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Select Committee on Economic Affairs

4th Report of Session 2006–07

The Finance Bill 2007

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CONTENTS

	<i>Paragraph</i>	<i>Page</i>
Abstract		5
Chapter 1: Introduction	1	7
Chapter 2: The Business Tax Reform Package	9	9
General description of the business tax reform package	9	9
Simplification	13	10
Review of the links with large businesses	23	12
Administrative costs	33	14
Small companies	41	15
Capital allowances	53	17
Tax Credits for Research and Development	65	19
Consultation	76	21
International competitiveness	85	22
Investment and innovation	92	23
Fairness	98	24
Chapter 3: Managed Service Companies	106	26
Background	106	26
Government Action	118	28
Is there an underlying problem not addressed by this legislation?	122	29
The need for the MSC legislation and its effectiveness	130	30
Impact on the Labour Market	142	32
Defining an MSC	148	33
Transfer of Debt Provisions	157	35
Chapter 4: Part 6 Finance Bill: Review of Powers, Deterrents and Safeguards	170	38
Background	170	38
Criminal Investigation: Outline of the legislation	177	39
Penalties for Incorrect Tax Returns: Outline of the legislation	178	39
The Evidence: General	179	39
The nature of the review	180	39
Is it right for powers and deterrents to be introduced before safeguards?	183	40
The consultation process	194	42
The balance between legislation and guidance	197	42
The Evidence: Criminal Investigation Powers	204	43
Exercise of the powers	205	43
Which HMRC officers can exercise these powers?	212	44
The powers for Scotland	219	45
Monitoring of how the powers are being exercised	223	46
The Evidence: Penalties for Errors	231	47
Definition of the categories of behaviour / Penalty levels	232	47
Appeal rights	242	49
Appeal procedures	247	49
Penalty position where agent acting	251	50
Drafting	257	51

Chapter 5: Part 6 Finance Bill: Online Filing and Electronic Payment	260	52
Background	260	52
Mandatory online filing	264	53
Mandatory electronic payment	277	55
Chapter 6: Conclusions and Recommendations	282	56
The Business Tax Reform Package	282	56
Managed Service Companies	304	59
Part 6 Finance Bill: Review of Powers, Deterrents and Safeguards	316	60
Part 6 Finance Bill: Online Filing and Electronic Payment	335	63
Appendix 1: The Finance Bill Sub-Committee		64
Appendix 2: List of Witnesses		65

NOTE: References in the text of the report are as follows:

(Q) refers to a question in oral evidence

(p) refers to a page of written evidence

The Report of the Committee is published in Volume I (HL Paper 121-I) and the Evidence is published in Volume II (HL Paper 121-II)

ABSTRACT

This report on the Finance Bill 2007 by a sub-committee of the House of Lords Select Committee on Economic Affairs is the fifth in a sequence which began with the Finance Bill 2003. Our terms of reference enable us to consider technical issues of tax administration, clarification and simplification, but not rates or incidence of tax.

We decided to focus on three topics: the business tax reform package, in the context of simplification; managed service companies (MSCs); and the measures in Part 6 of the Finance Bill which cover new criminal investigation powers, new civil penalties for errors in tax returns and online filing and electronic payment.

We chose business tax reform because much attention has been devoted to it, in the Budget and otherwise, and because this is an area in which tax simplification, one of our core interests, should, if achieved, reduce costs and help promote economic growth. MSCs are of interest because the existing rules relating to personal service companies were not fully effective: this led to further measures in the Finance Bill designed to tackle the significant loss of revenue from disguised employment. The Government's review of powers, deterrents and safeguards was launched in 2004 as the merger of the Inland Revenue and HM Customs & Excise approached. The first fruits of the review are the measures on criminal investigation powers and penalties for errors in tax returns in Finance Bill 2007 which might significantly affect the dealings of HM Revenue and Customs (HMRC) with taxpayers. The measures to promote online filing will affect the way in which taxpayers have to meet their taxation obligations.

Our private sector witnesses had mixed views about how far the business tax reform measures in the Finance Bill 2007 represented a simplification of the tax burden. We believe that more should be done. All those witnesses were well content with HMRC's progress towards implementation of its delivery plan for the recommendations in the Varney Review of how the needs of large business could be satisfied in the administration of the tax system. But fears were expressed that resource constraints could cause delays. We welcome HMRC's confidence that it can achieve both this plan and the programme to cut administrative costs. Small businesses need simplicity and certainty too and the ability to take commercial decisions without having regard to tax considerations: we recommend a review. We recommend a high priority for measures to increase the UK's international tax competitiveness; greater certainty over the taxation of businesses should also help here. The changes in the provisions for tax credits for R&D are comparatively small and overall we are not convinced that the business tax changes, in particular to capital allowances, will do much to meet the Government's aim of encouraging investment and innovation. We welcome HMRC's efforts to consult business about these and other issues and recommend wider consultation, including on the simplification of personal taxation which has been announced.

Most of our private sector witnesses saw the Government measures on MSCs as sticking plaster. We agree with them that the underlying structural issues need to be tackled and recommend a review to consider how far the differences in tax take between employment, self employment and working through a company could be reduced. Nevertheless, we also agree that meanwhile new legislation is needed to address the revenue loss flowing from the use of MSCs. However, we are not wholly convinced that it will be effective. Its operation will therefore merit close

scrutiny and other steps may need to be taken. We recommend close consultation with the private sector over accompanying guidance including on the definition of an MSC and on the debt transfer provisions, although the immediate step is for everyone to satisfy themselves that no further amendments to the legislation in the Finance Bill are necessary.

As regards the legislation coming from the review of powers, deterrents and safeguards, some of our private sector witnesses expressed concerns, which we shared, that the safeguards were being left behind. We therefore welcomed the publication during our inquiry of a consultative document on safeguards; as part of this we recommend consideration of a taxpayers' charter. We also recommend full consultation and the inclusion of as much as possible in legislation rather than guidance, particularly when important, serious issues such as powers and penalties are being considered. We welcome the assurances on the exercise by HMRC of the new criminal investigation powers and consider that monitoring of these will be vitally important. We recommend consideration of an annual report to Parliament on their exercise and of a standing committee of HMRC and the private sector to review how the powers are being exercised in practice and that the assurances currently being given are adhered to. On civil penalties for errors in tax returns, we note the general support from our private sector witnesses for the broad approach. We recommend the fullest consultation with the private sector to achieve the greatest clarity over how the penalty structure will apply to various categories of behaviour and the outcomes where an agent is involved. We recommend strengthened appeal rights.

Our private sector witnesses unanimously welcomed measures to promote online filing, but objected to compulsion. We agree and make recommendations accordingly. These witnesses were reassured on learning that bank giro cheques would still be an acceptable form of payment. We recommend however that payment by post should still be possible in particular cases.

The Finance Bill 2007

CHAPTER 1: INTRODUCTION

1. This is the fifth report in a series which began in 2003 when the House of Lords Select Committee on Economic Affairs first appointed a Sub-Committee to inquire into selected aspects of that year's Finance Bill. The Finance Bill Sub-Committee's inquiries address technical issues of tax administration, clarification and simplification rather than rates or incidence of tax.
2. Each year the Sub-Committee aims to publish its Report in time to enable Members of the House of Commons, if they so wish, to draw on its recommendations in moving amendments to the Bill at the Report Stage. The report should also inform the second reading debate of the Bill in the House of Lords.
3. As in previous years the Sub-Committee selected a few topics for close examination. If it chose to examine the whole Bill, its treatment of each topic could be only cursory. This year the Sub-Committee chose three topics which it considered of particular significance.
4. The business tax reform package contains significant reforms to the structure of the tax regime that applies to businesses. In looking primarily at the simplification provided by this package, the Sub-Committee also examined two major papers on the relationship of HM Revenue and Customs (HMRC) with business that were published at the time of the Budget: its plan for delivering the recommendations in Sir David Varney's Review of Links with Large Business and Progress towards reducing the administrative burdens on business.
5. The second topic was the compliance legislation designed to deal with the large increase in managed service companies—companies that provide labour services of workers. HMRC often finds it impracticable to apply the existing protective legislation to treat the income as employment income where appropriate.
6. The third topic consisted of the clutch of measures in Part 6 of the Finance Bill. These covered the review of powers, deterrents and safeguards and in particular the new criminal investigation powers which will apply to the new department formed from the merger of the Inland Revenue with HM Customs and Excise. The new civil penalty structure that will apply for errors in tax returns also formed part of the review and was examined. And finally the Sub-Committee inquired into the provisions that apply to online filing and electronic payment.
7. As in previous years, the Sub-Committee conducted its inquiry by taking written and oral evidence from leading professional and business organisations and from HM Treasury and HMRC. A list of those who have contributed to the inquiry in this way is given in Appendix 2: their evidence is in Volume II of this report. The Sub-Committee would like to thank all those who have contributed, often at short notice, to its work. Without their help this report could not have been written.

8. The Sub-Committee's findings about its three chosen topics are in Chapters 2 to 5 of this report (Chapter 4 covers powers and penalties and Chapter 5 online filing and electronic payment) and its conclusions are in Chapter 6.

CHAPTER 2: THE BUSINESS TAX REFORM PACKAGE

General description of the business tax reform package

9. In his Budget the Chancellor of the Exchequer announced significant reforms to the business tax system. According to Budget Note 02¹, the reforms were designed to achieve three main objectives:
 - enhancing the international competitiveness of UK based businesses;
 - encouraging growth, through investment and innovation;
 - ensuring fairness across the tax system.

10. The package contains both legislative changes and administrative reforms. Some of the legislative changes have immediate effect, while others will come into effect next year or later. The legislative changes contained in the Finance Bill are as follows:
 - clause 2 reduces the rate of corporation tax for the financial year 2008 to 28% (except for North Sea companies where the rate remains 30%);
 - clause 3 increases the small companies rate of corporation tax for the financial year 2007 to 20% (except for North Sea companies where the rate remains 19%);
 - clause 35 withdraws balancing adjustments and the recalculation of writing down allowances in respect of the industrial buildings allowance (IBA) and the agricultural buildings allowance (ABA);
 - clause 36 extends for a further year the increase to 50% in the first year allowance for expenditure on plant and machinery by small businesses;
 - clause 49 extends the definition of small or medium-sized enterprises (SMEs) for research and development (R&D) tax credits (so that a wider range of companies will qualify for the higher credit of 150% rather than the 125% for large companies).

11. The package also foreshadows much further legislation (on much of which there is to be consultation) most of which relates to capital allowances:
 - the small companies rate of corporation tax is to be further increased to 21% for 2008 and to 22% for 2009;
 - there will be only two rates of capital allowances. The allowances for plant and machinery will be reduced from 25% to 20%, while the allowances for long life assets (that is assets with an expected life of 25 years or more) will increase from 6% to 10%. Fixtures integral to a building, (e.g. lifts), will also qualify for the 10% rate;
 - industrial and agricultural buildings will cease to qualify for any allowances (currently 4% a year, they are to be reduced by 1% a year from 2008 and will be phased out by 2011);
 - there will be a new allowance, the Annual Investment Allowance (AIA), for all businesses, under which up to £50,000 expenditure on plant and

¹ Budget Note 02, paragraph 3

machinery (other than cars) will be written off immediately (subject to there being profits to cover);

- there will be enhanced capital allowances—at a rate yet to be announced—for energy and water efficient technology and for biofuels plant. These allowances will be payable to loss making companies;
 - the R&D tax credit for large companies is to be increased from 125% to 130% and for SMEs from 150% to 175% (subject to state aid clearance).
12. The legislative changes are accompanied by two major papers outlining changes in tax administration—in fact these incorporate a third paper; together, it is said, these will help to deliver significant improvements.
- Sir David Varney’s Review of Links with Large Businesses was published in November 2006². Its proposals were designed to deliver: earlier certainty about the tax treatment of transactions; a risk based approach to compliance; speedy resolution of issues; and clarity through effective consultation. On Budget day HM Revenue and Customs (HMRC) published its plan³ giving details of the progress already made and showing how it would be delivering on all the 14 proposals in the Review.
 - A paper on compliance risk management⁴ spells out how HMRC is seeking to implement two of the proposals of this review by assessing compliance risks and concentrating its compliance activities (including employer compliance reviews) on those large businesses where the risk appears highest. Low risk businesses will see fewer reviews and interventions with reduced compliance costs. High risk businesses will face at least annual reviews with increased emphasis on significant risks.
 - A paper on the progress being made towards the targets for reducing the administrative burden which HMRC places on businesses⁵. It relates to businesses generally, not only large ones, and in part is focussed on the construction industry.

Simplification

13. We sought views from our witnesses on the claim in the Economic and Fiscal Strategy Report⁶ that “The reforms announced in Budget 2007 represent a simplification of the underlying tax structure”. We received a mixed response, depending in part on whether the witness was considering only the changes in this year’s Finance Bill or looking at the package as a whole.
14. In response to the question how far the package delivered simplification, John Cullinane for the Chartered Institute of Taxation (CIOT) said “I think very much on the plus side, if you look forward to the time when all these reforms are worked through” (Q 136). He pointed in particular to areas in which business decisions would be driven more by commercial considerations, such as different categories of spending and investment, for a small business whether or not to incorporate, and in capital allowances. Tax

² Review of Links with Large Businesses. HMRC, November 2006.

³ Making a difference: delivering the review of links with large business. HMRC, March 2007.

⁴ HMRC approach to compliance risk management for large businesses. HMRC, March 2007.

⁵ Delivering a new relationship with business: Progress towards reducing the administrative burdens on business. HMRC, March 2007.

⁶ Economic and Fiscal Strategy Report, paragraph 3.36

simplification was not, he said, a one-year thing and we needed to take a long view. But he “would give credit for making a good move in the right direction” (Q 136).

15. Other witnesses took a less sanguine view, based on a shorter term perspective. Malcolm Gammie, for the Institute for Fiscal Studies (IFS), saw the main simplification in the removal of the IBA and ABA (Q 12). Ian McCafferty for the Confederation of British Industry (CBI) thought that the Bill offered “only what we would call a superficial element of simplification”. He also pointed to the abolition of the buildings allowances, but the further changes in capital allowances would, he said, add a modest complication to the system (Q 42).
16. Richard Baron for the Institute of Directors (IoD) similarly referred to the withdrawal of the buildings allowances, but he added that “the computations for them had got horribly complicated and it was time to do something”. Looking to the changes ahead he added “we do tend to see this as perhaps a broad trend towards simplification but with tweakings around the edges just to try to keep everyone happy” (Q 43).
17. Other witnesses were more negative. Ashley Greenbank for the Law Society of England and Wales (LS) said that “it is difficult to say that the changes are a simplification of the structure”, while Alan Barr for the Law Society of Scotland (LSS) said “We think that any claims to simplification that there have been over the last few years, perhaps particularly in relation to the business tax package, is a joke” (Q 92). The Association of Taxation Technicians (ATT) in its written evidence⁷ said that “these proposals do not give rise to much simplification of the tax system”.
18. Chas Roy-Chowdhury for the Association of Chartered and Certified Accountants (ACCA) said that “The business tax package specifically does not do anything very much for simplification”, while Frank Haskeew for the Institute of Chartered Accountants in England and Wales (ICAEW), endorsing that, added “What we are doing is probably replacing one lot of complexity with another lot of complexity so, overall, I do not think we see that there will be any change in the underlying complexity of the system” (Q 205). Chas Roy-Chowdhury also thought that simplification could not be achieved while there was so much new and complex legislation and added “I think the tax system itself needs to be made more transparent, it needs to be simplified, but after that we need a much steadier state” (Q 209).
19. In its written evidence⁸ the British Chambers of Commerce (BCC) said “The BCC does not believe the introduction of a Capital Allowance together with changes made to the main rate and small companies rate of corporation tax represents simplification”. It was concerned also that simplification of the tax regime must not undermine certainty for the business community, David Frost (BCC) adding “Clearly the view from the small business community is that they want much greater simplicity and streamlining” (Q 267).
20. In response Peter Curwen for HM Treasury (HMT) said that, within the package, simplification was a key element in encouraging investment and ensuring fairness. He pointed to the reforms to the capital allowances which were aimed at ensuring efficiency and simplicity and to the reduction in the

⁷ Memorandum of Evidence by the ATT (Volume II, p62).

⁸ Memorandum of Evidence by the BCC (Volume II, p96).

impact of tax as a factor in incorporation (Q 292). He added that simplification would be one of the key aspects in the consultation on the implementation of the annual investment allowance (Q 301).

21. **It is undeniable that the present tax system is highly complex. Simplification is essential if costs for businesses are to be reduced, greater certainty achieved, and the UK made more attractive to mobile international businesses.**
22. **We recommend that a more determined and consistent attempt at simplification be made. What we see in this Finance Bill is a very modest step and more could be done. This will necessarily take more than one year and will require a combination of administrative and legislative measures. There clearly may be a tension here with the desire for fairness: it will also be necessary not to open up scope for avoidance. But it should be possible to find a balance here if the work is well researched and subject to wide consultation.**

Review of the links with large businesses

23. As indicated in paragraph 12 above, in the course of his Budget last year, the Chancellor of the Exchequer asked Sir David Varney, at that time Chairman of HMRC, to work with business representatives to identify how the needs of large business could be better taken into account in the administration of the tax system. The report⁹, published in November 2006, was designed to deliver a modern, responsive tax administration and an improved relationship between business and HMRC built on greater trust and transparency.
24. The key recommendations of the review¹⁰ for HMRC were:
 - the introduction of an advance rulings system by the 2007 Pre-Budget Report;
 - extending the clearance process so that by the 2008 Budget businesses would get a view on tax consequences of significant commercial issues within 28 days;
 - implementing a risk-based approach to enquiries by the end of 2007;
 - a comprehensive approach by the end of 2007 to the settlement of transfer pricing enquiries within 18 months;
 - from Budget 2007 taking the business perspective into consideration in operational policy, legislation and administrative processes.

A Large Business Advisory Board, including senior business representatives, was to be established and HMRC was to publish a delivery plan by March 2007.

25. The intended outcomes were designed to improve the attractiveness of the UK business tax administrative environment with greater certainty, an efficient risk-based approach to dealing with tax matters, rapid resolution of issues, and clarity through effective consultation and dialogue.
26. HMRC published its delivery plan¹¹ on Budget Day and we asked our private sector witnesses for their views on the progress which had been made. The

⁹ Review of Links with Large Business.HMRC, November 2006

¹⁰ Pre-Budget Report December 2006, Box 3.6.

response from the large business organisations and those representing large businesses was unanimous. They were well content with the progress to date, but concerned that, given the cutbacks being made in the light of what we were told was a 5% real reduction in their budget, in practice HMRC might not have the necessary skilled staff to deliver the plan. There were also concerns for the impact on small businesses.

27. A typical example of the comments was that by Ian McCafferty (CBI) who said "... the intent and findings of the Varney review ... point in a very positive direction. Where we have worries is in the implementation, and the specific worry I have is that with the staff cuts now under way within HMRC as a result of the Gershon review ... we are slightly concerned whether the resources, the staffing resources in particular, would be available to deliver the sort of changes that Varney in particular has suggested" (Q 45).
28. Similarly Frank Haskew (ICAEW) said "All the recommendations that the Varney review have made are things we welcome and, in principle, if they were all introduced we think they would be a major step forward in encouraging transparency, trust and dialogue between HMRC and large businesses. HMRC have set themselves a very ambitious agenda ... but we have to recognise that they have got to do this within their existing resources and, on the face of it, it is going to be a tall order to do so when they are under budgetary constraints where there is a five per cent real reduction in their budget going forward" (Q 207).
29. Certainty for businesses was seen as a major prize. For the LS, Ashley Greenbank said "We are particularly interested in advance rulings and the extension of clearance procedures which could deliver an awful lot more certainty for businesses which, more than simplification, is I suspect what businesses want out of this: clarification and certainty of their tax position. An advance ruling system would go a long way to helping business in that respect and would help our international competitiveness, I suspect, because a lot of continental jurisdictions in particular have advance ruling systems which are of great benefit to inward investors in getting certainty of their tax treatment over a period of time" (Q 94). Mervyn Woods (CBI) also thought stability important for investors and told us that "Some other regimes are prepared to guarantee tax treatment for a particular number of years" (Q 58).
30. In response Dave Hartnett (HMRC) said that the Department regarded the Review as "absolutely fundamental to the change we want to bring about in how we link with big business in HMRC. We are moving very firmly to the basis of applying our resources to risk and that is a big challenge for us. We want to be able to provide businesses with more certainty, that is why clearances are really important to us, and I think that all your previous witnesses are right to challenge us as to whether we are going to pull it off. We are absolutely determined to do so ..." (Q 293) The Department was getting some help in understanding some sectors "and I am confident we will deliver".
31. **We welcome the progress being made by HMRC in its review of the links with large businesses as advanced in the delivery plan published at the time of the Budget. We note the concerns of our private sector**

¹¹ Making a difference: delivering the review of links with large businesses. HMRC, March 2007.

witnesses around the availability in HMRC of sufficient skills and resources. HMRC accepted that delivering the plan was a challenge and that it needed help to understand some business sectors. However it regarded carrying forward the recommendations of the review as absolutely fundamental and was confident that it could achieve the plan. We welcome this assurance which will undoubtedly be widely noticed.

32. We welcome in particular the consultations which are taking place on clearance procedures and advance rulings. There are many indications that our international competitiveness has slipped in recent years and one important contribution to reversing this would be to catch up other jurisdictions with the certainty about taxation which they provide for incoming businesses. We recommend that this should be a high priority.

Administrative costs

33. As noted in paragraph 12 above, at the time of the 2006 Budget targets were announced for reducing the administrative burdens of tax on businesses in dealing with forms and returns and with audits and inspections. At the same time the externally chaired Administrative Burden Advisory Board was set up to identify new areas for action that tackle the burdens of most concern to businesses.

34. There are two targets for reducing the burden—dealing with:

- forms and returns where a reduction of 10% is sought over 5 years with over a third of the reduction having been achieved so far;
- audits and inspections, where there is to be a reduction of 10% over 3 years and 15% over 5 years.

In all, total savings of £300 million in annual administrative costs are claimed to have been made.

35. The progress being made was reported by HMRC at the time of this year's Budget.¹² Our private sector witnesses welcomed this progress, but had some doubts as to whether it would really meet their major concerns or would go far and fast enough. Ashley Greenbank (LS) said that there had been some progress but beyond that "we would say the jury is still out" (Q 94). John Cullinane (CIOT) saw it as a first step and a move in the right direction but "there is a long way to go" (Q 139).

36. Richard Baron (IoD) thought that the targets were "better than nothing. They are pretty unambitious targets ... because, while the Revenue would dearly love to make things simpler for everyone, they are working against a background of policy set by Ministers and Ministers are likely to come up with complicated policies" (Q 46). Likewise Frank Haskew (ICAEW) welcomed the measures and "HMRC's and the Government's commitment to simplification in reducing business costs, but there is a general view that [these] are not the big ticket issues, they are not going to make that much of a difference and, indeed, some of them are effectively reversing things that have only been introduced in the last few years" (Q 206).

¹² Developing a new relationship with business: Progress towards reducing the administrative burdens on business. HMRC, March 2007.

37. Chas Roy-Chowdhury (ACCA) thought that reducing the administrative burden was more a matter for government policy and changes in legislation. With fundamental changes year after year “I do not see there is any real concerted effort on the part of Government to reduce the administrative burden of the tax system on business” (Q 206). Paul Bowes (BCC) took a similar line: “The trouble is the legislation becomes so complex as time goes on, more and more complexity is built in and the degree to which you can reduce administrative burden is somewhat mitigated by the increased complexity of legislation as time goes on” (Q 268).
38. In response, Theresa Middleton (HMRC) was pleased with the support which there had been from businesses. She thought that there would be a more noticeable impact as time went on and a wider range of changes took effect. She was confident that the Department would deliver on its targets which she thought were stretching. The UK compared well against some comparators, so there was perhaps less room to make a more significant reduction. “That partly reflects the fact that, believe it or not—and many businesses will not necessarily believe it—the UK tax administration is relatively regulation light” (Q 294). HMRC had tried to set targets which combined where the burden was biggest, but where the money came in, with areas which were particularly irritating for businesses. She also said that small businesses should have most to gain from the merger between the Inland Revenue and HM Customs & Excise.
39. **The programme to cut administrative costs is welcome. We note the concerns of some of our private sector witnesses that the programme is not eating into the core compliance burden or sufficiently ambitious.**
40. **Here again, HMRC, who thought that the programme was stretching and that the United Kingdom compared quite favourably internationally, was confident that it would be delivered, to the benefit of small businesses in particular. We recommend that this programme be pushed ahead vigorously.**

Small companies

41. After a lot of changes in recent years to the small companies corporation tax rate, with their varying impact on the incentive to incorporate, there were three aspects of the business tax reform package which affected small companies: first the impact on them of the further rate and capital allowance changes, bringing winners and losers; second the effect of the rate increases which, together with the forthcoming reduction in the basic rate of income tax, narrows the advantage for a small business of trading in corporate form; and third the impact of the administrative changes.
42. In its written evidence¹³ the IoD said that the rate increases had “given rise to justifiable concern” but pointed out that imbalances between the tax treatment of incorporated and unincorporated businesses had led to tax-motivated incorporations and that raising the small companies rate was one way of tackling the issue. But they thought that overall the burden should not be increased and ideally it should be reduced to minimise the number of

¹³ Memorandum of Evidence by the IoD (Volume II, p10).

losers. Equally the CIOT in its written evidence¹⁴ said that there would be the closest alignment of rates for some years. But there would be many different circumstances and considerable differences would remain. On balance incorporation was still likely to lead to lower tax burdens for many businesses, albeit with higher compliance costs.

43. This was also the general pattern of the oral evidence. Ian McCafferty (CBI) thought that there would be good number of small and medium-sized businesses which would not benefit net from the changes (Q 48). Adding to this, Richard Baron (IoD) said that “one has to recognise that it has been driven by the problem the Government has had that motivates incorporations and putting the small companies rate up to 22% achieves a certain balance for people who are already in the higher rate taxpayer bracket.” (Q 48) John Cullinane (CIOT) thought that, while the system remained complicated, some simplification was being introduced. He said “I think, if you are running a small business, when you are choosing whether to incorporate or not, you will find your choice less driven by tax than you might have done previously” (Q 137).
44. Likewise Malcolm Gammie (IFS) said that the Government had started to address the issue of the differences in tax liabilities that existed according to the organisational form. But initial work showed that there would still in 2009–10 be “incentives for individuals to organise themselves in a way ... which may, therefore, necessitate further measures in due course” (Q 1).
45. For HMT Peter Curwen picked up the point that reducing the issue of whether tax was a factor in incorporation was a simplification; incorporation could be a springboard for growth but tax should not drive the decision. However he was not saying that there was probably more to come: these changes would narrow the difference and “it will make decisions about legal form simpler for advisers, they can concentrate on commercial and legal considerations and less on tax because there are disadvantages—there are advantages too, surely, but there are disadvantages too—from moving to incorporation; complexity and other aspects” (Q 300).
46. **We share the common view that small businesses need certainty and stability as much as large ones. There was general agreement that they too ought to be able to take commercial decisions—for example whether or not to incorporate—without regard to the tax implications. Too many decisions have been taken with tax in mind and this must be seen as a weakness in the tax system.**
47. **In this context the frequent changes in the small companies rate of corporation tax have been unhelpful. However the change in the rate being made this year and the further changes which have been foreshadowed will, in conjunction with the proposed simplification of personal taxation, be helpful by reducing the difference between the tax burden on incorporated and unincorporated businesses.**
48. **This should however be only the start of the process. One approach towards reducing complexity and the distortions which tax considerations may bring to business decisions would be to stand back and review the issue as a whole in conjunction with the sector. It**

¹⁴ Memorandum of Evidence by the CIOT (Volume II, p55).

would certainly not be possible to remove all the complications, but the outcome might well be greater clarity and consistency.

49. Richard Baron (IoD) was also concerned about the implications of the HMRC staffing cuts on smaller taxpayers since from the Department's "point of view it is not worth devoting a huge amount of resources to each one. It is a mass production business to get roughly the right amount of tax out of each person and because of the pressure on costs there has been a certain amount of deskilling. Now, if you phone up the Revenue, you will be put through to someone on a helpline who will be working from a script who does not actually know the subject, so there are concerns about how the smaller taxpayer may get treated" (Q 46).
50. Paul Bowes (BCC) said that small business would like the same client relationship with HMRC as large business was getting. "Small business would like to see the same attention to detail, if you like, that they can contact somebody within the Revenue they know and who is appointed for their benefit as well. Maybe the answer to that could be we do not have manpower in the Revenue to achieve that" (Q 271). He was also concerned at the loss of approachability from the closing of local offices which was a worry to the business community because it would be inconvenient to get to a centralised office.
51. Dave Hartnett (HMRC) responded that this was more of a concern for tax practitioners than for businesses. "My experience of listening into calls and talking to businesses is that businesses generally get the answers they want from our call centres and we get lots of plaudits from businesses for that service. I would not want though to sound complacent and there is plenty we can do to improve that service as well" (Q 297).
52. **We recognise that, at a time of staffing cuts, HMRC has to prioritise its services carefully. It is important however that, while rightly concentrating on delivering the plan for its links with large companies, regard is also had to the taxation needs of small businesses and their advisers.**

Capital allowances

53. Our witnesses from the private sector were concerned by the withdrawal over four years of the buildings allowances and the consequential withdrawal of balancing allowances. They were also concerned at the two-rate system of allowances for plant and machinery. The introduction of the Annual Investment Allowance is to be the subject of consultation and was not a matter to which our attention was very much drawn.
54. As we noted in paragraph 15 above, Malcolm Gammie (IFS) saw that the withdrawal of the buildings allowances provided the major simplification in the business tax package: they had been high on the list for simplification, but he had not anticipated their removal. The uncertainty as to the future would be reduced as consultation proceeded but "obviously for long-term projects which require raising of long-term finance, a period of uncertainty in terms of the impact of these changes, is not entirely desirable" (Q 1).
55. Ian McCafferty (CBI) was worried about "the almost retrospective nature of some of the changes. Some of the long term allowances which have been abolished, particularly the IBA, and some of the changes in capital allowances apply to investment which was made fairly soon before the

Budget took place but which are now affected by the new regime. That, I think, does possibly reflect an element of unfairness” (Q 58).

56. In its written evidence¹⁵ the BCC also suggested that the phasing out of the IBA was effectively retrospective taxation and that only new buildings should have been affected. Likewise the Association of Taxation Technicians (ATT) said in its written evidence¹⁶ that the loss of allowances would be particularly harsh for a person who had acquired a building just prior to the Budget expecting to claim allowances for the next 25 years.
57. Chas Roy-Chowdhury (ACCA) was also concerned about the way in which the changes in the buildings allowances were announced given that they are long term investments. He said “ There seems to be little acknowledgement about the long-term planning requirements of businesses” (Q 205) and “To fundamentally change the regime without any consultation, without taking account of what the business has already done, is not in the least business-friendly or the right approach” (Q 210).
58. As for the allowances for plant and machinery, there was a general view that the changes were moving closer to economic depreciation. As Malcolm Gammie (IFS) said “It will obviously reduce the incentive to the extent expenditure on plant and machinery will have to be written off over a longer period ... it does not appear to be adding to incentives”. However “the impact ... will vary considerably between different businesses according to what equipment they are investing in and what their relative records of investment already are” (Q 7). He added that during an earlier consultation the majority of businesses had expressed “a preference to remain with the capital allowances system rather than moving to a relief for accounting depreciation” (Q 8).
59. Richard Baron (IoD) suggested however that it was not clear that, now that the rate for plant and machinery “had been reduced to 20%, that the argument that capital allowances are enormously more generous would still hold true ... The really significant point is that you do not have to take all your capital allowances each year” (Q 50).
60. Referring to the Annual Investment Allowance, the BCC said in its written evidence¹⁷ that it did not think that the allowance would be likely to have a big impact as it failed to take account of the dominance of the service sector in the UK. David Frost (BCC) emphasised this in his oral evidence when he said that he thought that the allowance was “unlikely to have a big impact, particularly because of the changing nature of the business that we see, increasingly a service sector based economy, a move away from manufacturing” (Q 266).
61. In response Peter Curwen for HMT said that the buildings allowances were “decades old and a slightly anachronistic feature of the tax system which had their genesis in the post-war reconstruction efforts, so their relevance was debateable, to put it mildly” (Q 301). Their withdrawal was a straightforward simplification. Because the rates were fixed annually their removal was not legally retrospective and “there is going to be a phased withdrawal between 2008 and 2011 and that gives business time to plan and

¹⁵ Memorandum of Evidence by the BCC(Volume II, p96).

¹⁶ Memorandum of Evidence by the ATT, appendix, (Volume II, p64).

¹⁷ Memorandum of Evidence by BCC(Volume II, p96).

... retaining the effect of those allowances beyond the point at which they are to be abolished would have potentially created a significant compliance burden for up to 25 years, so it would not have fitted with the simplification agenda” (Q 302).

62. On capital allowances generally he said that the “objective had been to reduce tax distortions and promote more efficient investment and generally to simplify the tax treatment of capital expenditure” (Q 301). He added that the 10% and 20% pools were a much better match for the real average rate of depreciation on plant and machinery. He also suggested that during the consultation on the Annual Investment Allowance key aspects would be implementation and simplification.
63. **The changes to capital allowances introduced in this year’s Finance Bill have brought only limited simplification. There has been less agreement among our private sector witnesses about the impact in this regard of the future changes which were also announced as part of the package, but we are pleased to note that these are to be the subject of consultation.**
64. **Any changes in the tax system may bring unwelcome uncertainty and this is especially so when the financing of long term investments is involved. This sits oddly in a package designed to encourage growth. We carefully considered the proposal which was put to us that there should be grandfathering of the changes to the building allowances in order to provide greater certainty and to avoid what was represented to us as retrospection. However the complexity from having two systems, and the avoidance which HMRC had experienced on an earlier occasion, persuaded us not to recommend it.**

Tax Credits for Research and Development

65. Our private sector witnesses expressed some doubt as to the impact of the R&D tax credits as they stood especially for small and medium-sized companies. Ian McCafferty (CBI) doubted whether the “changes in the rate of the R&D tax credit relative to the changes in corporation tax rates for SMEs are necessarily going to be of significant benefit” (Q 56).
66. John Whiting (CIOT) said that he was not convinced that the credit was at a sufficient level really to influence behaviour. The rate of the allowance was still relatively modest “and, also because of the complexity, there are still uncertainties as to what will qualify; it is not as generous and simple as it should be” (Q 146). He added that from a survey his firm had done, there was evidence that small businesses would prefer a simple, lower rate to these allowances because it would save the effort of working out whether or not they qualified.
67. Likewise Frank Haskew (ICAEW) said that from research the Institute had done, he doubted whether the credits would make much difference for small companies “... there is too much uncertainty surrounding getting them ... particularly at the smaller end it is quite difficult for small companies to fund research and development” (Q 215). He agreed with the suggestion that the expenditure might be incurred anyway. Chas Roy-Chowdhury (ACCA) added “... it has been very difficult for small businesses to convince some Revenue inspectors that they are due the credit. I think that needs to be

eased up if the Government is serious about encouraging R&D. That is one of the clear messages, hopefully, that will go out from here” (Q 217).

68. David Frost (BCC) also told us of research which the British Chambers had done. Half of the firms that had replied thought that the tax credit was a good initiative, it did encourage R&D but it needed far greater promotion. “When we asked why there was a discrepancy between awareness and take-up, the main reasons were that the rules were extremely complex, they did not allow significant R&D related expenses, such as the patenting of intellectual property, and they saw the application process and the prospect of a tax inquiry as being bureaucratic and time-consuming. From a small business point of view there are a significant amount of hurdles with the R&D tax credit” (Q 276).
69. By contrast, Malcolm Gammie (IFS) said that the “sort of changes that [HMRC] have made over the last year has been effectively to concentrate claims within specialist units, so that your claim is being made to people who are familiar with the credit and know all its detail. As far as I know, that has improved the situation and I assume the Revenue will continue to be committed to that, given the increase in the credit from next year” (Q 4).
70. John Cullinane (CIOT) thought that the problem with too many incentives was that there were too many conditions and eventually they were withdrawn leading to a lack of confidence in them. However on “research and development specifically, the Government has put a great deal of commitment to that over a period of time and I think there is some trust in the stability of that” (Q 144).
71. Theresa Middleton (HMRC) told us that there had been some 20,000 claims from small and medium enterprises and 3,000 from large companies, totalling some £1.8 billion. In research which HMRC had commissioned three quarters of the businesses reported that they had found it easy or fairly easy to engage in the process. Nonetheless HMRC had set up seven specialist units to deal with R&D claims: the initial feed back had been extremely positive.
72. There was a trade-off between having a targeted scheme and one which was simple, but a comparison made with other major fiscs in an article in the *Tax Journal*¹⁸ last year found that for small and medium enterprises the UK system was widely regarded as the most generous and simple to administer. Nonetheless HMRC was continuing to improve the process and had published new guidance and an improved definition of R&D. While the IFS had said that it could take as long as ten years before the incentive effect could be identified, the survey to which she had referred also found that 57% of the companies which had claimed the credits felt that they were an incentive to undertake further research. There was also anecdotal evidence that they were an incentive.
73. **This year’s Finance Bill sees further enhancements to the R&D tax credits. These aim to provide an important contribution to the thrust of the business tax package to encourage growth through investment and innovation.**

¹⁸ *R&D Tax Incentives* by Anne Fairpo, Director, Rawlinson & Hunter published in *The Tax Journal* Issue No. 835 on 1 May 2006

74. **We received mixed evidence as to the effectiveness of the credits. However the number of claims from small companies as well as from large ones and the independent research which HMRC has carried out casts doubt on some of the concerns expressed by some of the private sector witnesses as to the extent to which companies, in particular small ones, are aware of them or find them accessible. HMRC said that it was not complacent and had introduced specialist units to help businesses through the processes. HMRC also thought, contrary to a view expressed to us, that the credits compared well internationally.**
75. **Given that inevitably it will take time before a fully considered view on the effectiveness of the credits can be taken, the area must be kept under close review. But we see no reason to express any immediate concern.**

Consultation

76. In our report last year¹⁹ we said that we were very firmly in favour of consultation and we recommended that, if clarity, certainty and simplicity were to be achieved, in principle it should take place on all occasions where there was any significant technical content. We were therefore keen to learn from our witnesses how far the lessons from the failures last year had been learned.
77. Richard Baron (IoD) told us that his “feeling was that on the whole Treasury and HMRC do a pretty good job of consultation”: there had been the odd slip-up, but on the whole they did “a pretty good job, and they do want our views because they did not want to have to explain to Ministers why a proposal fell flat on its face when it was launched without announcement” (Q 62). Likewise John Cullinane (CIOT) said “that the actual volume of consultation on tax matters is much, much greater than it ever has been” (Q 151).
78. We also wanted to pursue the question how far consultation was practicable where sectoral issues were involved and where there would be winners and losers. Mervyn Woods (CBI) thought that all policy changes should be preceded by consultation since Ministers would then be able to take their decisions based not just on the views of officials but on those of business so as to ensure that they were implemented in an easier way for businesses to implement. He added “I think consultation across the piece is beneficial to all concerned” (Q 61).
79. John Whiting (CIOT) also said at Q 151 that it was important that officials understood the impact of their proposals on different sectors some of which could be quite complex. John Cullinane (CIOT) added in relation to this year’s business tax package “I believe [Ministers’] choices would have been better informed by a consultative process, even if they could not then do everything the people consulted wanted and even if they made some decisions that were opposed by some people at the end of it. You cannot closet yourself away in secrecy or calculate or foresee all the different permutations of how people will react or be affected by the decisions you make” (Q 151).

¹⁹ The Finance Bill 2006, HL Paper 204–1, para 140.

80. The accountancy bodies were less happy about the experience this year and in this respect saw some difference between HM Treasury and HMRC. Frank Haskew (ICAEW) said that there had been consultation on the reform of corporation tax, including capital allowances, going on for some time. Most respondents had said that they did not want to see the allowances changed and the Budget changes had come as a complete surprise to business which would impact on investment decisions which had already been made.
81. He said “There needs to be more open and transparent consultation on these sorts of changes ... On the one hand you have HMRC wanting to consult with business and, on the other hand, it seems we have got tax policy formation on which there is no consultation whatsoever. With the best will in the world we need to have consultation on key business policy decisions” (Q 210). Chas Roy-Chowdhury (ACCA) took a very similar line.
82. In response Peter Curwen (HM Treasury) thought that they were doing their best as the evidence from our witnesses indicated and he referred to many of the consultations which had taken place. He referred also to the consultation framework set out in the Varney review which complemented the guidance of the Cabinet Office. The issue of grandfathering had been raised with us in connection with the capital allowance changes and on this he said “our view is that it can have a role to play but it needs to be balanced against the downside, the complexity and the revenue impact, and it is under those terms that we will judge whether grandfathering is appropriate or not” (Q 305). Dave Hartnett (HMRC) added that it could be dangerous as on a previous occasion a grandfathering provision had been exploited very significantly by the tax planners.
83. **We welcome the increasing amount of consultation which is now taking place across the tax system on technical issues both on legislative and administrative aspects. Consultation may be less easy to arrange on issues where there are sectoral implications and where there would be winners and losers, such as this year in the case of the capital allowance changes. Nonetheless it is as important in these areas as it is elsewhere if proper consideration is to be given and simplicity and certainty given due weight.**
84. **Lessons ought to be learned from the progress on consultation made so far; the implications of the simplification of personal taxation, which was also announced at the time of the Budget, should also be subject to consultation so that its full impact can be fully assessed and implemented smoothly.**

International competitiveness

85. In these final sections of this chapter of our report, we consider how far the business tax reforms meet their three main objectives as set out in the Budget Notes²⁰. The first of these objectives was to “enhance the international competitiveness of UK based business”.
86. We noted in paragraph 32 above the importance in this regard of progress on providing certainty to businesses through advance rulings and clearances. As to the rates and burden of tax, John Whiting (CIOT) said “Our system was

²⁰ Budget Note 02, para 3

becoming less competitive, not necessarily for things we were doing, but others were overtaking us and moving past. There is at least a good signal of recognition now and I give Government credit for that” (Q 142).

87. Malcolm Gammie (IFS) noted that the reduction of the mainstream rate from 30% to 28% produced a rate which was internationally competitive. However the reduction did not affect our position significantly in terms of where the UK stood amongst EU member states. He warned that the Netherlands was in the process of reducing its rate to 26% and that Germany was anticipating a major corporate tax reform in 2008 which might incorporate a reduction in its corporate tax rate “so how viable 28% will be in the long term I think remains to be seen” (Q 1).
88. Ashley Greenbank (LS) thought that, although it was perhaps disproportionate, the headline rate was important because international businesses did not look at the tax base in as much detail as they ought to do. He also warned at Q 96 that the UK headline rate was becoming less competitive in Europe.
89. Richard Baron (IoD) likewise thought that the reduction in the main corporation tax rate from 30% to 28% was great, but it looked unlikely to be enough. He said “We would certainly be in favour of an ongoing programme of reduction to bring it down to something of the order of 25% simply to keep up with the competition” (Q 57). Ian McCafferty (CBI) added “that the only way to improve the underlying competitiveness of British business is not simply to change the marginal rate of corporation tax but to reduce the tax burden in its entirety as far as business is concerned” (Q 57).
90. In response Peter Curwen (HMT) noted that there was a cut in the main rate of corporation tax which added to the cuts announced in 1997 and 1998. He said “We believe that we are meeting the needs of international competitiveness with a cut in the CT rate” (Q 306). He referred to what the Chancellor of the Exchequer had said to the CBI about the task force²¹ which they had set up on the corporate tax regime “In the spirit of reform I welcome the task force on tax you announced yesterday. I want to work with you to ensure we continuously seek to modernise and simplify our regime and improve our tax competitiveness.” (Q 306)
91. **The setting up by the Confederation of British Industry of a task force to consider whether the UK business tax regime is fit for purpose is itself evidence of the extent of the concerns about the decline in the UK’s tax competitiveness and of the need to enhance it. The reduction in the headline rate of corporation tax in this year’s Finance Bill is likely to have a beneficial effect, but other countries are also reducing their rates and it is the extent of the burden as a whole—which is broadly unchanged—and how the system is administered which are equally germane. As to the latter we have already noted with approval the progress being made in the review of the links with large business and the need to press ahead with it vigorously.**

Investment and innovation

92. The second stated aim of the reforms is to “encourage growth, through investment and innovation”.²² As to this, Peter Curwen (HMT) told us that

²¹ Memorandum of Evidence by CBI (Volume II, p31)

²² Budget Note 02, para 3.

“We are boosting growth and innovation principally through the annual investment allowance but also through the capital allowances generally” (Q 306).

93. However, as noted above, in particular in discussing the allowances for plant and machinery at paragraphs 58 to 60, our private sector witnesses believed that overall the main impact of the capital allowances changes would be to allow for economic depreciation but no more and that any incentive effect in the present system would be withdrawn. Moreover, pending the promised consultations on the proposed annual investment allowance, there was some doubt as to how effective it would be, in particular in the service sector. As the Federation of Small Business (FSB) said in their written evidence²³ “Turning to the proposed annual investment allowance, considering the pattern of small business behaviour, including investment patterns, it is highly unlikely that the vast majority of small businesses would invest £50,000 year after year.”
94. The effect of the changes in capital allowances is significantly to increase the yield to the Exchequer. Even after taking account of the rate changes, as Ian McCafferty (CBI) said “It is clear from the Treasury’s own arithmetic that this Budget is at best revenue neutral when it comes to business” (Q 57).
95. **We are doubtful whether the changes in the business tax reform package will do much to meet the Government’s aim of encouraging growth through investment and innovation. Their overall impact is broadly revenue neutral. Apart from the investment allowance, the changes being made in capital allowances seem designed to recognise economic depreciation and in general withdraw any investment incentive.**
96. **The annual investment allowance to be introduced next year, on which there is now to be consultation, is intended to provide some incentive, but we await the details. It will be important to consider its impact on businesses in different sectors and of different sizes.**
97. **Against the impact of the business tax package as a whole, the changes in the R&D tax credits are comparatively small and perhaps not sufficient to make a very positive impact overall.**

Fairness

98. The third aim of the business tax reforms was said to be to ensure fairness across the tax system²⁴.
99. Our private sector witnesses did not find the concept of fairness as very helpful in this context. Richard Baron (IoD) said “It is just too vague a concept to be useful in formulating detailed tax policy, although it is sometimes rolled out as a great excuse for a policy that has been formulated for other reasons” (Q 57). Similarly Ashley Greenbank (LS) said “I think we struggle with the fairness concept, to be honest, because we are not sure what comparators you take to describe what fairness is, other than being taxed in accordance with the law” (Q 98).

²³ Memorandum of Evidence by the FSB (Volume II, p93)

²⁴ Budget Note 02, Para 3.

100. Speaking of the relationship between fairness and simplicity, John Cullinane (CIOT) said “I think that the complexity of our system is a huge source of unfairness to many, many people who cannot possibly understand the tax consequences of even very routine actions and it is a major problem and we should give priority to dealing with it” (Q 138).
101. Alan Barr (LSS) accepted that absolute fairness and absolute simplicity were mutually incompatible, but he told us “I do not think the necessary increase in fairness has to be entirely at the expense of simplification ... lawyers especially, I think, have to accept that some of the complication has come from an attempt at fairness. It is whether that is the right way to cure the unfairness, if indeed unfairness there was before” (Q 99). Ashley Greenbank (LS) added “I do not think the two are mutually exclusive. I accept that in order to produce what you regard as fairness, and people differ as to what that should be, in order to address particular people’s position you will have different regimes applying to them but you can design those in a simpler way than we have at the moment” (Q 100).
102. The particular aspect of the business tax changes which our private sector witnesses regarded as unfair was, as we noted at paragraphs 53 to 56 above, the withdrawal over four years of the buildings allowances for investments which were essentially long term. Ian McCafferty (CBI) said of it “That, I think, does possibly reflect an element of unfairness” (Q 58).
103. John Cullinane (CIOT) welcomed what he saw was some simplification overall, but added “But the system remains very complicated and of course on the particular matter of the industrial buildings, people who decided to invest in an industrial building will have factored in some tax relief that they are not now going to get, so that is a particular problem” (Q 137). John Whiting (CIOT) added “I do not think simplification drove this package ... and I do not think thought was given to the real wider impacts and, therefore, the fairness and the possible need for ‘grandfathering’ of existing building commitments” (Q 137).
104. Commenting briefly about fairness, Peter Curwen (HMT) referred to the narrowing of the difference in the tax treatment of unincorporated and incorporated small businesses which we discussed in paragraphs 41 to 48 above and the changes to managed service companies to which we turn in the next chapter. He added more generally “I think we can reassure you but we always stay vigilant and we always wish to scrutinise the tax system” (Q 306).
105. **No-one could disagree about the need to ensure fairness across the system. But fairness is an elusive concept and may mean different things to different people. As we said when commenting on the need for simplicity, a balance has to be struck between it and fairness.**

CHAPTER 3: MANAGED SERVICE COMPANIES

Background

106. Where an individual worker provides his services directly to an end client and enters into a contract of service, the worker is an employee and the client an employer. Employed levels of tax and national insurance contributions are payable by the employer and employee; the employer has to deduct tax and national insurance contributions (NICs) from the payments made to the employee under the Pay As You Earn (PAYE) regulations and account for this to HMRC. The worker has the normal employment rights of being an employee.
107. Where the individual worker carries on his own business and enters into a contract for services with the client, the worker is treated as self employed. The client pays the worker gross, without deduction of tax or national insurance. The individual worker is responsible for paying his own tax and NICs as a self employed person. There is considerable judicial guidance as to whether the arrangements between a client and a worker constitute a contract of service (and therefore an employment) or a contract for services (and therefore self employment). However the application of this guidance in individual circumstances can be difficult. Where a worker claims to be self employed, but, on the facts, is actually an employee, HMRC will require PAYE to be operated and employed levels of tax and NICs accounted for.
108. An individual may also provide his services through an intermediary company. The intermediary company enters into the contract with the client selling the services of the worker. The worker is normally a director of, and shareholder in, the intermediary company and manages that company. The intermediary company is usually referred to as a personal services company (PSC).
109. The interposition of a PSC gives scope for minimising tax and NICs payable. Payments for services are made gross by the client to the PSC and any profit in the company is liable to corporation tax. The PSC can make payments to the worker as director (in the form of salary) or as shareholder (in the form of dividends). There is also the potential for splitting income, typically to other family members who might be shareholders in the PSC and paying them dividends as well.
110. Salary is taxed differently from dividends and the amounts paid out as salary or dividends can be adjusted to achieve the minimum level of tax and NICs overall. Successive governments have been prepared to accept these tax and NIC differences, though over the years there have been various structural changes which have increased or reduced the difference in outcome of being an employee, being self employed or operating through a PSC.
111. However, where an individual worker claims that the PSC is carrying on a genuine business but, on the facts, the worker would be an employee of the client if the PSC were ignored, the PSC is actually masking employment status and preventing the accounting of the tax and NICs that would be payable if the worker were treated as an employee.
112. In the 1999 Budget the Government had become concerned that this masking of employment status was happening to such a degree in certain business activities that action was needed. Press Notice IR35 announced that

“There has for some time been general concern about the hiring of individuals through their own service companies so that they can exploit the fiscal advantages offered by a corporate structure ... The Government is going to bring forward legislation to tackle this sort of avoidance.”²⁵

113. The announcement gave rise to considerable contention and there was much discussion with the representative bodies as well as an unsuccessful legal challenge to the validity of the legislation. The legislation appeared in Finance Act 2000²⁶. It is commonly referred to as the IR35 legislation after the original press notice. The IR35 legislation operates on a contract by contract basis. Each contract between the end client and the PSC has to be examined to establish whether or not the true relationship between the client and the individual worker is that of employer and employee. Its application is therefore resource intensive for HMRC. Also it operates retrospectively in that the employed levels of tax and NICs are not quantified until after the year end and the amounts payable some time after that. The delay can give rise to collection problems; the transient nature of some PSCs and the flexibility to close down one PSC and open up another one with no assets left in the first PSC—a practice often known as phoenixism—means that the tax and NICs cannot be collected.
114. One response to the IR35 legislation has been the creation of large numbers of Managed Service Companies (MSCs). An MSC is, as is a PSC, a company through which workers provide labour services. But typically, the MSC is set up by an MSC scheme provider which is a business (usually a company in its own right) which provides these generic company structures and then administers them.
115. The presence of a scheme provider is a key feature of MSCs. It is claimed that often the worker does not fully understand the difference in his status and the nature of the contractual relationships as a result of setting up the intermediary company. The worker takes no part in the on-going management or financial control of his MSC. The MSC scheme provider handles payments between the client (or the agency if there is an agency involved in placing the worker with the end client) and the MSC, deducting a fee and arranging for the payment of the worker. The worker will be a shareholder in his MSC so that part of the return for services can be paid out as dividends, minimising the tax and NICs payable.
116. HMRC estimates that the number of MSCs has increased from around 65,000 in 2002/03 to at least 245,000 in 2005/06²⁷. This is a consequence of MSC scheme providers (of which there were around 150 in total, but 10 or so large ones) encouraging the take up of MSCs for workers who would not otherwise be prepared to run their own company.
117. In principle, the IR35 legislation applies to MSCs as much as to PSCs. But the resources available to HMRC are not sufficient to examine every contract entered into by the vastly increased numbers of MSCs. And the collection difficulties have become particularly acute with MSCs. There is also a more technical issue with travel expenses.

²⁵ Press Notice IR35 published 9 March 1999 as part of Budget 1999

²⁶ Eventually consolidated into Chapter 8 Part 2 Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003)

²⁷ Consultation Document *Tackling Managed Service Companies* published by HMT and HMRC 6 December 2006 paras 2.28 and 2.29

Government Action

118. In the 2006 Budget²⁸ the Government announced that it “will consult on action to tackle disguised employment through managed service company schemes.” The Pre-Budget Report (PBR) of December 2006²⁹ signalled that action would be taken “Income received by workers in MSCs in relation to services provided through the MSC will be subject to employed levels of tax and NICs, with the MSC obliged to operate Pay As You Earn (PAYE) and deduct tax and Class 1 NICs on that income—and the rules for tax relief for travel expenses will be the same as for other employed workers. The Government will also address the problem of MSCs escaping payment of tax and NICs due by allowing the recovery of these debts from appropriate third parties”³⁰.
119. A consultative document was published at the time of the PBR³¹ seeking views on the suggested approach and draft clauses were exposed for comment. The consultation document announced that the tax and NIC debts of MSCs could be transferred to appropriate third parties where the MSC did not pay the sums due. The draft legislation for implementing this was published for comment in February 2007³².
120. The 2007 Budget confirmed that the Government was taking action “The consultation has shown widespread support for action on MSCs and the Government will be introducing legislation as planned. However, the Government is amending its approach in response to some key concerns raised in the consultation, as explained in *Tackling Managed Service Companies: summary of responses* published today. The definition of an MSC will be strengthened to give greater clarity and certainty; the scope of the transfer of debt legislation will be clarified; and the Government will delay the application of the debt transfer legislation to third parties (other than MSC scheme providers, and directors, office holders or associates of the MSC) until 6 January 2008.”³³
121. The Finance Bill sets out the legislation at clause 25, a short introductory provision, and Schedule 3, which contains the detail of the provisions. It works by disappling the IR35 legislation to MSCs and inserting a new Chapter 9 into Part 2 Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003). Chapter 9 contains new sections 61A to 61J. New section 61B, which featured strongly in the evidence that was given, is at the heart of the new legislation, setting out the definition of an MSC. In addition, a new section 688A is inserted into the PAYE provisions in ITEPA 2003 which allows the debts of an MSC in respect of tax and NICs to be transferred to third parties if the MSC does not pay. Again, this provision featured strongly in the evidence put to us.

²⁸ Economic and Fiscal Strategy Report published 22 March 2006 as part of Budget 2006, HC 968, para 5.86

²⁹ The 2006 Pre-Budget Report, Cm 6984 ‘Investing in Britain’s potential: Building our long-term future’

³⁰ Press Notice 03: *Ensuring fairness for all taxpayers* published alongside PBR 2006

³¹ *Tackling Managed Service Companies* published by HMT and HMRC 6 December 2006

³² *Managed Service Companies: Transfer of Pay as You Earn and national insurance contributions debts* published on 8 February 2007

³³ Economic and Fiscal Strategy Report, published 21 March 2007, as part of Budget 2007, HC 342, para 5.115

Is there an underlying problem not addressed by this legislation?

122. Most of our private sector witnesses felt that the new legislation, and the previous IR35 legislation, were in the nature of “sticking plaster”, attacking the symptoms, not the cause. The underlying cause, which they suggested was not addressed by this anti-avoidance legislation, was the difference in tax and NICs payable by a taxpayer operating through different structures: as an employee; as a self employed individual; or through a company.
123. The Institute of Chartered Accountants in England and Wales (ICAEW)³⁴ wrote “Looking at the wider picture, we remain concerned that the MSC provisions are just the latest example (the changes to the small companies rate and the IR35 rules from 2000 are others) of ‘sticking plaster’ legislation that may be papering over obvious cracks but does little to address the underlying structural difficulties in the UK tax system that give rise to the problem.” The Association of Tax Technicians (ATT) concurred³⁵ “As can be seen, over the years, each successive piece of legislation is like a ‘sticking plaster’ added to the previous legislation in an attempt to heal yet another perceived wound.”
124. The witnesses who appeared before us gave weight to the point. Mervyn Woods for the Confederation of British Industry (CBI) questioned “whether there should be a huge difference in the tax treatment of employed and self-employed people” (Q 64); Alan Barr for the Law Society of Scotland (LSS) proposed “reforming [the NIC system] root and branch so that there was not this difference between employment NICs and other NICs” (Q 115); John Whiting for the Chartered Institute of Taxation (CIOT) “Yes, it is a good idea for starting with a blank sheet and trying to get to a system that does not bring tax differentials to a situation which should not really be significantly influenced by tax” (Q 153); Frank Haskew for the ICAEW said “Sticking plaster is obviously the word on the street in relation to managed service companies” (Q 218); others echoed these views.
125. Malcolm Gammie, for the Institute for Fiscal Studies (IFS) accepted that the differences would be narrowed, but gave quantitative weight to the differences that will remain “if we look forward to 2009/10, when these changes will have been implemented in full, initial work by the IFS as part of its Mirrlees Review of the tax system suggests that there will be discrepancies for those earning £25,000 per annum: in the order of £2,000 less tax if they are self employed [than if they were employed] and £3,300 less tax if they incorporate. These are quite significant differences in tax liabilities for earnings of £25,000, and obviously for larger earnings the discrepancy gets larger still” (Q 1).
126. John Cullinane (CIOT) put a slightly different slant on this for us pointing out that the tax differential between an incorporated and an unincorporated business “is in a sense a kind of a technical differential, whereas the tax treatment of the employed and the self-employed is more of a potentially different borderline, there are more, if you like real differences there. So I think it is harder to achieve and that probably explains why they have gone finally for trying to level up the incorporated versus unincorporated thing, while on the other hand with employed and self employed and managed

³⁴ Memorandum of Evidence by the ICAEW (Volume II, p 80)

³⁵ Memorandum of Evidence by the ATT (Volume II, p 66)

service companies, they are still in the kind of sticking-plaster mode” (Q 158). In effect, John Cullinane was saying that it is harder to level out the differences between the employed and self-employed than between unincorporated and incorporated businesses, but we do not think he was dissenting that this would be a worthwhile objective.

127. Officials saw things differently. For HM Treasury (HMT) Peter Curwen said “The measures on managed service companies address the very specific issue of mass marketed schemes being used to disguise employment and that is in marked contrast to the measures we took on the structural issue on the small companies rate, so this is a compliance problem rather than a structural problem that we are dealing with in the context of the managed service company measures.” He continued “To put it at its boldest, if an individual wants to become self-employed they can do so, if an individual wants to operate on his own account then that is absolutely fine, but what we cannot have is people being employed and pretending to be otherwise, and that is what the MSC measure was addressing” (Q 307).
128. **We agree with the view put forward by our private sector witnesses. There can be no satisfactory long-term resolution of the issues raised by personal and managed service companies without tackling the underlying structural issues, however difficult they may be to resolve.**
129. **We therefore recommend that the Government should review the taxation of employees and small businesses operating in various forms with a view to making structural changes to reduce the differences in outcome in terms of tax and NICs payable whether an individual is employed, self employed or operating through a company. This will overlap with the review of small business that we recommended earlier and should provide a good opportunity to help meet our recommendations on simplification generally.**

The need for the MSC legislation and its effectiveness

130. Some of our private sector witnesses claimed that the operation of the IR35 legislation had been patchy, some companies being brought within the terms of the legislation, while others in very similar circumstances had not. They thought that it might have been possible to make IR35 work more effectively before moving on to new legislation.
131. In his evidence Malcolm Gammie (IFS) stated “The [tax] advantage they were obtaining was purely one that arose from the failure of the Revenue actually to police the existing IR35 rules” (Q 22). Richard Stratton for the Law Society of England and Wales (LS) commented “One of the questions is, would it have been possible to amend IR35 for MSCs rather than abandon them? If you are looking at that question, you could amend IR35” (Q 108). And later, he continued “Our starting point was that the best place to start is to try and enforce IR35 as effectively as possible but the policy view of HMRC is that for two reasons they do not feel able to do that, those reasons being in their consultation paper. One is that there is too much resource drawn from them in trying to analyse the employment relationships and, two, when they catch up with MSCs they do not pay the tax” (Q 113).
132. Our private sector witnesses went on to question whether the new legislation would be effective. Malcolm Gammie (IFS) thought the new legislation would work effectively in the sense that “it will be easier for the Revenue to

police managed service companies. But of course the big question is where all the individuals who currently have been operating through managed service companies migrate to. Is there a different organisational form that they can find which will effectively circumvent the legislation that is now being introduced?” (Q 23)

133. This theme was picked up by most of our other private sector witnesses, particularly in the light of the large increase in the number of companies which were set up during the early months of 2007. Richard Baron for the Institute of Directors (IoD) said “Whether it will work or not is questionable. I suspect quite a lot of people in MSCs are going to disappear into PSCs and be as hard to catch as they always were under the existing IR35 rules” (Q 66).
134. John Whiting for the CIOT put it this way “Therefore, if everybody is going off to their own company, it does raise the question as to whether, although the stable door has been bolted, there are not many horses left inside” (Q 157). And a little later “I think we have always said that we may yet have to have another round in the sense that we have had the IR35 round, the managed service companies round, and one suspects that there may well be a third iteration to really solve this problem and perhaps the answer, as we have alluded to, is back to basics and to try and look at the overall position” (Q 158). John Kimmer for the ATT agreed “I think I would go along with that. I foresee that we will go on another round, if we do not start and look at the basics again and try and level it out and introduce a system that is actually going to make the thing more equal all the way round” (Q 158).
135. Responding to these points for HMRC, Dave Hartnett said that they were surprised at the comments doubting the need for the MSC legislation. “Representative bodies, particular sectors of business, individual businesses have written a huge number of letters to us supporting what the Government is trying to do with managed service companies” (Q 308). He accepted that the enforcement of IR35 had been patchy, but in his view the reasons for moving to differently targeted legislation were still valid (Q 308).
136. On the effectiveness of the new legislation and the increase in recently formed companies, Peter Curwen for HMT presented a table³⁶ showing the number of incorporations from November 2006 to April 2007 and took comfort from the fall in the number of incorporations during April as an indication that once the legislation appeared in the Finance Bill, workers and MSC providers saw how difficult it would be to bypass the new legislation (Q 318).
137. A different explanation for the decrease in April was given by Malcolm Gammie (IFS), notwithstanding that at the time he was speaking the April figures were not available “One assumes that there is a finite number of individuals who are affected by this, so at some time it would presumably tail off. Assuming it does tail off, that would indicate, or at least suggest, that it is this change in legislation that has driven the short-term increase between December and April” (Q 27).
138. **On the need for the new legislation, we are persuaded that the revenue loss had to be addressed in the short term. Given the collection difficulties and that HMRC have not been able to devote the**

³⁶ Memorandum of Evidence by HMT (Volume II, p 122)

resources to policing IR35, we think that a new legislative solution is the only option.

139. **However, we are not persuaded that the position concerning the effectiveness of the new legislation is as comforting as HMT/HMRC portray. We recommend that they keep under close scrutiny the operation of the new legislation.**
140. **We also recommend that they review the resources allocated to the operation of the IR35 legislation so that if they have to fall back on that legislation, all angles are covered. The collection issue may have to be addressed separately.**
141. **It would be unfortunate if there had to be a further round of legislation in this area, in advance of the more fundamental review recommended above.**

Impact on the Labour Market

142. There was concern amongst some of our private sector witnesses that the new legislation would reduce the flexibility of the labour market, particularly, as “in a number of occupations [there are] employers [who] do not want to have the direct contractual relationship with the individual; they want to put an intermediary between themselves and the individual, not just for tax reasons but also for employment rights and related things” Malcolm Gammie (IFS) (Q 14).
143. For the CBI, Ian McCafferty thought that “A number of [MSCs] ... certainly provide a very useful function in the labour market by providing a good deal of flexibility” (Q 68). And for the LS, Richard Stratton considered that “You do need entities providing outsourcing for clients, for businesses, so that business must continue and it is important that there is the ability to provide labour flexibility in the market place” (Q 114).
144. In their written evidence, the Federation of Small Businesses (FSB)³⁷ welcomed the new legislation “because it should clarify what an MSC is”. However, they went on to qualify this “there are concerns that this legislation could have a similar effect to IR35, which favours large contractors and suppresses an important route from employment into entrepreneurship”. In his evidence before us, Mike Cherry for the FSB expanded on this “if you are a joiner working for a building company at the moment and you have enough skills and ability to want to set up on your own but a large proportion of your existing work would come from your previous employer, as I understand it, that would catch IR35 or the new legislation coming in” (Q 281). Later, in supplementary written evidence³⁸, the FSB clarified that their main concern was with the operation of the IR35 legislation.
145. For HMT, Peter Curwen expanded on the information in the regulatory impact assessment³⁹. Their overall conclusion was that there should be no significant effect on the flexible labour market. He saw three reasons: the proceeds from the tax advantage were shared between the worker, MSC scheme provider and end client so the impact on wages from removing the

³⁷ Memorandum of Evidence by FSB(Volume II, p94)

³⁸ Memorandum of Evidence by FSB(Volume II, p 105)

³⁹ Full Regulatory Impact Assessment—Managed Service Companies published by HMRC 27 March 2007

advantage should be limited; competition should be enhanced by preventing MSCs from undercutting compliant workers and businesses; workers can still enjoy the flexibility of temporary contracts (Q 310). Peter Curwen took comfort from the fact that “some aspects of this legislation took effect on 6 April and, I know it is early days, but there is no evidence to date of any significant disruption of the temporary labour market and this is not a sector that is quiet and I think we might have heard fairly quickly after it came in if there had been” (Q 310).

146. **We hope that HMT’s view that the new legislation should have no significant impact on the flexibility of the labour market is correct. We recommend that HMT should monitor this carefully.**
147. **In addition we recommend that HMRC should review the way that it applies the IR35 legislation and, where necessary the new MSC legislation, to genuine new businesses so as to ensure that they are not strangled soon after birth.**

Defining an MSC

148. At the heart of this new legislation is the new section 61B ITEPA 2003 which defines an MSC. It is vital that this section targets accurately the intended companies and that it does not go outside the target so as to cause collateral damage.
149. We were met with widespread concern about this targeting measure. In their written evidence the LS⁴⁰ wrote that the safe haven for lawyers and accountants in section 61B(3) required modification to cover a wider category of adviser than, for example, individuals regulated as accountants. The LS had a number of detailed points on the clause and considered that the provisions did not apply clearly to partnerships although a company was defined as including a partnership.
150. In their written evidence the CIOT⁴¹ expressed concerns: section 61B(1)(d) was not sufficiently closely defined; the scope of section 61B(2) was too wide—many of those who provide services to small companies could be said to “influence” such companies; and they had a “significant concern” with section 61B(3) which echoed the point made by the LS. The ICAEW⁴², the Association of Chartered Certified Accountants (ACCA)⁴³ and the ATT⁴⁴ all had similar points in their written evidence.
151. In his oral evidence, Ian McCafferty (CBI) saw the possibility of collateral damage “The danger is that some of those that provide significant benefits to the wider economy, particularly, for example, the recruitment agencies, will be lost with those that were perhaps set up for tax purposes only” (Q 65). In his oral evidence, Mervyn Woods (also CBI) pleaded the case for clarity in the legislation (Q 69).
152. Richard Stratton of the LS accepted that much had been done to target the provisions more accurately, but thought that the definition of an MSC would

⁴⁰ Memorandum of Evidence by LS (Volume II ,p 33)

⁴¹ Memorandum of Evidence by CIOT(Volume II, p 56)

⁴² Memorandum of Evidence by ICAEW (Volume II, p 80)

⁴³ Memorandum of Evidence by ACCA(Volume II, p 79)

⁴⁴ Memorandum of Evidence by ATT (Volume II, p 65)

“still catch some entities which are genuine business service providers” (Q 107). Chas Roy-Chowdhury (ACCA) expressed the view that the legislation “does not really differentiate between those who are genuinely self-employed, who do not know where their next job is coming from, and those who, to all intents and purposes, are like other employees. It is not specific and focused in terms of its impact” (Q 218).

153. For HMRC, Dave Hartnett thought that section 61B made it “pretty clear that an accountant or a tax adviser or a lawyer who is engaged in the normal business you would expect of them as professional people to be involved in is outside this legislation. Accountants, tax advisers and lawyers who get involved in influencing or controlling how payments are made to workers will be inside but we do not think there are large numbers of those. Section 61B goes on to take employment agencies behaving in the way we had expected employment agencies to behave (and I mean all of us, not just HMRC) outside, and then there are provisions which help chartered secretaries and the like to stay outside” (Q 311). Summing up, Dave Hartnett said “We do not anticipate the need to do any more with section 61B. We think it targets the measure well and effectively and numbers of professionals have said that to us.” (Q 311) He confirmed that they were listening to outside representatives but he stated that the challenge to them was to show HMRC the analysis which made further changes necessary (Q 312).
154. Since hearing the evidence from most of our witnesses, we have had the benefit of reading the debate in the Public Bill Committee⁴⁵. As justification for section 61B not going too wide, the Financial Secretary to the Treasury relied heavily on the detailed wording of section 61B(1)(d). A company could be an MSC only if a person who carries on a business of promoting or facilitating the use of companies to provide the services of individuals (“an MSC provider”) was involved with that company. The Financial Secretary considered that this wording excluded most of the situations where concern had been expressed by private sector bodies.⁴⁶ A technical amendment was made in the Committee⁴⁷ to clarify section 61B(4) which exempts recruitment agencies from the scope of the provisions.
155. **We were troubled to find how many concerns there were in respect of the definition of an MSC. This targeting provision is central to the appropriate operation of this legislation. We think that it is now for our private sector witnesses to review, as a matter of urgency, the operation of the new section 61B in the light of the comments of the Financial Secretary to the Treasury and the explanations given by HMRC to us. If they are not persuaded, they should make further representations setting out the detail of the changes that they think are still necessary. We recommend that if this happens, the Government should bring forward further amendments at the Report Stage of the Bill.**
156. **In any case, the drafting of the guidance on this provision will be vital in ensuring that it operates without collateral damage. We recommend that HMRC enters into full consultation with the private sector in developing this guidance to achieve full clarity, both**

⁴⁵ Public Bill Committee Hansard 15 May 2007,cols 147–179

⁴⁶ Public Bill Committee Hansard 15 May 2007,cols 168–178

⁴⁷ Public Bill Committee Hansard 15 May 2007,col 179Amendment No. 97

generally and particularly on those points on which our private sector witnesses might continue to have doubts.

Transfer of Debt Provisions

157. There have been major concerns with the new section 688A ITEPA 2003, which is being inserted by Schedule 3 to the Bill. This seeks to address the weakness that under the IR35 provisions the tax and NICs liability are not payable until well after the end of the tax year and in many cases collection difficulties arise because the MSC may have been closed down by the time the liability is established or any assets out of which the tax would have been paid have been moved elsewhere. This section provides for regulations to authorise the recovery from third parties of sums that should have been deducted and accounted for by an MSC from a payment of income to an individual. The third parties are set out in subsection (2).
158. In their written evidence⁴⁸, the IoD expressed serious concerns: with the drafting of subsection (1); that subsection (2)(c) encompassed too wide a range of people; the exclusion provided by subsection (3) was too narrow; subsection (7) contained too wide a power for the Treasury to make regulations. Their comments on subsection (2)(c) are important: “Subsection (2)(c) encompasses too wide a range of people. It means that people could have tax debts passed on to them without culpability. This is a major departure from the normal principle that people can only be penalised when there is some fault on their part. We regard the failure to include some culpability test as wholly unacceptable, and as reflecting a desire to design a system to suit the convenience of officials.”
159. The CBI pointed out⁴⁹ the “imperative to protect innocent taxpayers against transfer of liabilities under new S688A and to provide cast iron certainty to those taxpayers that they have no exposure. It is understood that the draftsman of new Section 688A believed that this protection was achieved by the wording of new Section 688A(2)(c). Unfortunately business does not think that the current wording meets this shared objective and urges that the new Section be amended.”
160. The LS made the same point in a slightly different way⁵⁰ “To make other parties liable for tax liabilities gives rise to a need for very clearly focused legislation.” They went on to query the position of the end client under section 688A and also that of the worker himself. The CIOT was concerned⁵¹ with the position of ordinary employees of an MSC provider and urged that the legislation should be clarified that these are not persons to whom the tax debts of the MSC could be transferred.
161. In their oral evidence, the representatives of these bodies emphasised their concerns. John Whiting’s contribution on behalf of the CIOT was typical “I think the basic proposal is justified and is realistic because otherwise it would be too easy for an MSC user ... to strip the value out of the company and say there is nothing to pursue ... The concern is that it potentially goes very wide” (Q 175). Later, he unequivocally agreed with a question that was put

⁴⁸ Memorandum of Evidence by IoD (Volume II, pp 10–11)

⁴⁹ Memorandum of Evidence by CBI (Volume II p 18)

⁵⁰ Memorandum of Evidence by LS (Volume II, p 34)

⁵¹ Memorandum of Evidence by CIOT (Volume II, p 57)

to him “So the view that some people are expressing to us of concern about the way this thing might operate in perfectly legitimate situations is one that you would share?” (Q 177)

162. Since we took evidence from most of our witnesses, this provision has been the subject of debate in the Public Bill Committee⁵² where the Government brought forward amendments. The first reduces the scope of section 688A(2)(c) by deleting the words “facilitated or otherwise” so that now it is only “a person who (directly or indirectly) has encouraged, or been actively involved in the provision by the MSC of the services of the individual” who will be treated as a person to whom the debts of the MSC can be transferred.⁵³ It will be for the private sector witnesses to conclude whether this goes far enough, particularly in addressing the point made by the IoD (paragraph 158 above).
163. Two further amendments reflect the Government’s response to the concerns that employment businesses or agencies might be within the scope of the debt transfer provision, simply as a result of carrying on their normal business of placing individuals.⁵⁴ The amendments seek to clarify that this cannot happen.
164. In the debate in the Public Bill Committee, the Financial Secretary to the Treasury gave reassurance that the debts could not be transferred to the end client who simply used the MSC’s labour. If the client did more, for example telling those whom it employed that they must move to an MSC, that would be considered “encouragement” within the meaning of section 688A(2)(c) and the debts could be transferred to such an end client.⁵⁵ Again it will be for our private sector witnesses to decide whether they find the Financial Secretary’s arguments sufficiently persuasive.
165. The Financial Secretary also gave comfort on the position of the ordinary employees of the MSC provider. He said⁵⁶ “Let me make it clear that we do not intend ordinary employees of MSCs or third parties to be caught by the debt transfer provisions.”
166. In his evidence, Dave Hartnett for HMRC (who was giving evidence after the clause had been considered and amended in the Public Bill Committee) stated, as he thought Treasury Ministers had already made clear, that “this measure is about offering an opportunity to transfer debts to those who have been deeply involved in aspects of the MSC that lead to a loss of tax. This is not about transferring debt in any way to innocent parties and we accept that the vast majority of tax professionals, employment agencies and the like are innocent parties in this” (Q 313).
167. Dave Hartnett also confirmed that that the debt transfer provision would be handled by a special unit which HMRC are setting up to deal with this “so we can guarantee an absolutely consistent approach and if difficulties do arise, and I do not expect them to, ... they can be referred to policy makers very quickly indeed” (Q 313). He also went on to clarify the “circumstances in which the client could be asked to account will only be circumstances

⁵² Public Bill Committee Hansard 15 May 2007 cols 180–193

⁵³ Public Bill Committee Hansard 15 May 2007 col 192 Amendment No. 98

⁵⁴ Public Bill Committee Hansard 15 May 2007 col 193 Amendment Nos. 99 and 100

⁵⁵ Public Bill Committee Hansard 15 May 2007 col 190

⁵⁶ Public Bill Committee Hansard 15 May 2007 col 191

where the client has already been intimately involved in whatever action has led to the loss of tax” (Q 316).

168. **We were concerned at the number of worries expressed to us about the debt transfer provisions. We think that it is now for our private sector witnesses to review, as a matter of urgency, the operation of the new section 688A in the light of the Government amendments made in Committee, the explanations of the Financial Secretary to the Treasury and the evidence given by HMRC to us. If they are not persuaded, they should make further representations setting out the detail of the changes that they think are still necessary. We recommend that if this happens, the Government should bring forward further amendments at the Report Stage of the Bill.**
169. **This is an area where it is vital that third parties know whether or not they are in danger of having debts visited upon them. We therefore recommend that guidance is drafted with the full input of the private sector to provide clarity on the issues, particularly those where the private sector might have continuing doubts.**

CHAPTER 4: PART 6 FINANCE BILL: REVIEW OF POWERS, DETERRENTS AND SAFEGUARDS

Background

170. The Review of Powers, Deterrents and Safeguards was announced on 8 December 2004 by the Paymaster General, Dawn Primarolo, during the Second Reading of the Commissioners for Revenue and Customs Bill⁵⁷ which provided the statutory framework for merging the Inland Revenue with HM Customs and Excise to form HM Revenue and Customs (HMRC).
171. She announced that a consultation document would be issued “that will consider the suitability of the existing range of powers, including the requirement to provide information, interest and surcharge regimes for late payment, penalties for non-compliance and rights of appeal, and the modern regulations and practices that HMRC will need to be a high-performing 21st century tax administration.”⁵⁸
172. On 4 March 2005, HMRC published an introductory consultative document setting out the high-level objectives of the review and promised that it would be comprehensive and involve wide consultation.⁵⁹ A more detailed consultative document was published in March 2006⁶⁰. This reported on the review’s progress to date, reaffirmed the principles that underpinned the design of powers, deterrents and safeguards and how HMRC was seeking to embed those principles in practical proposals. This document included early suggestions for both criminal powers and civil powers for incorrect tax returns.
173. A Technical Consultation Document on Criminal Investigation Powers followed on 9 August 2006⁶¹. This document picked up the suggestion in the March document that existing provisions that were generally used in the investigation of other kinds crime should be adopted for tax crime. This suggestion had been preferred by most of the respondents. The August document took forward the approach of applying the Police and Criminal Evidence Act 1984 (PACE) in England and Wales and Northern Ireland and sought views on the necessary modifications. It also sought views on the equivalent provisions for Scotland (PACE does not apply in Scotland), taking account of the Scottish criminal justice system.
174. A consultative document, published on 19 December 2006⁶², picked up some early suggestions in the March 2006 document on civil penalties for

⁵⁷ Hansard 8 December 2004 cols 1167–1237

⁵⁸ Hansard 8 December 2004 col 1173

⁵⁹ Consultation Document *HM Revenue and Customs and the Taxpayer: Modernising Powers, Deterrents and Safeguards* published by Inland Revenue and HM Customs and Excise 24 March 2005

⁶⁰ Consultation Document *HM Revenue and Customs and the Taxpayer: Modernising powers, deterrents and safeguards: A consultation on the developing programme of work* published by HM Revenue and Customs 30 March 2006

⁶¹ Technical Consultation Document *HM Revenue and Customs and the Taxpayer: Modernising Powers, Deterrents and safeguards: Criminal Investigation Powers* published by HM Revenue and Customs 9 August 2006

⁶² Consultation Document *HM Revenue and Customs and the Taxpayer: Modernising Powers, Deterrents and Safeguards: A new approach to penalties for incorrect tax returns* published by HM Revenue and Customs 19 December 2006

incorrect tax returns and explored a new approach. Draft clauses were included in the consultation document.

175. A consultative document of 17 January 2007⁶³ published draft clauses and explanatory notes on proposed criminal investigation powers.
176. The Government announced in the 2007 Budget that it would introduce both the criminal and the civil powers taking account of comments on the consultative documents. The announcement confirmed that the criminal powers would be based on PACE with comparable provisions for Scotland⁶⁴. The announcement on the civil penalties for incorrect tax returns stated that the new provisions would “make a clear distinction between those who make a genuine mistake, who will not incur a penalty, and those who deliberately under-state their tax liability.”⁶⁵

Criminal Investigation: Outline of the legislation

177. The legislation is contained in clauses 81 to 86 and the associated schedules 22 and 23 to the Finance Bill. Clauses 81 and 82 provide for an order to be made applying the provisions of PACE, modified as necessary, to criminal investigations conducted by HMRC. Clause 84 introduces Schedule 23 which sets out comparable provisions for Scotland.

Penalties for Incorrect Tax Returns: Outline of the legislation

178. The legislation is set out in clause 96 of and Schedule 24 to the Finance Bill. Clause 96 provides that the detailed provisions in Schedule 24 shall come into force on date(s) specified in Treasury order(s). Schedule 24 contains the detailed provisions. Clause 96 and Schedule 24 will apply to returns for income tax, capital gains tax, PAYE, construction industry deductions, corporation tax and value added tax. The approach will also be extended to national insurance contributions by provisions outside the Finance Bill.

The Evidence: General

179. Some of the evidence that was presented to us applies generally to both the criminal powers and the penalties for incorrect tax returns. We therefore discuss this first. Subsequently, we consider the evidence that applies specifically to criminal investigation powers and to penalties for incorrect tax returns.

The nature of the review

180. Malcolm Gammie for the Institute for Fiscal Studies (IFS) questioned the validity of the review “It is, I think, a widely held view that the consultation process being adopted in this case is a flawed consultation process, in the sense that it would have been more satisfactory to have appointed an

⁶³ Consultation Document *HM Revenue and Customs and the Taxpayer: Modernising Powers, Deterrents and Safeguards: Criminal Investigation Powers: Publication of draft clauses and explanatory notes Responses to the August 2006 consultation document* published by HM Revenue and Customs 17 January 2007

⁶⁴ Economic and Fiscal Strategy Report, published 21 March 2007, as part of Budget 2007, HC 342, para 5.94

⁶⁵ Economic and Fiscal Strategy Report, published 21 March 2007, as part of Budget 2007, HC 342, para 5.95

independent committee, such as the Keith Committee⁶⁶, to review this whole area” (Q 1). Later in that answer he offered the thought that the review “rather like justice, has to be both done and seen to be done and that is extremely difficult when it is the Revenue itself conducting the review of its own powers, even though it is obviously consulting to a significant extent and has an independent group appointed to discuss the issues with it” (Q 1).

181. Dave Hartnett, for HMRC, did not accept that this would have been appropriate: “The powers review had to do something rather different from the Keith Committee. It had to provide us with powers for a new department. We have a steering group, a consultative group, which is very substantially made up of private sector representatives, leading QCs, human rights lawyers, criminal lawyers, tax lawyers, accountants, representatives of business and the like, and, if I may so, and I do this with enormous respect to the Keith Committee, we are moving a little faster than the Keith Committee did” (Q 322).
182. **Even if an independent body to conduct the review of powers, deterrents and safeguards would have been more appropriate—and we do not express a view on that—it is now too late to change the approach that has been taken.**

Is it right for powers and deterrents to be introduced before safeguards?

183. Some private sector witnesses were concerned about the review being split into constituent parts, some parts having to be implemented in advance of others. In particular, there was concern that the review had started with powers and deterrents and left safeguards until later.
184. Mervyn Woods for the Confederation of British Industry (CBI) was unhappy with this legislation being in the Bill as the first stage of what is a much bigger picture. He went on: “It seems rather odd, to put it mildly, to start by introducing into Parliament penalties for doing wrong things before you have finally determined what sort of regime you are going to have, what sort of relationship that will involve, et cetera. Penalties to my mind would be the last thing you would come to logically” (Q 80). And later in that answer he said “To my mind introducing part of the package that is going to emerge before the totality is there is not how I would have done it myself” (Q 80).
185. Richard Baron for the Institute of Directors (IoD) was concerned about the more specific aspect of separating off consideration of the new tribunal system. He saw the tribunals as an important safety mechanism in the determination of the levels of penalties. Otherwise he was not so concerned about fragmentation of the review (Q 80). For the Chartered Institute of Taxation (CIOT) John Whiting stated that there was more work to be done on safeguards generally (Q 194).
186. Others put forward the view that as part of the review of safeguards, there should be consideration of a taxpayers’ charter, or a bill of rights, as first introduced by the Inland Revenue and HM Customs and Excise in 1986. For the British Chambers of Commerce (BCC) Paul Bowes said “The concern is that these powers are exercised in a proportionate manner. One of the things that we have put forward at British Chambers is something that

⁶⁶ This investigation into the *Enforcement Powers of the Revenue Departments* was chaired by Lord Keith of Kinkel and reported in 1984

has been widely discussed within the tax profession, which is a Taxpayers' Charter, which is, to be fair, a very general statement of the kinds of services that a taxpayer can expect and the kinds of reactions that you can have from the Inland Revenue service in all sorts of circumstances, and at the same time there is a requirement on the taxpayer to act honestly and with integrity. It is those sorts of things, a balance of powers between the Revenue and the taxpayer" (Q 240).

187. Mervyn Woods (CBI) supported this "There is the question of the taxpayers' charter. We used to have a charter ... We no longer have a charter. Other fiscs around the world do. One might say that the taxpayers' charter ought to be the first manifestation of how the new relationship between HMRC and taxpayers is going to be conducted rather than not having one at all" (Q 80).
188. For HMRC, Dave Hartnett responded "There have been a lot of representations about a taxpayers' charter and references to them being in place around the world ... We have had some preliminary discussions within our steering group about how a taxpayers' charter might work" (Q 320).
189. On the question of why powers were addressed before safeguards Dave Hartnett's justification was "The review was set up on the back of Revenue and Customs being formed out of the two previous departments and, although this might seem a slightly odd statement, to ensure compliance and carry out the work effectively we needed to create a new set of powers because whenever we undertook an investigation, criminal or civil, which involved direct and indirect taxes, we had distinct laws and distinct processes and sometimes had to do the same thing twice in different ways and that is why we started where we did" (Q 320).
190. Later, in response to a suggestion from the Chair that the review had an element of piecemeal about it, Mr Hartnett replied "Piecemeal, if I may be very bold, has a derogatory sense to it and I hope that that is not appropriate. Are we doing it bit by bit in manageable pieces? We are trying to do that and we have tried to deal with really very pressing things" (Q 323).
191. Whilst the Sub-Committee was deliberating, HMRC published two consultative documents covering "Safeguards for Taxpayers"⁶⁷ and "A new approach to compliance checks".⁶⁸
192. **We were very concerned at the fact that the review was considering powers and deterrents in advance of safeguards. Had the consultative document on safeguards not been published when it was, we should have been making firm recommendations in this regard. We are pleased to see that this is now in hand and we urge the adoption of appropriate safeguards for taxpayers as quickly as possible.**
193. **As part of the consultation on safeguards, we recommend consideration of a taxpayers' charter or other formal statement of the rights and responsibilities of both HMRC and taxpayers.**

⁶⁷ Consultation Document *HM Revenue and Customs and the Taxpayer: Modernising Powers, Deterrents and Safeguards: Safeguards for Taxpayers* published by HM Revenue and Customs 17 May 2007

⁶⁸ Consultation Document *HM Revenue and Customs and the Taxpayer: Modernising Powers, Deterrents and Safeguards: A new approach to compliance checks* published by HM Revenue and Customs 17 May 2007

The consultation process

194. Most of our private sector witnesses were complimentary about the way the consultation process was being handled. However, some felt that the time given to consideration of the detailed legislation was too short. As Malcolm Gammie (IFS) put it “One might regret that [the legislation] has appeared so quickly, given that the consultation documents on which the current legislation is based were only issued in December and January this year, allowing a very short period for consultation” (Q 1).
195. For HMRC, Dave Hartnett considered that they were consulting very widely indeed (Q 322).
196. **We recognise the time pressures, both generally and in relation to the Finance Bill timetable. And we acknowledge that illustrative/draft clauses were included in the December and January papers. However, we urge that adequate time is given to consultation, particularly on important, serious matters such as powers and deterrents.**

The balance between legislation and guidance

197. There was a widely-held view among our private sector witnesses that detailed rules should be in legislation rather than guidance.
198. In their written evidence⁶⁹, the CIOT wanted assurances from HMRC (on who can exercise the criminal powers) to be included in the legislation. John Whiting (CIOT) expanded on this in his oral evidence “And we had suggested that it would be appropriate to write something into the legislation to make it that it was only to be exercisable as criminal powers by trained, authorised and controlled HMRC officers. We are told that this is not necessary, that the procedures exist, but we still feel that there is a need to give that reassurance ...” (Q 181). The Association of Chartered Certified Accountants (ACCA) echoed this in their written evidence⁷⁰ by wanting the assurances given in the Notes to be incorporated in the legislation. And in their written evidence⁷¹, the Institute of Chartered Accountants in England and Wales (ICAEW) express concern that “detailed rules will be in HMRC published guidance and not in law, and will not therefore be subject to Parliamentary oversight.”
199. In our examination of the LS representatives, we asked whether we should be content that Parliament was being asked to pass legislation when the guidance which taxpayers were going to get had not yet been produced. Responding, Richard Stratton explained further the source of their concern “Obviously, the only really important words are the words of the statute themselves. Guidance is merely something that a taxpayer can go on and gives an indication of how the administration will react in certain circumstances. That is all it is and it can be changed from day to day and has no real comfort if he is in a court room. All you can look at are the words of the legislation” (Q 122).
200. When these concerns were put to HMRC, Dave Hartnett responded “Maybe I can surprise you a little with the answer. In relation to powers and penalties

⁶⁹ Memorandum of Evidence by CIOT (Volume II, p 53)

⁷⁰ Memorandum of Evidence by ACCA (Volume II, p 79)

⁷¹ Memorandum of Evidence by ICAEW (Volume II, p 81)

in particular we are through this process getting into legislation, and primary legislation at that, more than was there in the past. We have our behavioural approach to penalties set out in the legislation. We have very clear publication on the scale of the penalties. We have introduced the deferral penalties in particular circumstances and I think this is a very significant step forward from the approach to penalties that has been around in the past. Inevitably, we need to rely in part on guidance because no two taxpayers, and particularly those who are serious miscreants, go about it in the same way and we are consulting now on the safeguards” (Q 324).

201. **We accept that it is not possible to include everything in primary legislation and that there has to be supporting guidance. We see it as particularly important that where serious matters such as powers and penalties are under consideration, as much as possible is written into primary legislation.**
202. **We recommend that great care be taken to ensure that all significant changes in published guidance be the subject of detailed and timely consultation.**
203. **We recommend that a way be found for the administrative procedures and guidance to be kept current and easily accessible alongside the primary legislation as a permanent record of the assurances that are presently being given in respect of these important powers and penalties.**

The Evidence: Criminal Investigation Powers

204. We received evidence relating specifically to the criminal investigation powers in clauses 81 to 86 and the associated schedules.

Exercise of the powers

205. A number of our private sector witnesses thought that these important powers should have been exercised by the police or the Serious Organised Crime Agency. In their written evidence⁷² the ICAEW wrote: “we question whether HMRC ought to have criminal investigation powers as we think that serious organised tax crime ought to be dealt with by the Serious Organised Crime Office.”
206. Supporting this in his oral evidence, John Whiting for the CIOT said “One of our concerns all along has been that whilst HMRC clearly needs powers to tackle the sort of offences that are perpetrated against the tax system, the very significant criminal powers that we are talking about really are arguably more police powers, so we have had concerns and have expressed them that the powers are perhaps better located with the police and the SFO rather than HMRC” (Q 181).
207. A related point was raised by the ICAEW in their written evidence⁷³ “It is vital that HMRC make clear publicly the circumstances in which the powers of arrest will be used.” And later, they made a more general point “In particular, we think it important for HMRC to reassure people that it will always use the least intrusive of the powers that it has that is consistent with

⁷² Memorandum of Evidence by ICAEW (Volume II, p 81)

⁷³ Memorandum of Evidence by ICAEW (Volume II, p 81)

obtaining its objective. For example, we believe that HMRC ought to give a public assurance that they will not seek to obtain documents under a search warrant when they could obtain the document by applying for an order for delivery under section 20BA, TMA 1970.”

208. In their written evidence⁷⁴, the Federation of Small Businesses (FSB) expressed concern about the exercise of these powers against home-based businesses as “over a third of small businesses are operated from the home, therefore HMRC needs to ensure that these powers are used with due care so that families and children are not affected.”
209. For HMRC, Dave Hartnett explained “I think the place I need to start is here in Parliament. When the Serious Organised Crime Agency was established there was a lot of discussion here and elsewhere about who should do what, if I can put it that way, and our Ministers felt that there was an ongoing role for Revenue and Customs in criminal investigations, and that is where we have ended up. Why are Revenue and Customs better placed to carry out this work than the police or SOCA? I think the simple answer to that is that the tax expertise lies inside Revenue and Customs and both departments, admittedly with the odd serious hiccup in the past, have demonstrated very serious expertise in this area” (Q 326).
210. As for businesses operating from home, Dave Hartnett said “The first thing to say is that whenever anyone’s home is involved we will exercise powers with enormous sensitivity ... What we are trying to get at is an approach to monitoring compliance that lets us test things *in situ* where they can only be tested *in situ* ... we will, and I am happy to give you this assurance, try and look at business records and the like somewhere other than people’s homes wherever we can” (Q 330).
211. **We recognise that the decision has been taken concerning the exercise of criminal investigation powers by HMRC. We are reassured by the comments of HMRC as to how they intend to exercise these powers. We consider it very important that the assurances that are being given at the present time are adhered to in practice.**

Which HMRC officers can exercise these powers?

212. Most private sector witnesses were concerned to ensure that the powers would be exercisable only by properly trained and supervised officers and that those exercising criminal powers would not also be exercising civil powers.
213. John Whiting of CIOT put it this way “our concern moves to making sure that the very significant powers that exist are only exercisable by properly trained and properly supervised HMRC officers. The figure of 2,000 seems reasonable but the issue is where is the control of that, how can we get some assurances that it really is just that 2,000 or roughly 2,000 people?” (Q 181)
214. In their written evidence⁷⁵, the LS expressed concern “that there is no statutory basis for the separation of criminal from civil powers within HMRC. It is therefore basically only internal guidance and administrative steps that covers the separation of the Criminal Investigation Directorate and

⁷⁴ Memorandum of Evidence by FSB (Volume II, p 94)

⁷⁵ Memorandum of Evidence by LS (Volume II, p 36)

the personnel within that directorate who can use the powers available to HMRC.”

215. During our deliberations, clauses 81 to 84 and Schedules 22 and 23 were considered in Committee of the Whole House⁷⁶. The Financial Secretary to the Treasury, John Healey, gave assurances: that only those provisions in PACE which were appropriate to a tax authority were being given to HMRC; that none of the criminal powers could be used for civil matters; that no HMRC officer would be responsible for both civil and criminal matters; and that the objective of the powers being exercised only by properly trained and authorised officers was already ensured by the legislation.
216. In his evidence, Dave Hartnett echoed the reassurance given by the Financial Secretary. He confirmed that the number of HMRC officers with the power of arrest would be reduced from its present level of around 20,000 (though in practice only a proportion of those ever exercised that power) to around 2,000, excluding others who have a power of arrest at the frontier. “They will be properly identified, they will be properly trained, they will not be allowed to do this work until they are properly trained, and they will only be doing this work in relation to criminal activity” (Q 326).
217. We are conscious of the valuable contribution that has been made by the exercise of the existing civil powers within HMRC. We are pleased to see that the exercise of the criminal powers will be kept separate from the exercise of the new civil powers.
218. **Overall, we are persuaded that sufficient assurances have been given by the Government in Committee of the Whole House and in HMRC’s evidence to allay fears concerning who in HMRC can exercise these important criminal powers.**

The powers for Scotland

219. Few of our private sector witnesses felt able to comment on Schedule 23 to the Finance Bill which sets out comparable powers for Scotland to those which will apply in other parts of the UK through the operation of PACE.
220. However, Alan Barr for the LSS did express concern: “We have very few criminal tax lawyers in Scotland so the consultation has not gone as well, I suspect through lack of resource on the part of those consulted as opposed to anything from HMRC. This is an area where there is a real problem, a real clash in the devolution settlement, in that we are dealing with the tax system, which is a reserved matter, [and] the criminal system and particularly criminal procedure, which is a devolved matter ... I do not practise in this area at all myself but I fear that the interaction has not been looked at in sufficient detail to see what is happening in terms of criminal evidence and of police powers which are being extended for the first time to the Revenue offences in Scotland. I do not think that has been looked at to the same extent” (Q 120).
221. Dave Hartnett for HMRC did not share these concerns “It was really important for us to find an approach to our criminal investigation work in Scotland which struck the right balance ... between the devolved powers and those powers that remained in Westminster, tax and the criminal code. We

⁷⁶ Hansard 1 May 2007 cols 1458–1473

talked to anyone who would listen, quite frankly, and I am really pleased that so many people were ready to listen. We talked to the Scottish Executive, the Crown Office, the Office of the Solicitor to the Advocate General, one of the three law officers for the UK and I think we got a very strong sense that the solution we developed was the right solution” (Q 327).

222. **We recommend that if Scots lawyers have any remaining concerns with Schedule 23 to the Finance Bill, they should communicate these to HMRC as quickly as possible and that the Government should bring forward amendments as necessary at the Report Stage of the Bill.**

Monitoring of how the powers are being exercised

223. It was considered important by our private sector witnesses that there should be monitoring of the way that these powers are being exercised and that the assurances presently being given are adhered to.
224. In their written evidence⁷⁷, the LS considered “that the powers vested in CID [Criminal Investigations Directorate] should be monitored so that there should be a standing committee between HMRC and practitioners, including barristers, to review how the powers conferred operate in practice.” They went on to recognise that this may not be necessary immediately, “but given the prosecution failures in recent years there may be a case not only of scrutiny of how an investigation is run (which is done by HMIC [HM Inspector of Constabulary]), but also of other matters such as funding, training, and so on.”
225. John Whiting for the CIOT suggested “that there is a report on the use of the powers, potentially in HMRC’s annual report or, ideally, given that these are very serious, significant powers, in a separate annual report presented to Parliament” (Q 183). Frank Haskew for the ICAEW said “Our view is that some sort of independent scrutiny is probably the right way forward” (Q 231). Invited to expand on what sort of independent body he said that “it should probably be a new body” (Q 232). Commenting on the same question, what sort of independent body, Chas Roy-Chowdhury of the ACCA said “I do not think the National Audit Office would do the job or some existing body. It probably needs to be separate and fully streamlined so it can report back pretty quickly on how these powers are operating” (Q 232).
226. In his response, Dave Hartnett on behalf of HMRC said that “The independent monitoring will come from the Inspectorate of Constabulary and indeed from the Independent Police Complaints Commission, but that is not all. The Police and Criminal Evidence Act requires law enforcement agencies to keep and publish certain statistics and certain information and those provisions will apply to us as they apply to other law enforcement agencies. The Adjudicator who looks in at all our work will, I am sure, look in on this work as well. I am not at all sure at the moment against that backdrop that we need a standing committee but I suspect that *de facto* for the next year or two there will be one in that our powers steering group, as I said earlier on substantially made up of members of the private sector ... are going to want to look at how we are taking forward the issues they have

⁷⁷ Memorandum of Evidence by LS (Volume II, p 36)

discussed and which have become enacted. So I think *de facto* for a while there would be a committee of that sort” (Q 328).

227. Responding to a question specifically about annual reports to Parliament, Dave Hartnett (HMRC) said “We make an annual report to Parliament now in the form of the HMRC annual report which contains quite a lot on our investigation work. I am not at all sure we need to go further than that at the minute but perhaps I can say that we will have a look at it” (Q 329).
228. **We consider that monitoring of how these powers are being exercised is vitally important.**
229. **We therefore recommend that serious consideration should be given to HMRC providing an annual report to Parliament setting out the way that these powers have been exercised in the previous year and how the assurances that have been given at the present time are being adhered to. That report could either be incorporated into the HMRC departmental report or be separate.**
230. **We also recommend that firm consideration should be given to the setting up of a standing committee (HMRC/private sector) to review the operation of these powers as well as issues such as funding and training. It is particularly important that such a committee should be in place before the powers steering group is disbanded and is no longer able to perform this function.**

The Evidence: Penalties for Errors

231. This section of the report examines the evidence received in respect of clause 96 of and schedule 24 to the Bill and makes recommendations. There was general support amongst our private sector witnesses for the new regime as a distinct improvement on the existing penalty regime. However, our witnesses had concerns.

Definition of the categories of behaviour / Penalty levels

232. Many private sector witnesses thought that the definitions of the three categories of behaviour which could lead to penalties were not sufficiently clear to apply in practice, particularly as to what constituted careless behaviour.
233. In their written evidence⁷⁸, the CIOT welcomed the distinction between “careless inaccuracy”, for which a relatively low penalty is exigible and innocent error which attracts no penalty. They noted HMRC’s view “that it would be very difficult to define the term ‘without reasonable care’ in the legislation, because this will vary from person to person, taking into account their personal circumstances.” CIOT continued “We are however, concerned that this should be defined as clearly as possible in the initial guidance notes to minimise the problems that can occur when guidance is altered.”
234. Richard Stratton (LS) supported this by saying “Dealing with the categories, as you will probably be aware, the actual categories are not very closely defined in the legislation. The concept of failure to take reasonable care is simply defined as careless, I think. There is very little elaboration.” (Q 121)

⁷⁸ Memorandum of Evidence by CIOT (Volume II, p 62)

And later “There is potential for uncertainty, yes. The penalty regime is introduced against the background of what is in reality a very complex tax system with a huge number of overlapping provisions that people could fall foul of ... The concept of what is not careless against that background is a very difficult concept” (Q 123).

235. There was some concern with the level of penalty that will apply to these various categories and the flexibility to depart from the fixed level in “special circumstances”. The LS in their written evidence⁷⁹ expressed the view “Paragraph 11 provides for reductions of the penalty in ‘special circumstances’. These circumstances are only defined negatively rather than positively. The Law Society considers that there should be a wider power within HMRC to depart from the fixed penalties than is currently contained within the provision.” They were also concerned that the penalty was too high in respect of losses that had been overstated and could not be used immediately.
236. The ICAEW focused⁸⁰ on a different aspect: “We see the merit in charging severe penalties for the most serious types of default but we are concerned that those at the less serious end of the behaviour spectrum will be more heavily penalised than at present, which may discourage voluntary compliance.”
237. The CIOT mentioned⁸¹ the situation “where an underpayment and an overpayment occur, and these are attributable to connected parties, a penalty could be charged on the underpayment but there is no compensation for the overpayment ... We understand your [HMRC] concern that this could be open to abuse. We therefore consider there should be at least a power to allow HMRC to reduce the penalty in such circumstances.”
238. Dave Hartnett (HMRC) made the point that for the first time the legislation made it “clear beyond any doubt that innocent error where reasonable care has been taken is no longer within the scope of penalty. I think that of itself is a big step forward. The three categories of carelessness, deliberate understatement ... and deliberate understatement with concealment I think are very clear indeed and the differentiation is very clear” (Q 331).
239. On “special circumstances” Dave Hartnett explained “You asked me about special circumstances as well and special circumstances are intended to be used rarely but to acknowledge very clearly when an act of God or something else simply made it impossible for someone to comply” (Q 332). On penalties at the less serious end of the spectrum, Mr Hartnett pointed out that no penalty would be due where the person had taken reasonable care. And on losses he said that “there was a strong sense on our part and on the part of our steering group and a number of commentators that we had to bring those situations within the scope of the new regime” (Q 333).
240. **In our view it is very important that if the new penalty regime is to influence behaviour and encourage better compliance, there should be a common understanding of what type of behaviour falls into which degree of culpability. Whilst we note HMRC’s view that the**

⁷⁹ Memorandum of Evidence by LS (Volume II, p 38)

⁸⁰ Memorandum of Evidence by ICAEW (Volume II, p 82)

⁸¹ Memorandum of Evidence by CIOT (Volume II, p 61)

categories are very clear indeed, we remain concerned that others are not so confident.

241. **We recommend that particular thought and effort goes into the drafting of the guidance on these aspects and that private sector representatives are given full time to comment on it.**

Appeal rights

242. Schedule 24 gives the taxpayer the right to appeal against the imposition of a penalty and against the amount of the penalty imposed. In general, our private sector witnesses were comfortable with the appeal rights against the imposition and the level of penalties, though Paul Bowes for the BCC felt that the taxpayer should be able to make an appeal to the Special Commissioners instead of the General Commissioners (Q 250).
243. However, there is a restriction on the appeal tribunal's power to substitute its own decision for that of HMRC. This is in two situations: where HMRC has declined to suspend a penalty or sets conditions on the suspension; and the extent to which a penalty can be reduced because of special circumstances. In both cases the tribunal can change the decision of HMRC only if it considers that that decision was flawed. Mere disagreement with the decision of HMRC is not sufficient to permit the tribunal to substitute its own view. According to the Explanatory Note⁸², "The restriction of the tribunal to a supervisory role in relation to special reductions and decisions not to suspend a penalty as well as suspension conditions, reflect the fact that these are relieving measures".
244. In their written evidence⁸³ the LS, having made the point that a flawed decision is one that is susceptible to judicial review, made the point that "it would be extremely difficult to demonstrate that HMRC had acted so unreasonably that their decision could be subject to judicial review". They went on to write that they considered this restriction "to be an unnecessary protection" for HMRC.
245. Dave Hartnett (HMRC) justified this approach on the basis that "the appeal tribunal has to act rather more like a judge in the judicial review setting and look at the reasonableness of the approach we have taken" (Q 334).
246. **We do not see why there should be a restriction on an appeal tribunal's powers. In all other respects the tribunal has the power to substitute its own decision for that of HMRC. Our view is that this should extend to decisions relating to special circumstances and the suspension of a penalty. We recommend that the Government should bring forward amendments at the Report Stage of the Bill to change the way that these appeal rights operate.**

Appeal procedures

247. Some of our private sector witnesses advocated an informal dispute resolutions procedure to operate alongside the formal procedure. As the CIOT wrote⁸⁴ "The consultation document which preceded the Bill spoke of

⁸² Explanatory Note, Schedule 24, Part 3, para 35

⁸³ Memorandum of Evidence by LS (Volume II, p 39)

⁸⁴ Memorandum of Evidence by CIOT (Volume II, p 62)

introducing an informal dispute resolution process to deal with penalty appeals, in the expectation that it would offer a less expensive, more accessible and swifter procedure than the traditional appeal routes.” They then offered some comments on the type of model to be adopted.

248. Richard Baron (IoD) commented that “it is very important that the taxpayer should have easy access to an appeal procedure” (Q 80). Expanding on the written evidence, John Whiting (CIOT) offered the view that it would give much more confidence in the penalty regime if the original decision were capable of informal review (Q 193). Responding to a question “Do you think that protection is really sufficient for the taxpayer?” John Whiting (CIOT) said “I think there are built in within this whole system enough safeguards because there is this informal procedure at one level and then we have the formal appeal procedure if people really want to take issue” (Q 194).
249. The consultative document on *Safeguards for Taxpayers* issued⁸⁵ on 17 May 2007 includes a section inviting comments on an informal dispute resolution process.
250. **We are pleased to see that the suggestion of an informal dispute resolution process is included in the recent consultative document and urge HMRC to take this forward as rapidly as possible so that the informal process can operate from the time the new penalty structure is implemented.**

Penalty position where agent acting

251. Many of our private sector witnesses were concerned at the position when an agent is acting and the interactions that exist within the tripartite relationship HMRC/agent/taxpayer. This is provided for in paragraph 18 of Schedule 24. The basic approach is that where a taxpayer appoints an agent, the agent provides HMRC with a document, and that document contains a careless inaccuracy, a penalty is payable by the taxpayer. However, where the taxpayer satisfies HMRC that he or she took reasonable care to avoid the inaccuracy, the penalty is not levied.
252. There are a number of different points of concern. Richard Stratton (LS) gave some background “There was huge debate over this as the consultation went through. The basic position of professional bodies I think was that if you go to a behaviour-based system then it should be your behaviour that counts rather than the behaviour of your agent. You are not responsible for your agent if the agent makes a mistake” (Q 124).
253. He went on “When the first draft of the provisions came out the principal was simply ‘liable for the agent’ ... Where it has got to at the moment is that in the case of failure to take reasonable care the principal can demonstrate that ... he is not careless then there is no penalty that can be extracted from him for that mistake, and there is none from the agent because the agent is merely an agent, so no penalty is payable. The question that is left hanging at this point is, is picking a competent agent enough to get you off the hook? That is not answered in the legislation and I suppose I as a professional would say, ‘Yes, it jolly well ought to be’ ... I do not know the response of HMRC to that, but HMRC know where the professional bodies stand on that point” (Q 124).

⁸⁵ Consultation Document *HM Revenue and Customs and the Taxpayer: Modernising Powers, Deterrents and Safeguards: Safeguards for Taxpayers* published by HM Revenue and Customs 17 May 2007

254. In their written evidence⁸⁶, the CIOT was concerned at the message paragraph 18 sends—“that a taxpayer could deliberately mislead HMRC into believing that he had taken reasonable care to avoid an inaccuracy when the agent has omitted something from a return, when the fault might well lie with the client not having provided the information to the agent in the first place.” John Whiting (CIOT) commented that “it is a concern as to whether and to what extent the penalty regime ... really recognises the tripartite relationship between tax authority, taxpayer and agent and whether all the potential permutations have been thought of. For example, we do have to recognise that there will be situations where an agent does get it badly wrong, possibly deliberately; to what extent should that rebound on the taxpayer? One accepts that in general it is only the taxpayer who can be penalised but we would like some more explanation, or exploration perhaps I should say, of how this tripartite situation should be run in practice” (Q 185).
255. Dave Hartnett (HMRC) was asked about, and agreed with, the proposition that if we are moving to a situation of behaviour it should be the client’s behaviour, not his agent’s, that should hold him liable. Dave Hartnett then went on to contrast two taxpayers. The first is a wholly diligent taxpayer who provides all the material to their agent and constantly chases and harries him to complete his return on time. The second is the not so diligent taxpayer who signs his return form blank and leaves everything else to his agent. The first is taking reasonable care, the second is not and the second could be liable to a penalty if something goes wrong (Q 336).
256. **We accept that at the extremes given in the evidence by HMRC, the position where an agent is acting is clear. But we think that there is a substantial middle ground where the position is less clear and there are therefore grounds for dispute. We recommend that either the Government bring forward amendments at the Report Stage of the Bill to clarify this or guidance is carefully drafted with full consultation with the private sector representatives.**

Drafting

257. A number of our private sector witnesses made detailed drafting points in their written evidence. One issue, above all, predominated: the use of the phrase “HMRC think” in Schedule 24. There was universal disquiet with this as being too subjective and various suggestions as to what it should be replaced with.
258. In Committee of the Whole House, the Financial Secretary to the Treasury, John Healey gave a commitment⁸⁷ to table amendments to Schedule 24 to remove the phrase. These amendments were made⁸⁸ during the time we were deliberating. The amendments delete the words “HMRC think” (and equivalent words) so that the provisions now read objectively.
259. **We think that the Government amendments should meet the concerns that have been expressed with the use of “HMRC think”. We urge the Government to consider the other detailed drafting amendments that have been suggested to us in the written evidence.**

⁸⁶ Memorandum of Evidence by CIOT (Volume II, p 61)

⁸⁷ Hansard 1 May 2007 col 1460

⁸⁸ Public Bill Committee Hansard 5 June 2007 cols 473–474

CHAPTER 5: PART 6 FINANCE BILL: ONLINE FILING AND ELECTRONIC PAYMENT

Background

260. The Government has invested over £500 million in HMRC's online services and further substantial investment is planned. There has been slow but steady progress in increasing the levels of take-up of these services on a voluntary basis. However the Government has concluded that more proactive measures will be required if the take-up is to be increased more quickly and the benefits fully realised within what it believes to be a reasonable period.
261. In July 2005 the Government asked Lord Carter of Coles to review these services and his report⁸⁹ was published at the time of the Budget last year. Subsequently in the light of consultation he revised his recommendation in relation to the filing dates for income tax self assessment returns. With this amendment his recommendations are to be introduced under regulations to be made under powers included in the current Finance Bill.
262. A full list of the proposals can be found in the Regulatory Impact Assessment⁹⁰, but in essence they are as follows:
- income tax self assessment returns for 2007–08 and subsequently must be filed by 31 October following the end of the year if made on paper and by 31 January if made online;
 - online filing of company tax returns, accounts and tax computations will be required for accounting periods ending after 31 March 2010 where the return is submitted after 31 March 2011. Paper submissions will not be accepted. Companies will also be required to pay corporation tax electronically;
 - online filing of VAT returns and electronic payments of VAT will be required for traders with an annual turnover of more than £100,000 for accounting periods starting after 31 March 2010 and similarly for traders registering for VAT for the first time after that date. Traders with a turnover below this figure will be encouraged but not required to file online. The need for this exception will be reviewed in line with Lord Carter's recommendation that HMRC should aim for universal electronic delivery of the main business tax returns by 2012;
 - the move to compulsory online filing of PAYE/NIC returns is already under way. Employers with more than 50 employees are already required to file end-year returns electronically and will be required to file in-year forms electronically from April 2009. Smaller employers are being offered inducements to persuade them to file end-year returns online over the five years 2004 to 2009. They will be required to do so from April 2010 and to file in-year forms electronically from April 2011.
263. The Bill also includes regulation making powers to treat payments made by cheque as made only once the funds have cleared into HMRC's account and

⁸⁹ Review of HMRC online services, Lord Carter of Coles, March 2006.

⁹⁰ Regulatory Impact Assessment 5, HMRC Online Services: Increasing Use of Online Filing and Electronic Payment, Annex A.

not, as today, when the cheque is received by the Department. This is intended to remove the cash flow advantage of cheque payment compared with electronic payment.

Mandatory online filing

264. Our private sector witnesses were pretty well unanimous in their views. They were supportive of the measures which had already been taken to promote online filing. They were very ready to encourage HMRC to take further measures to improve the service and to make it more robust and ensure its security. In this way HMRC would increase the proportion of taxpayers and their agents who choose to file electronically rather than make paper returns. Our witnesses thought that that proportion would in any case grow as the systems became more friendly and more and more people became used to using computers.
265. The witnesses were unhappy however at any suggestion that electronic filing be made compulsory. They thought that there would be some people who would remain IT illiterate or who for whatever reason would be unable to use the service and there would be costs involved. They were also concerned at the possibility of systems breaking down, of which there was some experience.
266. To give but one example, Frank Haskew (ICAEW) spoke for many when he said “I am afraid we do object to compulsion in relation to e-filing ... We support the move to e-filing. We are right behind the drive but it has to be business led. It is absolutely essential that these decisions are taken because it makes life easier for businesses and taxpayers and it reduces costs. But I do not think we are in that position at the moment. We are quite a long way from it, only last week we saw major problems on the PAYE system. We are a long way from having robust, reliable electronic systems. Therefore I am afraid we disagree. We think compulsion sets the wrong tone when people are struggling to try to submit data. It just does not ring true. What we should be concentrating on is getting these systems right and then the natural move for businesses and taxpayers will be to use them. You may then have 90% and you will have to decide what to do with the ten per cent but we are not at that position at the moment” (Q 234).
267. Richard Stratton (LS) who made very similar points was also concerned about the use of regulations to introduce the provisions. He said “we do not think the public at large should be faced with [the requirement to file electronically] until the matter has been reconsidered by Parliament and Parliament decides whether everything is up to scratch at that point” (Q 126). John Cullinane (CIOT), who again had very similar concerns about compulsion, was also worried that online facilities might be seen “as a way of coping with the complexity of the system and not doing anything about it” (Q 197).
268. Theresa Middleton (HMRC) told us that the Department had been concentrating on getting agents to support their clients in their requirements to file online. Apart from PAYE, the smallest businesses would not be required to file electronically before 2012 so there was a lot of time to prepare the ground and work with businesses to understand how HMRC could help them.

269. She said “we believe [compulsion] is essential to maximise the benefits for businesses, the wider taxpaying public and the Government. Lord Carter found when he did his review that there was a reluctance to engage with Government online and that was why he recommended a package of measures to maximise the adoption of services over a period of time. It is also the case that online services do offer a wide range of benefits for those who use them” (Q 338). HMRC was doing a lot of work researching the needs of people with visual impairment and how they could be met: the new portal for online services would be designed to take them into account.
270. Theresa Middleton added that HMRC was planning to ensure that their systems worked. She said “Lord Carter recommended that we should do capacity testing and that we should do so for a year in the run-up to the introduction of new services. The recent decision announced around the time of the Budget to push back the start date for some of these services should, I hope, provide reassurance that we are taking that very seriously and we will be carrying out capacity testing before the new services come on stream. The other thing that is worth considering is increasing confidence by the business community in our online performance” (Q 342).
271. The self assessment filing deadlines had worked really well, but she accepted that recently there had been a couple of glitches with the PAYE online service. However if people needed to file but could not because of a fault, extra time would be allowed. Dave Hartnett (HMRC) confirmed that other countries also provided more time, but HMRC was looking with others to see “how we can build more resilience into our systems than perhaps we have had in the past. There is a great pooling of work going on in the tax community around the world” (Q 342).
272. Theresa Middleton also told us that the smallest non-business employers, such as those employing someone to look after a child or a relative or themselves, would not be required to file online until 2010. However, as a result of the incentive payments totalling £825 over 5 years, 70% of small employers were doing so already. The service was good and quicker and data was transmitted more accurately. It would undoubtedly reduce the burden on small employers. They did not need to incur any cost as the HMRC service was free.
273. **We remain concerned that the implications of making online filing mandatory for Corporation Tax and Value Added Tax have not been fully thought through. We understand why HMRC has taken the line which it has and certainly it has taken many steps to encourage online filing: it should continue to do so by every means. But the range of issues raised by our private sector witnesses need further consideration. There should be further concentration on ensuring the robustness and reliability of the systems and on making the change more attractive for those who are IT illiterate. We do not think that the efficiency savings to HMRC justify compulsion.**
274. **We recommend that the present proposals for requiring online filing by smaller businesses be dropped: better marketing by HMRC of the benefits of e-filing would be a better approach. There may come a time when e-filing could be made compulsory, but we think it premature at present.**

275. **We hold a similar view in respect of mandatory online filing of PAYE/NIC returns which is currently due to come in in 2010. We fully accept that significant steps are being taken over a long period to pave the way for this, but we do not think that they are sufficient to cover every case, for example of individuals who become employers for the first time towards the end of the phasing in period.**
276. **We recommend that the present timetable for mandatory online filing of PAYE/NIC returns be cancelled and that the smallest employers be permitted to put in paper returns in 2010 and beyond.**

Mandatory electronic payment

277. Our private sector witnesses were reassured when they learned that payment could still be made by cheque through the bank giro method. Theresa Middleton (HMRC) confirmed that bank giro credit was treated as electronic and that this would be so for at least the medium term although it would be kept under review along with changes in the banking system. These proposals applied only to corporation tax and VAT and not to the smallest businesses. As for housebound people who could not get to a bank, they could set up an electronic payment over the telephone or by internet banking.
278. She added “In each of the areas that you are concerned about there should be some reassurance for you that on the one hand a giro credit is and for now will continue to be accepted as an electronic form of payment and for people who cannot get out of the house to go to the post office to present their cheque there are other means by which they can procure electronic payment on their behalf” (Q 344).
279. **We fully accept that there should be no cash flow advantage for payments by cheque.**
280. **We were reassured to learn that the provisions for mandatory electronic payment of Corporation Tax and Value Added Tax would include payment by cheque using the bank giro method and that it was only cheques sent by post or handed in which would not be acceptable. We should be concerned if this facility were to be withdrawn in the medium term. Despite this facility, we are concerned that there will still be some people for whom payment by any electronic means will be difficult.**
281. **We recommend that there should continue to be provision for payment by post in particular cases.**

CHAPTER 6: CONCLUSIONS AND RECOMMENDATIONS

The Business Tax Reform Package

Simplification

282. It is undeniable that the present tax system is highly complex. Simplification is essential if costs for businesses are to be reduced, greater certainty achieved, and the UK made more attractive to mobile international businesses. (para 21)
283. We **recommend** that a more determined and consistent attempt at simplification be made. What we see in this Finance Bill is a very modest step and more could be done. This will necessarily take more than one year and will require a combination of administrative and legislative measures. There clearly may be a tension here with the desire for fairness: it will also be necessary not to open up scope for avoidance. But it should be possible to find a balance here if the work is well researched and subject to wide consultation. (para 22)

Review of the links with large business

284. We welcome the progress being made by HMRC in its review of the links with large businesses as advanced in the delivery plan published at the time of the Budget. We note the concerns of our private sector witnesses around the availability in HMRC of sufficient skills and resources. HMRC accepted that delivering the plan was a challenge and that it needed help to understand some business sectors. However it regarded carrying forward the recommendations of the review as absolutely fundamental and was confident that it could achieve the plan. We welcome this assurance which will undoubtedly be widely noticed. (para 31)
285. We welcome in particular the consultations which are taking place on clearance procedures and advance rulings. There are many indications that our international competitiveness has slipped in recent years and one important contribution to reversing this would be to catch up other jurisdictions with the certainty about taxation which they provide for incoming businesses. We **recommend** that this should be a high priority. (para 32)

Administrative costs

286. The programme to cut administrative costs is welcome. We note the concerns of some of our private sector witnesses that the programme is not eating into the core compliance burden or sufficiently ambitious. (para 39)
287. Here again, HMRC, who thought that the programme was stretching and that the United Kingdom compared quite favourably internationally, was confident that it would be delivered, to the benefit of small businesses in particular. We **recommend** that this programme be pushed ahead vigorously. (para 40)

Small companies

288. We share the common view that small businesses need certainty and stability as much as large ones. There was general agreement that they too ought to be able to take commercial decisions—for example whether or not to incorporate—without regard to the tax implications. Too many decisions have been taken with tax in mind and this must be seen as a weakness in the tax system. (para 46)
289. In this context the frequent changes in the small companies rate of corporation tax have been unhelpful. However the change in the rate being made this year and the further changes which have been foreshadowed will, in conjunction with the proposed simplification of personal taxation, be helpful by reducing the difference between the tax burden on incorporated and unincorporated businesses. (para 47)
290. This should however be only the start of the process. One approach towards reducing complexity and the distortions which tax considerations may bring to business decisions would be to stand back and review the issue as a whole in conjunction with the sector. It would certainly not be possible to remove all the complications, but the outcome might well be greater clarity and consistency. (para 48)
291. We recognise that, at a time of staffing cuts, HMRC has to prioritise its services carefully. It is important however that, while rightly concentrating on delivering the plan for its links with large companies, regard is also had to the taxation needs of small businesses and their advisers. (para 52)

Capital Allowances

292. The changes to capital allowances introduced in this year's Finance Bill have brought only limited simplification. There has been less agreement among our private sector witnesses about the impact in this regard of the future changes which were also announced as part of the package, but we are pleased to note that these are to be the subject of consultation. (para 63)
293. Any changes in the tax system may bring unwelcome uncertainty and this is especially so when the financing of long term investments is involved. This sits oddly in a package designed to encourage growth. We carefully considered the proposal which was put to us that there should be grandfathering of the changes to the building allowances in order to provide greater certainty and to avoid what was represented to us as retrospection. However the complexity from having two systems, and the avoidance which HMRC had experienced on an earlier occasion, persuaded us not to recommend it. (para 64)

Tax Credits for Research and Development

294. This year's Finance Bill sees further enhancements to the R&D tax credits. These aim to provide an important contribution to the thrust of the business tax package to encourage growth through investment and innovation. (para 73)
295. We received mixed evidence as to the effectiveness of the credits. However the number of claims from small companies as well as from large ones and the independent research which HMRC has carried out casts doubt on some of the concerns expressed by some of the private sector witnesses as to the

extent to which companies, in particular small ones, are aware of them or find them accessible. HMRC said that it was not complacent and had introduced specialist units to help businesses through the processes. HMRC also thought, contrary to a view expressed to us, that the credits compared well internationally. (para 74)

296. Given that inevitably it will take time before a fully considered view on the effectiveness of the credits can be taken, the area must be kept under close review. But we see no reason to express any immediate concern. (para 75)

Consultation

297. We welcome the increasing amount of consultation which is now taking place across the tax system on technical issues both on legislative and administrative aspects. Consultation may be less easy to arrange on issues where there are sectoral implications and where there would be winners and losers, such as this year in the case of the capital allowance changes. Nonetheless it is as important in these areas as it is elsewhere if proper consideration is to be given and simplicity and certainty given due weight. (para 83)
298. Lessons ought to be learned from the progress on consultation made so far; the implications of the simplification of personal taxation, which was also announced at the time of the Budget, should also be subject to consultation so that its full impact can be fully assessed and implemented smoothly. (para 84)

International competitiveness

299. The setting up by the Confederation of British Industry of a task force to consider whether the UK business tax regime is fit for purpose is itself evidence of the extent of the concerns about the decline in the UK's tax competitiveness and of the need to enhance it. The reduction in the headline rate of corporation tax in this year's Finance Bill is likely to have a beneficial effect, but other countries are also reducing their rates and it is the extent of the burden as a whole—which is broadly unchanged—and how the system is administered which are equally germane. As to the latter we have already noted with approval the progress being made in the review of the links with large business and the need to press ahead with it vigorously. (para 91)

Investment and innovation

300. We are doubtful whether the changes in the business tax reform package will do much to meet the Government's aim of encouraging growth through investment and innovation. Their overall impact is broadly revenue neutral. Apart from the investment allowance, the changes being made in capital allowances seem designed to recognise economic depreciation and in general withdraw any investment incentive. (para 95)
301. The annual investment allowance to be introduced next year, on which there is now to be consultation, is intended to provide some incentive, but we await the details. It will be important to consider its impact on businesses in different sectors and of different sizes. (para 96)
302. Against the impact of the business tax package as a whole, the changes in the R&D tax credits are comparatively small and perhaps not sufficient to make a very positive impact overall. (para 97)

Fairness

303. No-one could disagree about the need to ensure fairness across the system. But fairness is an elusive concept and may mean different things to different people. As we said when commenting on the need for simplicity, a balance has to be struck between it and fairness. (para 105)

*Managed Service Companies**Is there an underlying problem not addressed by this legislation?*

304. We agree with the view put forward by our private sector witnesses. There can be no satisfactory long-term resolution of the issues raised by personal and managed service companies without tackling the underlying structural issues, however difficult they may be to resolve. (para 128)
305. We therefore **recommend** that the Government should review the taxation of employees and small businesses operating in various forms with a view to making structural changes to reduce the differences in outcome in terms of tax and NICs payable whether an individual is employed, self employed or operating through a company. This will overlap with the review of small business that we recommended earlier and should provide a good opportunity to help meet our recommendations on simplification generally. (para 129)

The need for the MSC legislation and its effectiveness

306. On the need for the new legislation, we are persuaded that the revenue loss had to be addressed in the short term. Given the collection difficulties and that HMRC have not been able to devote the resources to policing IR35, we think that a new legislative solution is the only option. (para 138)
307. However, we are not persuaded that the position concerning the effectiveness of the new legislation is as comforting as HMT/HMRC portray. We **recommend** that they keep under close scrutiny the operation of the new legislation. (para 139)
308. We also **recommend** that they review the resources allocated to the operation of the IR35 legislation so that if they have to fall back on that legislation, all angles are covered. The collection issue may have to be addressed separately. (para 140)
309. It would be unfortunate if there had to be a further round of legislation in this area, in advance of the more fundamental review recommended above. (para 141)

Impact on the Labour Market

310. We hope that HMT's view that the new legislation should have no significant impact on the flexibility of the labour market is correct. We **recommend** that HMT should monitor this carefully. (para 146)
311. In addition we **recommend** that HMRC should review the way that it applies the IR35 legislation and, where necessary the new MSC legislation, to genuine new businesses so as to ensure that they are not strangled soon after birth. (para 147)

Defining an MSC

312. We were troubled to find how many concerns there were in respect of the definition of an MSC. This targeting provision is central to the appropriate operation of this legislation. We think that it is now for our private sector witnesses to review, as a matter of urgency, the operation of the new section 61B in the light of the comments of the Financial Secretary to the Treasury and the explanations given by HMRC to us. If they are not persuaded, they should make further representations setting out the detail of the changes that they think are still necessary. We **recommend** that if this happens, the Government should bring forward further amendments at the Report Stage of the Bill. (para 155)
313. In any case, the drafting of the guidance on this provision will be vital in ensuring that it operates without collateral damage. We **recommend** that HMRC enters into full consultation with the private sector in developing this guidance to achieve full clarity, both generally and particularly on those points on which our private sector witnesses might continue to have doubts. (para 156)

Transfer of Debt Provisions

314. We were concerned at the number of worries expressed to us about the debt transfer provisions. We think that it is now for our private sector witnesses to review, as a matter of urgency, the operation of the new section 688A in the light of the Government amendments made in Committee, the explanations of the Financial Secretary to the Treasury and the evidence given by HMRC to us. If they are not persuaded, they should make further representations setting out the detail of the changes that they think are still necessary. We **recommend** that if this happens, the Government should bring forward further amendments at the Report Stage of the Bill. (para 168)
315. This is an area where it is vital that third parties know whether or not they are in danger of having debts visited upon them. We therefore **recommend** that guidance is drafted with the full input of the private sector to provide clarity on the issues, particularly those where the private sector might have continuing doubts. (para 169)

Part 6 Finance Bill: Review of Powers, Deterrents and Safeguards

General Issues

The nature of the review

316. Even if an independent body to conduct the review of powers, deterrents and safeguards would have been more appropriate—and we do not express a view on that—it is now too late to change the approach that has been taken. (para 182)

Is it right for powers and deterrents to be introduced before safeguards?

317. We were very concerned at the fact that the review was considering powers and deterrents in advance of safeguards. Had the consultative document on safeguards not been published when it was, we should have been making firm recommendations in this regard. We are pleased to see that this is now

in hand and we urge the adoption of appropriate safeguards for taxpayers as quickly as possible. (para 192)

318. As part of the consultation on safeguards, we **recommend** consideration of a taxpayers' charter or other formal statement of the rights and responsibilities of both HMRC and taxpayers. (para 193)

The consultation process

319. We recognise the time pressures, both generally and in relation to the Finance Bill timetable. And we acknowledge that illustrative/draft clauses were included in the December and January papers. However, we urge that adequate time is given to consultation, particularly on important, serious matters such as powers and deterrents. (para 196)

The balance between legislation and guidance

320. We accept that it is not possible to include everything in primary legislation and that there has to be supporting guidance. We see it as particularly important that where serious matters such as powers and penalties are under consideration, as much as possible is written into primary legislation. (para 201)
321. We **recommend** that great care be taken to ensure that all significant changes in published guidance be the subject of detailed and timely consultation. (para 202)
322. We **recommend** that a way be found for the administrative procedures and guidance to be kept current and easily accessible alongside the primary legislation as a permanent record of the assurances that are presently being given in respect of these important powers and penalties. (para 203)

Criminal Investigation Powers

Exercise of the powers

323. We recognise that the decision has been taken concerning the exercise of criminal investigation powers by HMRC. We are reassured by the comments of HMRC as to how they intend to exercise these powers. We consider it very important that the assurances that are being given at the present time are adhered to in practice. (para 211)

Which HMRC officers can exercise these powers?

324. Overall, we are persuaded that sufficient assurances have been given by the Government in Committee of the Whole House and in HMRC's evidence to allay fears concerning who in HMRC can exercise these important criminal powers. (para 218)

The powers for Scotland

325. We **recommend** that if Scots lawyers have any remaining concerns with Schedule 23 to the Finance Bill, they should communicate these to HMRC as quickly as possible and that the Government should bring forward amendments as necessary at the Report Stage of the Bill. (para 222)

Monitoring of how the powers are being exercised

326. We consider that monitoring of how these powers are being exercised is vitally important. (para 228)
327. We therefore **recommend** that serious consideration should be given to HMRC providing an annual report to Parliament setting out the way that these powers have been exercised in the previous year and how the assurances that have been given at the present time are being adhered to. That report could either be incorporated into the HMRC departmental report or be separate. (para 229)
328. We also **recommend** that firm consideration should be given to the setting up of a standing committee (HMRC/private sector) to review the operation of these powers as well as issues such as funding and training. It is particularly important that such a committee should be in place before the powers steering group is disbanded and is no longer able to perform this function. (para 230)

*Penalties for Errors**Definition of the categories of behaviour / Penalty levels*

329. In our view it is very important that if the new penalty regime is to influence behaviour and encourage better compliance, there should be a common understanding of what type of behaviour falls into which degree of culpability. Whilst we note HMRC's view that the categories are very clear indeed, we remain concerned that others are not so confident. (para 240)
330. We **recommend** that particular thought and effort goes into the drafting of the guidance on these aspects and that private sector representatives are given full time to comment on it. (para 241)

Appeal rights

331. We do not see why there should be a restriction on an appeal tribunal's powers. In all other respects the tribunal has the power to substitute its own decision for that of HMRC. Our view is that this should extend to decisions relating to special circumstances and the suspension of a penalty. We **recommend** that the Government should bring forward amendments at the Report Stage of the Bill to change the way that these appeal rights operate. (para 246)

Appeal procedures

332. We are pleased to see that the suggestion of an informal dispute resolution process is included in the recent consultative document and urge HMRC to take this forward as rapidly as possible so that the informal process can operate from the time the new penalty structure is implemented. (para 250)

Penalty position where agent acting

333. We accept that at the extremes given in the evidence by HMRC, the position where an agent is acting is clear. But we think that there is a substantial middle ground where the position is less clear and there are therefore grounds for dispute. We **recommend** that either the Government bring forward amendments at the Report Stage of the Bill to clarify this or

guidance is carefully drafted with full consultation with the private sector representatives. (para 256)

Drafting

334. We think that the Government amendments should meet the concerns that have been expressed with the use of “HMRC think”. We urge the Government to consider the other detailed drafting amendments that have been suggested to us in the written evidence. (para 259)

Part 6 Finance Bill: Online Filing and Electronic Payment

Mandatory Online Filing

335. We remain concerned that the implications of making online filing mandatory for Corporation Tax and Value Added Tax have not been fully thought through. We understand why HMRC has taken the line which it has and certainly it has taken many steps to encourage online filing: it should continue to do so by every means. But the range of issues raised by our private sector witnesses need further consideration. There should be further concentration on ensuring the robustness and reliability of the systems and on making the change more attractive for those who are IT illiterate. We do not think that the efficiency savings to HMRC justify compulsion. (para 273)
336. We **recommend** that the present proposals for requiring online filing by smaller businesses be dropped: better marketing by HMRC of the benefits of e-filing would be a better approach. There may come a time when e-filing could be made compulsory, but we think it premature at present. (para 274)
337. We hold a similar view in respect of mandatory online filing of PAYE/NIC returns which is currently due to come in 2010. We fully accept that significant steps are being taken over a long period to pave the way for this, but we do not think that they are sufficient to cover every case, for example of individuals who become employers for the first time towards the end of the phasing in period. (para 275)
338. We **recommend** that the present timetable for mandatory online filing of PAYE/NIC returns be cancelled and that the smallest employers be permitted to put in paper returns in 2010 and beyond. (para 276)

Mandatory Electronic Payment

339. We fully accept that there should be no cash flow advantage for payments by cheque. (para 279)
340. We were reassured to learn that the provisions for mandatory electronic payment of Corporation Tax and Value Added Tax would include payment by cheque using the bank giro method and that it was only cheques sent by post or handed in which would not be acceptable. We should be concerned if this facility were to be withdrawn in the medium term. Despite this facility, we are concerned that there will still be some people for whom payment by any electronic means will be difficult. (para 280)
341. We recommend that there should continue to be provision for payment by post in particular cases. (para 281)

APPENDIX 1: THE FINANCE BILL SUB-COMMITTEE

The Members of the Sub-Committee which conducted the inquiry were:

Rt Hon Lord Barnett
Lord Blackwell
Lord Paul
Lord Powell of Bayswater
Rt Hon Lord Sheldon
Lord Sheppard of Didgemere
Lord Vallance of Tummel
Rt Hon Lord Wakeham

Mr Leonard Beighton, CB and Dr Trevor Evans CBE JP both retired senior officials of the Inland Revenue, were appointed as Specialist Advisers for the inquiry.

Declarations of Interest

A full list of Members' interests can be found in the Register of Lords Interests:

<http://www.publications.parliament.uk/pa/ld/ldreg.htm>

APPENDIX 2: LIST OF WITNESSES

The following witnesses gave evidence. Those marked * gave oral evidence.

- * The Association of Chartered Certified Accountants
- * The Association of Taxation Technicians
- * British Chambers of Commerce
- Business in Sport and Leisure
- * The Chartered Institute of Taxation
- * Confederation of British Industry
- * Federation of Small Businesses
- * HM Revenue and Customs
- * HM Treasury
- * The Institute of Chartered Accountants in England and Wales
- * Institute of Directors
- * The Institute for Fiscal Studies
- * Law Society of England and Wales
- * Law Society of Scotland