based on the right information”? If it was based on the circumstances at the time of claim, these circumstances had not changed, and the figure given for 2001/02 income was correct, then there is nothing wrong with this information - but there may still be an overpayment due to a rise in income of more than £2,500.

In the first bullet point on the flyer you say that the overpayment may have arisen ‘because there was a delay before we knew about, or processed, a change in your income’ but, of course, for many people they could not have told you their 2003/04 income, even if they wanted to (and they are not obliged to do so). Even if they could predict their 2003/04 income with confidence, and they had told you in say September 2003 and you processed the information right away they could still be in an overpayment situation because the new income affects the credits for the whole year, not just those payable from the date they notified you of the income change.

”We think your communication on income changes and the move from previous year to current year is inadequate for people to understand why they are in overpayment situations.

”Would it not be possible to explain that the 2004/05 awards to which you refer in this Update will be (as 2003/04 awards initially were) provisional payments based on the prior year’s income? You repeatedly refer to the ‘amount due to you for 2004/05’ but this is only the amount initially due.”

*The TC820 was amended, but mostly by being considerably shortened. As finally issued it was silent on how overpayments might have arisen. The Tax Credit Update was only amended in minor ways and still did not carry examples of overpayments.*

#### **Comments sent in March 2004 in response to the latest version of the award notice notes**

“But the main issue with these Notes is the continuing theme that people who notify ‘changes’ in good time will thereby avoid overpayments. For example, on page 5:

”Tell us straight away about a change which might reduce the amount of your tax credits, because any reduction will apply from the date of the change – not the date you tell us about it – and you will have to pay back any tax credits you have been overpaid.’

”This is simply not true of income changes, they apply from the beginning of the tax year. Likewise, and more especially, on page 10:

“If you expect your income to rise above the higher figure shown on your award notice, tell us **immediately** so that we can adjust your tax credits award. Otherwise, you may receive too much tax credit and have to pay it back when we check your award at the end of the tax year.”

”For many income changes, even if you notified immediately you would still have an overpayment and, for some, this cannot be recovered in year – see the last example in our guidance to members on protective claims published in April last year, <http://www.tax.org.uk/attach.pl/1733/483/Lathwood.pdf>, with amendment at <http://www.tax.org.uk/showarticle.pl?n=&id=1791>.”

*The Inland Revenue response in June 2004 was:*

*“I understand the point that you make and that has been well made by you and others at Consultative Group meetings. In-year changes in income will work back across the whole year and, in some cases, say where one partner returns to work, they may end up having to payback tax credits that were paid earlier in the year on the basis that they would be getting much less income for the year as a whole. But from a plain message perspective, I think that our primary objective is simply to encourage customers to let us know about changes at the earliest opportunity so that their TC award can be got right at the earliest opportunity.”*

In 2005, as the Government’s statistics show, we now have lots of people left with overpayments without an adequate explanation as to why.

## **Appendix B**

### **Extract from May 2005 Finance Bill representations**

#### **Avoidance involving tax arbitrage (Clauses 24 – 31)**

We are pleased to note that some account has been taken of the comments raised in response to the original proposals. However, we do have some remaining concerns.

##### *Purpose of the legislation*

HMRC have stated orally that the purpose of the legislation is to counteract contrived schemes, but the legislation is not drafted on that basis.

For example, the provisions on hybrids do not link the tax advantage to the hybrid, but assume that any structure involving a hybrid is caught. Para 19 of the revised guidance notes says that the comparator should be equivalent arrangements that do not make use of hybrids. For example, in Example One of the revised guidance notes, HMRC, in considering whether Condition C is satisfied, begin by saying that this depends on the facts and circumstances, but end by saying that it is “therefore” satisfied, without considering the facts and circumstances. A similar situation arises with Example two, where HMRC say that “the investment could have been made by a simple loan ...” therefore Condition C is satisfied, again without considering the facts and circumstances. We believe that this interpretation is unduly restrictive and is likely to be challenged in the courts.

We believe that further work needs to be done on the guidance notes to ensure that genuine commercial arrangements are not caught by the new legislation. We would be happy to take part in any consultation on this matter.

Generally, we think that where there is a difference in the treatment of a payment and the corresponding receipt in different tax jurisdictions, it should not be assumed automatically that it is the UK's tax system that is wrong, rather than the other tax system. This is particularly relevant in the context of the EU. For example, if the tax system of a Member State includes a relief or election, and the result of claiming that relief or making the election is that HMRC seek to collect further tax in the UK under the new anti-avoidance legislation, that would be a breach of Art 43 of the EC Treaty (freedom of establishment) – see, for example, the decision of the ECJ in the case of *Inspire Art Ltd* (Case C-167/01).

It should be borne in mind that that the existing thin capitalisation rules and the unallowable purposes rule have to be applied: the new legislation sets up an additional test. Where financial restructuring is cleared under the thin capitalisation rules and the unallowable purposes rule, why should it be subject to an additional test?

##### *Inbound investment*

We remain of the view that inbound investment should not be targeted by the new legislation. The offshore lender's arrangements should not concern HMRC.

#### **Clearance procedures**

The wording of the proposed new legislation is modelled on ICTA 1988 s703. In effect, we will have a series of mini-GAARs with no statutory clearance mechanisms.

This situation is unsatisfactory. The undertaking to operate an informal clearance procedure helps, but is no substitute for a statutory procedure. Specifically, there is no appeal procedure.

### **Receipts cases: avoidance purpose**

We think that the provisions of Condition C in clause 24 should be repeated in clause 26. The provisions of clause 26(10) and (12) would then not be required.

#### *Notice powers*

We remain of the view that powers of this nature are by definition arbitrary and create uncertainty. Moreover, they do not fit with a self-assessment system.

Clause 28(1) appears to imply that if a return is submitted more than 90 days after the date of a notice, it *must* comply with the notice. There ought to be a statutory right of appeal in such circumstances. What is the position where the return does not comply with the notice because the company thinks that the conditions for the issue of the notice are not satisfied, and draws this to the attention of HMRC when submitting the return?

#### *Disclaimers under clause 25(14)*

Whilst addressing concerns as to the previous 'all or nothing' nature of any adjustment in practice, this provision, taken together with the informal clearance procedure and lack of an appeals mechanism, is likely to mean that large companies will be required to negotiate adjustments with HMRC, in conjunction with any discussions on thin capitalisation, s765 etc. This raises the fundamental issue that taxation should be rule-based and not discretionary, based on negotiations between taxpayers and HMRC.

### **SMEs**

We think that there should be an exemption from these rules for SMEs. Essentially, they are designed to achieve greater certainty for the fisc about its tax take at the expense of considerable uncertainty for corporates as to how the tax rules they have to operate under will actually work out for them in practice. Whatever arguments there may be about the right balance here as between the Government and large corporates, it seems completely inappropriate to apply this to SMEs.

#### *Drafting points*

For the avoidance of doubt, we think that the reference to "the scheme" in clause 24(4) and (5) should be to "the qualifying scheme".

In clause 26(12), if this provision remains (see above), the meaning of contribution to capital needs to be set out.

### **Qualifying scheme (Schedule 3)**

In para 3(1)(a), the reference to "any territory" should be a reference to any relevant territory. For this purpose a relevant territory is the territory of any entity that is a party to the transactions forming part of the scheme.

In para 3(1)(b), the reference to any territory should be a reference to the territory of any other person treated as having the profits of the entity.

In para 6(4), the reference is to TA 1988 s254 for a definition of security. Unfortunately, however, the definition in s254(1) is not a proper definition. Something more definitive is required.

In para 10(2)(a), does “ordinary shares” have the same meaning as ordinary share capital in TA 1988 s832? If not, what does it mean? Would it not be better to delete “ordinary” so that para 10(2) referred to shares that are fully paid up and satisfy (b) and (c)?

## **Avoidance involving financial arrangements (Schedule 7)**

### *Introduction*

In our view, the fundamental issue here (and behind previous anti-avoidance based on the “guaranteed return” concept), is that, despite toying with the idea of treating certain preference shares as loans in 1995, the Government opted to adopt a legal-form based definition of “loan relationships” in 1996, an approach which in the main it still retains, but has never been happy with the inevitable consequence that economically similar things can then happen with different fiscal results. The answer is to reconsider the basic approach, not to complicate the tax system with burdensome, complex and penal asymmetric provisions which threaten commercial as well as tax driven arrangements. The words of Lord Hoffman in a recent article seem apposite:

“It is not only literalism on the part of the judges which leads to what the Revenue regard as tax avoidance. There is also the way in which taxing statutes are often drafted. Judges sometimes draw a distinction between acceptable tax avoidance, like giving up smoking, and unacceptable tax avoidance, like schemes with platinum sponge. The difference, said Lord Templeman in *IRC v Challenge Corp Ltd.*, [FN32] lies in the fact that in one case the taxpayer actually reorders his affairs: he stops buying the taxed commodity, or he receives less income or incurs more expense. In the other case, the taxpayer still buys the taxed commodity or receives the same income, but structures the transaction to fall outside the taxing statute. This distinction is, if I may say so, based upon sound instinct, but it depends upon the assumption that Parliament imposes taxation by reference to economic and other events in the real world. If only this were true. But Parliament, for various reasons, sometimes leaves the taxpayer a choice of achieving the same economic result by two different methods, one of which may attract tax and the other not. [FN33] Worse still, Parliament may not be content to describe the economic event which should attract tax because it does not trust the courts to understand such a concept and apply it in a practical way. Instead, it enacts a mass of detailed rules which it is hoped will tie up the taxpayer in a net from which he cannot escape. But sometimes there are holes in the net and the courts find that they cannot plug them by appealing to the economic event which, at a higher level of generality, it appears that Parliament wished to tax. It is one thing to give the statute a purposive construction. It is another to rectify the terms of highly prescriptive legislation in order to include provisions which might have been included but are not actually there.” Source: B.T.R. 2005, 2, 197-206 British Tax Review Article TAX AVOIDANCE (section 205).

The question of assimilation of equity to debt should follow consultation and should be based on economic tests rather than random complexity based on perceived avoidance.

*Paragraph 9(3) and FA 1996 s91B*

These provisions, partly intended to counter perceived avoidance by financial institution groups, make a fundamental and asymmetric change to the UK tax code affecting all corporates.

The change, so far as it relates to financial institutions, could have been achieved by amendment to ICTA 1988 s95 along the lines of ICTA 1988 s798(5).

Instead, certain shares which are in economic substance similar to subordinated debt are assimilated to debt *and* in an asymmetric way, so that the holder is taxed on the income but the issuer does not obtain a deduction. Moreover, this is done on a retrospective basis while the exact parameters of the change are still subject to debate. This type of approach threatens the rule of law as the basis of taxation.

*Assimilation of Preference Shares to Debt*

This fundamental change was the subject of extensive debate during the consultative process leading up to the Finance Act 1996. At that time the decision was made not to proceed in this way.

Of course, at no point was it suggested that the system should be asymmetric.

Part of the rationale for not proceeding was the perceived difficulty in defining the line between debt and equity. The conditions set out in FA 1996 s91C are arbitrary at best, and are far more relevant to specific transactions the legislation is seeking to catch rather than an appropriate debt/equity test.

The assimilation of preference shares to debt without full consultation is completely inappropriate.

The drafting of s91C has been amended to address the concerns raised on the original draft that standard intra-group treasury companies would be caught – as the shares held in them would almost inevitably increase in value at an interest like rate given the nature of the underlying assets. This has been done by the incorporation into the definition of ‘good’ income producing assets of the items listed in FA 1996 Sch 10 para 8(2), which includes money placed at interest, etc.

Consider, however, a chain of companies A, B and C, where C is the treasury vehicle. The shares held by B in C are clearly excluded, but if B is simply a holding company with no other activity then there is nothing that excludes the shares in B held by A. The shares in C will increase as before at an interest-like rate because of the assets held by C, and so must the shares in B also. At this stage, therefore, the effect of the drafting change is simply to move the problem up a tier.

What is needed is a further exclusion in s91C(2) for shares in a company which is itself excluded by the provisions of s91C(1) – so that these shares would also be regarded as ‘income producing’.

*Asymmetric treatment*

The only possible justification for this is to counter avoidance on a well-targeted basis. Despite some improvements since the original Finance Bill, it is still rushed and potentially wide-ranging rather than well-targeted.

The legislation as a whole should be qualified by the limitation in s91D(3)(c). There is no reason why this legislation, which is expressed to be to counter avoidance, cannot be so qualified.

#### *Transactions affected*

The assets in s91C(2) should be extended to cover a wider class of securities. It creates uncertainty to regulate with retrospective effect (s 91C(3) and (4)).

Moreover, the reference in s91C(2)(d) to the list of assets in FA 1996 Sch 10 seems to us to be inappropriate. Schedule 10 Para 4 says that a UK corporate's investment in an offshore fund is to be treated as a loan relationship and subject to mark-to-market accounting if (broadly speaking) more than 60% of the fund's investments are (again broadly speaking) assets that would be taxed under the loan relationship or derivative contract rules if held by the corporate directly. The list of assets is contained in para 8(2) of schedule 10. This is a 'black list' in the sense that, if an asset is on the list, it is more likely that the corporate will be caught by the charge under para 4. However, the list is not based on loan relationships and derivative contracts and similarly well-defined terms, but contains vague terms such as "money placed at interest" and "securities". However, a corporate could be on the safe side if it assumed a wide interpretation of those terms and eschewed investments in funds that might bring it within para 4.

It is now proposed to use the same list as a 'white list' in the context of s91C(2)(d). This means that if a corporate invests in shares that are potentially tainted by s91B, it helps avoid s91C condition 1 if the investee company has assets on the list. The list is still vague, but this time if its vague terms are interpreted too widely, the corporate will be caught.

Presumably, the policy intention here is that, if the company that issued the potentially tainted shares holds loan relationships and derivative contracts, then the income will be taxed under those rules at the level of that company. In the circumstances, there seems to be no reason to impose a charge under s91B at the level of the investor company. Therefore, we think that the exclusion should be based on the well-defined concepts of loan relationships and derivative contracts, rather than the more vague Schedule 10 list. Indeed, it might make sense to adopt the same approach with the Schedule 10 list itself, subject to further consultation.

#### *Retrospection*

Retrospection should not be a substitute for proper thought and consultation. The impact of this would, of course, be more properly targeted were (as suggested above) this provision to be qualified by the motive test.

Section 91E has been substantially extended since the first Finance Bill this year. The extension, relating to associated transactions (widely defined) which are not derivative contracts, should be made retrospective only to 26 May, not 16 March. Some of the EU and human rights issues that have been raised in relation to retrospection may be more acute in relation to this extension than they are more generally.

The scope of s91E is so wide that it could apply to a number of transactions in the field of Mergers and Acquisitions, and to general corporate activity. Again, this could be dealt with by a motive limitation similar to that in s91D(3)(c).

*Unallowable purposes*

One way to reduce the collateral damage on the innocent would be to extend the motive test in s91D (3)(c) to the whole of s91B, and arguably to s91A.

While the reason behind s91D(9) is clear (such groups are, after all, the target of the legislation), it is a very wide restriction. The motive test should be sufficient without excluding such groups.

The limitation on s91C is also welcome although you will note the comments made above.

*Summary*

The proposals in Schedule 7 para 10 amount to a fundamental change in the tax system by assimilating preference shares into the loan relationships rules, and by doing so asymmetrically as between the investor and the company. In our view, such a fundamental change, and such complex legislation, require proper consultation. The rules should balance predictability for the government against predictability for the taxpayer.

**Transfer pricing and loan relationships (Schedule 8)**

We think it is essential that HMRC should issue guidance on what constitutes acting together for the purposes of TA 1988 Sch 28AA new para 4A(1)(c). It should be borne in mind that the transfer pricing rules are operated by self-assessment, so taxpayers need an understanding of the rules so as to be able to make proper returns – and to have reasonable certainty when they do so.

*Private equity structures*

The changes being made to the thin capitalisation rules are intended to target private equity structures. We have two sets of concerns about this issue: firstly with the way in which this issue has been handled, and secondly, with the substance.

Firstly, on process, the structures used by the Private Equity industry were well known to the Inland Revenue, were based on the 1998 "agreement" with the Inland Revenue, and were operated on that basis for many years. At some point the Revenue appears to have decided that there was not a level playing field between corporate and financial buyers of businesses and that companies owned by private equity firms should pay more tax. At this point, the sensible thing to do would have been to engage the industry and other affected parties in consultation about the differences in treatment, and the reasons for them, to explore related issues (such as those raised below in relation to the substance of what is now intended), to establish if the reasons for the previous treatment were valid and if not, to determine the changes that needed to be made.

Instead, the debate began with accusations of 'avoidance', which seems wholly inappropriate, and has sent the debate off into a wholly unconstructive direction, with positions being taken about past agreements which have led to a judicial review case being taken. The reputation of the UK as welcoming to private equity has been damaged before any extra tax has been raised. There will always be trade-offs between immediate revenue collection and competitiveness but the terms of these trade-offs are worsened if issues not are discussed rationally and without accusation.

These concerns are heightened by the issue of timing of the new rules, where some people remain very concerned as to how practical the transitional arrangements are. How easy will it be to restructure arrangements? Moreover, the requirement that existing relationships should not be "varied" in the period up to April 2005 needs clarification. For example, what if the interest rate has to alter if the rest of the financing is being rearranged, or if interest rates change generally? Whatever the arguments on substance, this is a destructive way in which to approach possible change.

It would be preferable if the energies that are being devoted into confrontation could be directed to effective consultation. This should include the following points on the substance of what is proposed:

- The financing structures and objectives of financial and corporate buyers are fundamentally different. Corporate buyers normally make less use of leverage and use the entire group resources to support the acquisition, thus enabling such groups to borrow at lower rates.
- Experience of applying the equivalent legislation in the corporate market is that the negotiations with the Inland Revenue can take many years and be a costly process for both sides. The process is not well suited to a fast moving deal market, using significant amounts leverage and an array of highly complex financial instruments. We have concerns as to whether HMRC will be able to devote sufficient resources to this.
- A detailed review of European thin capitalization rules reveals that the application to private equity transactions is quite restricted. Therefore, the proposed new rules may put the UK at a disadvantage.
- Under the transfer pricing rules, there is provision for a "compensating adjustment" (Sch 28AA para 6). However, the way the Sch 8 provisions are framed, it is not entirely clear that a lender who does not actually participate in (ie have shares in) the company in question will be able to claim an adjustment.

## Appendix C

### TAXED BY LAW, UNTAXED BY CONCESSION

#### Introduction

This short paper is in the nature of a stocktake of the current state of the UK's tax law and practice. Its conclusion is that the position is unsatisfactory, and that there needs to be a commitment to improve matters.

The review is prompted by the increasing use of Notices and other Statements having the force of law, Extra-Statutory Concessions, Statements of Practice, Revenue Interpretations, Frequently Asked Questions (FAQs) and Answers, Guidance Notes and other material to deal with ambiguities and anomalies in the primary and secondary legislation. (It is notable that FAQs and Guidance Notes have proliferated in recent years.)

The CIOT believes that the current situation is unsatisfactory. We accept that it is useful (arguably it is essential, following the *Veltema* case) to know how the Revenue and Customs apply statutory rules in particular circumstances. To the extent that Revenue Interpretations and other guidance explain this, they are welcome. Certainly we would never suggest that the discussion and correspondence that led to many of these statements should cease. The problem is with the legislation and the process that has brought it about.

Where the law is unclear, ambiguous or anomalous, we think that the proper solution is that legislation corrects the position; it is unsatisfactory to have the tax authority effectively attempting to make the law by issuing (non-statutory) statements which tend to be applied as if they were law.

Because of the taxpayer's right to challenge any interpretation of the law before the Commissioners or in the Courts, it is in the nature of things that Revenue and Customs interpretations and guidance will generally have an ameliorating effect upon a strict interpretation of the law. It might appear anomalous to object to such amelioration, but it is unsatisfactory that law as enacted is impractical or unduly harsh, and that taxpayers are subject to the fiat of the tax authority, which may be altered without notice or reason, may be unenforceable, and is probably subject to a general caveat such as that it may not be applied in cases of tax avoidance. As concessions almost inevitably imply a reduction in tax, the determination of when this is to be treated by the tax authority as unacceptable avoidance, or simply not what the concession was intended for, is likely to be inconsistent. Any such uncertainty reduces the value of the interpretation.

We accept that the Tax Law Rewrite project has legislated a number of such statements. However, it is a long-term project. It has already been in progress for ten years, and is barely half-way through its programme. It has also identified anomalies that have been left in place. A further effort is required to deal with the present unsatisfactory situation.

#### The legislative process

There is growing concern about the way the UK's tax law is developing. It is becoming increasingly complex, for reasons summarised in a paper produced by the CIOT in 2000: 'Tackling complexity in the tax system' (a digest of which appears at <http://www.tax.org.uk/showarticle.pl?id=232&n=>).

The problem is aggravated by the fact that consultation with the representative bodies in advance about proposed new rules does not always take place. Such consultation would at least help the parliamentary draftsmen to understand more about the circumstances in which new legislation will fall to be applied, but even the Government's own code of conduct is not always followed. The CIOT has already produced a report on recent consultations: 'The good, the bad and the complex – a survey of tax consultations' (see <http://www.tax.org.uk/showarticle.pl?id=1348&n=>). That report illustrates the value of proper consultation, including the circulation of draft clauses for comment.

The draftsmen's difficulties are compounded by the fact that the government at times seems to give them inadequate time to draft rules with sufficient forethought as to how the rules will work in practice. Sometimes this problem becomes so acute that the legislation itself deals only with broad principles, leaving the real rules to be set out in Statutory Instruments. Indeed, even the SIs themselves do not always set out the rules with sufficient clarity and with sufficient detail.

The regulations on disclosure of tax avoidance schemes are an illustration of this. These regulations were amended within a matter of weeks after being laid before Parliament, and are supplemented by Revenue guidance notes, which effectively take on the status of tertiary legislation. (Though at the same time as objecting to this process, we would pay tribute to the willingness of the tax authorities to engage in constructive discussion aimed at improving the rules. We suspect that, in many ways, the tax authorities find the position as frustrating and unsatisfactory as does the profession.)

New legislation is frequently not properly debated in Parliament. For example, consideration of the 2003 Finance Bill was guillotined by the government. Moreover, the complex and, in places, illogical rules applying SDLT to partnerships were inserted into the 2004 Bill at report stage, leaving no time at all for scrutiny.

SIs are usually not scrutinised at all. The increasing use of SIs, coupled with the lack of scrutiny, could be seen as a technique used by the government effectively to bypass proper parliamentary scrutiny of new law. This subject is covered in some detail in the Statute Law Society's Annual Lecture, given on 16 May 2000 by Dr Philippa Tudor, Clerk to the House of Lords' Delegated Powers Committee.

Further difficulties may arise where new legislation is not drafted in the rewrite style. The problems of drafting in the old style are illustrated by FA 2003 Sch 22, on which we have made separate representations. Where necessary, therefore, draftsmen need instruction on the elements of the rewrite style (which we understand is now happening) and need to support the new style.

The result of all this is that anomalies appear in the legislation, sometimes only shortly after it has been enacted. Even with proper consultation and adequate time for drafting, some anomalies will inevitably appear, since it is impossible to foresee all the situations in which new legislation might be relevant.

### **Dealing with anomalies and uncertainties**

In the past, anomalies and uncertainties have been dealt with by:

- (a) introducing amending legislation or SIs - but at times, especially when any amendment would work in the taxpayer's favour, this is said to be

- “impossible” due to lack of space in the next Finance Bill (this despite the existence of 600-page Bills in recent years);
- (b) publishing a Statement of Practice, where the way in which a particular rule is to be applied in certain circumstances is not clear;
  - (c) publishing a concession, where legislation operates more harshly than was intended, or in circumstances that were not foreseen;
  - (d) publishing guidance notes or Frequently Asked Questions (FAQs) (an increasing feature recently); or
  - (e) being ignored.

Concessions can remain in existence for many years. They operate subject to the general caveat that the Revenue and Customs may refuse to operate a concession if it is being used for tax avoidance purposes, a practice upheld by the Court in the case of *R v Inspector of Taxes (ex parte Fulford Dobson)*, 60 TC 168. Reliance on concessions has presented problems for judges when cases have come before the courts. This is illustrated by the case of *R (on the application of Wilkinson) v IRC*, [2002] EWHC 182 (Admin), which we understand is to be heard by the House of Lords.

Some concessions are eventually legislated. Some capital gains tax concessions were legislated in FA 1996 s201, and some relating to employment matters in ITEPA 2003. Many other concessions remain. For example, recently the CIOT has drawn attention to anomalies in the definition of ‘associated companies’. They are only partially alleviated by Concession C9. Whilst recognising the existence of the anomalies, there seems to be a reluctance to legislate the concession and amend the definition further to deal with them. This is considered unsatisfactory in a self-assessment system.

The use of FAQs is in principle very helpful. They are flexible and can be added to (or changed) easily. They can be written in easy-to-follow style. However, they exemplify the problem with anomalies and uncertainties.

### **Problems with the position**

One concern with the poor quality of the legislation is the uncertainties it causes. Taxpayers crave certainty; if the law contains anomalies and difficulties, commercial transactions become more difficult to undertake.

The other major concern is that it puts the power into the hands of the tax authorities to decide, in effect, what the law really means and how it should operate. Whilst it is accepted that many of the curative actions are prompted by taxpayers and their advisers, the control is with the tax authorities without, in many cases, oversight from Parliament.

It must also be acknowledged that the problems are not solely with the taxpayer. It is presumably of concern to the government that such a major piece of anti-avoidance legislation as FA 2003 Sch 22 required so much explanation by way of FAQs, followed by amending legislation in FA 2004 and (probably) F(2)A2005. There is surely a commonality of interest between government and taxpayer for better quality of legislation.

### **Ways to a solution**

The first part of the solution is to recognise and accept there is a problem.

That should lead to a commitment to proper consultation and proper scrutiny by Parliament of the primary legislation. There needs to be a mechanism developed to scrutinise or review non-statutory material.

In an ideal world, there would always be proper consultation about proposed changes in the law, including adequate drafting time, consultation on draft clauses and proper scrutiny by Parliament. In practice, the prospects for this seem pretty remote. Therefore, a more satisfactory way of dealing with anomalies needs to be found, as it has to be accepted (by all sides) that these will arise. What is needed, in general terms, is a systematic review process for non-statutory material.

It would also be helpful if, when trying to solve an issue with the existing rules, there was greater consideration of the underlying problem. It may be preferable to improve the existing rules rather than overlay screeds of new legislation (eg non-corporate distribution rate, pre-owned assets).

### **Review of concessions**

At the time of writing, there are 115 Inland Revenue ESCs in operation:

- (a) 41 relating to individuals (the A series);
- (b) 20 relating to individuals and companies (the B series);
- (c) 14 relating to companies (the C series); and
- (d) 40 relating to capital gains (the D series), 3 of which relate to the now obsolete retirement relief.

These concessions need to be reviewed to see which relate to legislation that is still in force and to determine whether there is any reason in principle why they cannot be legislated.

### **Review of other anomalies**

Numerous anomalies have been identified, including some arising from the Tax Law Rewrite process. They need to be collected together and reviewed to see whether there is any reason in principle why they cannot be corrected by legislation.

It will be recalled, however, that the professional bodies have, from time to time, called for a special Bill to deal with anomalies, given the limited time available in the Finance Bill process. These calls have been conspicuously unsuccessful so far.

### **The use of tertiary legislation**

Certain VAT Notices issued by Customs & Excise have legal effect. Certain paragraphs from other Notices have legal effect. These collectively form an important body of tertiary legislation. Each of them is authorised by a statutory provision.

As far as the direct taxes are concerned, the Guidelines on the meaning of research and development, issued by the DTI, have legal effect (TA 1988 s837A), as do the Energy Technology lists (CAA 2001 s45A) and the European definition of SME for R&D purposes (FA 2000 Sch 20 para 2).

It is for consideration whether tertiary legislation is to be welcomed and developed. For example, should an ESC have the same legal effect as a VAT Notice that has legal effect? Should Revenue and Customs have power to issue such Notices in

relation to the direct taxes? Should the OECD's guidance on transfer pricing and the attribution of profits to PEs be regarded as tertiary legislation, for example?

The difficulty with such material is the lack of scrutiny it receives.

### **The use of FAQs**

As noted, these are useful, but should lead to a review of the legislation that has driven the need for what are effectively explanations.

### **The use of rulings**

The UK does not have a rulings culture. Such a procedure might be considered as a means of clarifying the operation of complex rules in particular circumstances (cf the procedure in the US). However, it is unsatisfactory as a means of making law and places burdens on the tax authorities. It needs to be recognised that it is a route that we may have to follow if tax law increases its uncertainties.

### **Conclusion**

The position is unsatisfactory, and getting worse as the volume of tax law increases. There is a need for commitment to improve the process of making tax law and, coupled with it, a commitment to a rolling review of non-statutory rules. An overriding principle should be that no tax rule change or interpretation that lays down how the law operates should take place without legislative scrutiny or prior consultation or, preferably, both.

The Chartered Institute of Taxation  
14 April 2005