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Select Committee on Economic Affairs

4th Report of Session 2006–07

The Finance Bill 2007

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Minutes of Evidence

TAKEN BEFORE THE SELECT COMMITTEE ON ECONOMIC AFFAIRS
(FINANCE BILL SUB-COMMITTEE)

WEDNESDAY 25 APRIL 2007

Present	Barnett, L	Sheppard of Didgemere, L
	Paul, L	Wakeham, L (Chairman)
	Sheldon, L	

Examination of Witness

Witness: Mr Malcolm Gammie CBE QC, Director, Tax Law Review Committee, Institute for Fiscal Studies, examined.

Q1 ***Chairman:*** Good afternoon. It is nice to see you again. You are extremely welcome. You know exactly what the form is. We have chosen the three topics we think are the most suitable for us, bearing in mind our terms of reference which you know all about. We suspect they are the ones that the House of Commons will also debate most. I suggest you tell us what you would most like to tell us about those three clauses at the beginning, and then, if there is anything left to ask you, we will ask you questions at the end. Is that all right with you?

Mr Gammie: Yes, my Lord Chairman, that is fine. I am obviously very pleased to be here and to have the opportunity to assist you this year in your deliberations. Perhaps I could start with the business tax package which of course contained three main elements in what was announced: the change in the rates of corporation tax; changes to the capital allowances system; and an increase in the incentives for research and development expenditure. To the extent that changes occurred in the rates of tax, there is no particular simplification as such to the system and it is just a matter of applying a percentage to the calculated profits. In that sense, the changes in both the mainstream rate of corporation tax and the small companies' rate of corporation tax and the changes in research and development relief do not, I think, have any particular implications for the simplification of the system or its administration. Obviously over the last year, since the 2006 Budget, the Inland Revenue, or Her Majesty's Revenue and Customs as I must now call them, have taken steps to make the research and development incentives more accessible to taxpayers and the administrative and compliance burden of those easier. I have no reason to think that has not made a significant difference in the way in which those incentives are administered. I will say something about the changes in the small companies' rate of corporation tax when I come on to make some comments on the managed service company regime. In so far as the reduction in the mainstream corporate tax rate from 30 per cent to 28 per cent with effect from next year produces a viable long-term corporation tax rate which is internationally competitive, I think one must note that certainly within the European Union it does not affect our position significantly in terms of where we stand amongst the Member States in terms of rates. Obviously relative to the larger economies in the European Union it leaves us in a fairly favourable position, but the Netherlands, I believe, is in the process of reducing its corporate tax rate to 26 per cent and Germany is anticipating a major corporate tax reform in 2008 which may incorporate a reduction in its corporate tax rate, so how viable 28 per cent will be in the long term I think remains to be seen. The major change, of course, in terms of the administration and simplicity of the system relates to the changes in capital allowances. To the extent that allowances have been eliminated for buildings over a transitional period, that must inevitably simplify the system to the extent that it is no longer necessary to do all the calculations that buildings allowances otherwise required. I think buildings allowances were always fairly high on many people's list for simplification, although I am not sure we necessarily anticipated their removal entirely. To the extent that the allowances on plant and machinery will be reduced from 25 per cent to 20 per cent, of course that again does not make a significant difference to the administration or simplification of the system, it is just applying a different rate. To the extent that both buildings allowances are removed and plant and machinery allowances are reduced, the incentives to invest or incur expenditure in those particular areas are at least reduced to some extent, although it is obviously difficult to balance the reduction in corporate tax rate against the changes in allowances because those two effects will vary according to the nature of the business and its particular investment needs. In terms of the other changes to be made to the system, of course, we await more detailed

consultation from the Inland Revenue. I think it is a short-term point. It appeared that the Revenue was not able to give significant assistance in terms of informing taxpayers as to the implications of these changes in the light of the Budget, but no doubt that will be cured as the consultation proceeds; although, 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. The main new element in the system that may be complex is the relief that will be given at a 10 per cent rate for fixtures in buildings where the expenditure is on plant and machinery which becomes part of the building. At the moment, that is dealt with within the ordinary capital allowances pool, though there are special provisions dealing with fixtures and entitlement of allowances, and whether that system will become simpler or not as a result of these changes must await the outcome of consultation. Perhaps the more significant aspect in terms of immediate impact from the Budget announcements in relation to this year's published documents were the three that were published on the relationship with large business. There was one document on delivering a new relationship with business which built on previous consultation between the Revenue and business on reducing administrative burdens; there was a publication on the Revenue's approach to compliance risk management for large business; and then a third delivering a review of links with large business. All of those documents were very welcome, in the sense that they reinforced the specific targets and commitments that the Revenue had entered into in an attempt to reduce administrative burdens on large business. In that sense published commitments are obviously welcome and the moves that are made to achieve those targets and commitments. From my own limited knowledge of the work that has been going on within the Revenue with large business, I would certainly say that the Revenue is making a significant effort to achieve those targets and to achieve a better understanding, both of business's position in relation to tax it pays and its tax obligation and what the Revenue can do to assist business. In particular, the consultation that will take place on a new set of clearance procedures and advance rulings will be welcomed by many businesses. Again, however, the detail of that will only become apparent later in the year as consultation advances. One of the main issues that arises from all this is that it is one thing for the Revenue to move for better relationships with large business and to improve the administrative procedure for dealing with large business, but that obviously has to be set against the general legislative stance, where we have seen significant change in the details of corporate tax rules, particularly in the area of anti-avoidance legislation, and the complexity that tends to bring, and there is anticipation of change from an international perspective in relation to rulings of the European Court of Justice. There will have to be significant changes in the way in which international business is dealt with, and all of that of course has to be balanced against a greater ease of administration, whatever greater ease of administration the Revenue can achieve. My final comment in this particular area would be that the Revenue has taken on a very considerable workload in terms of the administrative changes, both in this area and in other areas you are considering, and the question will obviously be whether in fact the Revenue, within the sort of timeframes it is setting itself, can achieve and deliver all that it has promised to do. I would like to turn to make some comments about managed service companies. The fundamental problem in this particular area is just the basic fact that the employed, the self-employed and those who operate in incorporated form through small companies are subject to very different tax burdens. At the same time, of course, we have to bear in mind that the environment within which many people work has become a great deal more flexible, both in terms of the organisational form in which they work but also the impact, for example, of employment rights on the willingness of employers to engage people, whether as self-employed persons, employees, or through a personal service company. In a sense, the changes which have been taking place in the tax system reflect the response of individuals to the implicit incentives that exist within that system to minimise their tax liabilities. In a sense the managed service company legislation, as the IR35 personal service company legislation before it, attacks the symptom not the cause of the particular problem and that raises a number of issues that one can ask about managed service company legislation. The question really is whether that legislation is there and designed effectively to eliminate the use of managed service companies entirely or merely to render neutral the choice of organisational form, whether people are employed in a conventional manner, whether they use a managed or personal service company or whether they can achieve the status of self-employment. Of course, to the extent that employers and the employment market means that ordinary employment is not on offer, it raises further issues as to how an individual organises himself as a way of obtaining gainful work. Inevitably when you are faced with these issues, there is, particularly for the Revenue, a question of how much resources one devotes to policing legislation which may have the effect of reducing the incidence of particular forms of organisation, which therefore makes it more difficult to justify concentrating resources on dealing with it. Of course, one criticism of the managed service company legislation is that if the personal company

service legislation had been more effectively policed by the Revenue in the first place, then maybe managed service companies would not have arisen. On the other hand, we are in a field—because we are attacking the symptoms rather than the cause—where individuals, in particular those who offer means of reducing their tax liabilities, tend to move from one form to another as particular opportunities are closed off. As an illustration of this, one can look at the difference in tax liabilities that exist according to the organisational form. To an extent the Government has started to address this by its changes in the small companies' rate. The essential problem being, of course, that if you organises yourself through a company you can take dividends without liabilities, in particular, to national insurance contribution. By increasing the small companies' rate of tax in a stepped phase over the next few years, the Government is essentially compensating for the absence of national insurance contributions on corporate profits distributed as dividends. Nevertheless, 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 still be discrepancies for those earning £25,000 per annum: in the order of £2,000 less tax if they are self-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. That inevitably will continue to provide incentives for individuals to organise themselves in a way that circumvents both personal service company legislation and managed service company legislation and may therefore necessitate further measures in due course. I will move to the final topic on your list for consideration this year and that is the range of administrative issues that are dealt with in part 6 of the Finance Bill. This covers a range of issues, from the new criminal powers conferred on the revenue department to changes in the penalties regime dealing with the date of filing of tax returns and the incentive or the requirement to file electronically. The changes in the criminal powers and the changes in the penalties are obviously the first product of the review the Revenue has been conducting into its powers in the light of the merger of Revenue and Customs. I think everybody accepts this is an appropriate review and a necessary one, on the basis that it does not make sense for the department to be operating with a whole series of different powers according to different taxes, even though those taxes are paid by a very similar body of persons. 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 independent committee, such as the Keith Committee, to review this whole area, because, inevitably, the interests of taxpayers and the revenue authorities has to be balanced in deciding upon the measures to be introduced and, however fair the revenue authorities may be in conducting their review, it, 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. I have no reason to think the Revenue is not dealing with this matter extremely conscientiously and fairly. I think most people would generally be satisfied that their responses to the consultation are being considered appropriately by the Revenue. I think the important aspect of this is that it is something that will have to build up over several Finance Bills, and, as I say, what we have in this Finance Bill is very much a first product of the consultation. One might regret that it 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, and in that sense maybe it is appropriate that the measures are not being enacted necessarily for immediate implementation but through implementation in due course on an appointed day. Inevitably the changes to penalties will take some time to introduce, given the need for changing revenue procedures, for guidance to taxpayers and the like, and therefore there is obviously a period following enactment of this year's provisions over which further comments and consideration can no doubt be given to the extent that the regime is thought to require further consideration. Nevertheless, in relation to the new penalty provisions, there is generally support, I think, for the direction in which the Revenue has moved and for the structure that it is creating in this year's provisions. In relation to electronic filing and changes in the time limits for filing returns, I do not think I want to say a great deal. There is obviously an issue as to whether electronic filing should become compulsory or not and the particular measures that are appropriate for taxpayers who would otherwise pay their tax perfectly on time through an ordinary paper return but find that is no longer an option open to them. To the extent that the incentive to file electronically is being conferred in an extended timetable for filing as against paper returns, one can merely note that the United Kingdom is extremely generous compared with most countries in terms of is filing deadlines. In that sense, moving filing deadlines forward, particularly in terms of paper returns, is perhaps difficult to criticise when one looks at the international comparisons and the time allowed in other countries, although obviously every country deals with the administration of the tax system

differently and therefore there are a variety of aspects to the establishment of appropriate filing dates. My Lord, I think that is all I wish to say by way of opening but I am very happy to deal with any questions.

Q2 ***Chairman:*** That is very kind of you. As usual, a pretty comprehensive run through of the issues we are going to concern ourselves with. We are going to get a lot of evidence from the usual professional bodies and others and in it there are going to be some of the things which are really important and some of the things which might be called special pleading and over-egging the pudding and so on. I wonder if we could take each one of the subjects and you could give us an indication of the areas which you think we would have a fruitful time discussing with them, areas where they will tell us that the consultation has not been enough or they have not recognised some of the problems. We can therefore probe them a bit further and also be a little sceptical of some of the more exaggerated things which they will perfectly reasonably say to us and do a better job of teasing out what are the real issues. Maybe the right thing to do is to take each of the three subjects, starting therefore with the business tax reform. I and my colleagues will ask you questions about that and then we will move on to the next one. Perhaps I could start on the business tax reform package. You said there had been progress on the three objectives. What do you think the business world is going to tell us about these things? Are they going to be satisfied or are they going to be dissatisfied? In which areas do you think they will be dissatisfied with the progress so far?
Mr Gammie: In relation to the basic proposal, I am sure most will be satisfied with the reduction in the mainstream corporate tax rate. The contentious aspect in relation to capital allowances is the different sectors upon which that falls, because obviously the service sector may be considerably less affected by the removal of buildings allowances than the industrial sector or the hotel sector, for example. I am sure there will be a number of complaints from industry and the hotel sector, and I suppose the farming lobby as well, that these changes disadvantage them in not allowing relief for ordinary depreciation.

Q3 ***Chairman:*** As long as I have been involved in these things there has always been a trade-off between fairness and complication and, almost inevitably whenever you decide to simplify something, somebody is going to be able to say, "It's unfair". You think that will come out in the capital allowances area.
Mr Gammie: Of course the Government's own consultation on the reform of the corporate tax system a couple of years ago put up a suggestion that maybe relief should be given according to accounting depreciation rather than under the capital allowances system. By removing allowances entirely from buildings, you are not giving any relief for any depreciation. No doubt the Revenue may say that is to an extent balanced by the fact that increases in value of the land are not taken into account in computing profits anyway, so to the extent that there is trade-off between the land values and depreciation of buildings then there is some offset, but of course that is a very imperfect situation because there is no guarantee that the person who owns the land is the person who incurs the expenditure on the building.

Q4 ***Lord Barnett:*** Good afternoon. With the industrial buildings allowance removal there will obviously be some complaints, as you have said, but as farmers complain that they do not make a profit anyway, surely it should not bother them so much, I suppose. The way the capital allowance system will work in conjunction with the increase in corporation tax for small firms is what many have complained about, as you know. The Chancellor seemed to be arguing that anybody making something like, say, £150,000 to £200,000 a year in a small company would be no worse off because of the capital allowances they would be able to get, the extra capital allowances. The research and development tax credit is referred to. Tax credit has been a peculiar problem for individuals, in the sense that it is not claimed to a large extent. You mentioned that the Revenue are trying, as it were, to help make these claims. Are they being successful in that regard?
Mr Gammie: Of course the research and development credit gives, at the moment, 150 per cent relief for expenditure on research and development, which, to the extent that there are inadequate profits to offset that 150 per cent against, can be converted into a repayable credit based on the small firms PAYE and national insurance obligations. Of course the companies that are eligible to claim the research and development credit may be a very different category from those who have suffered the withdrawal of allowances. Obviously all these changes have very different effects, depending on the particular company and the particular sector in which it is operating. When the research and development credit was first introduced—which I think was in 2000 for small companies and 2002 for larger companies—the administration of it was very much left to individual districts. There was some difficulty within the Revenue in ensuring that claims were handled expeditiously and there was a lack of expertise, I think, amongst those inspectors who were faced with claims for the credit. The sorts of changes that the Revenue 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.

Q5 ***Lord Barnett:*** I understood you to be saying that you did not see much in the way of simplification here.
Mr Gammie: I do not see very much by way of simplification because by just changing the rate at which the—

Q6 ***Lord Barnett:*** It is changes in capital allowance.
Mr Gammie: It is just a change in percentage that you apply to particular expenditure but it does not do anything to simplify the system as such.

Q7 ***Lord Sheldon:*** I am a bit worried about the investment in companies. You talk about going to reduce the allowances from 25 per cent to 20 per cent next year. This is bound to have some serious consequence. Many people feel that investment in companies is much less than we would like to see, even now. This is going to make it not easier to increase investment but to provide means of reducing the investment.
Mr Gammie: It will obviously reduce the incentive to the extent that expenditure on plant and machinery will have to be written down over a longer period of time. Yes, I would agree, it does not appear to be adding to incentives. Of course, there is an issue with plant and machinery allowances as to what extent 25 per cent is giving relief for actual economic depreciation of the asset and to what extent it is operating as an actual investment incentive. Studies that have been done have suggested that at a 25 per cent rate a great deal of expenditure on plant and machinery is being written off at a faster rate than economic depreciation would normally recognise. To that extent the reduction from 25 to 20 per cent may be moving closer to true economic depreciation of expenditure as part of the business expenditure but, inevitably, the impact of that will vary considerably between different businesses according to what equipment they are investing in and what their relative records of investment already are.

Q8 ***Lord Sheldon:*** As you rightly say, there are differences between companies in the kinds of investments they undertake. In the first year 25 per cent is automatically gone, almost whatever you invest in, and in many areas of investment the depreciation is getting larger because of the competition between companies wanting to produce something more attractive, and so this is likely to be harder than perhaps was originally envisaged.
Mr Gammie: That may well be the case. As I say, inevitably, so long as you have a capital allowance system which just gives a standard rate, the impact of that will vary according to the nature of the asset and the depreciation period, which is one reason why the Government's suggestion of a few years ago was to ask whether or not one should move to economic depreciation or accounts depreciation. It is fair to say that at that time the majority of business response to that consultation was to express a preference to remain with the capital allowances system rather than moving to a relief for accounting depreciation.

Q9 ***Lord Sheppard of Didgemere:*** You were talking about the impact, for example, between service industries and whatever you call the other industries. Has there been a great deal of stuff already published on that on the invitation of various industries?
Mr Gammie: Not that I have seen. There was obviously a degree of comment immediately following the Budget but I have not seen any particular work. Obviously sectors such as the hotel industry would be particularly affected, because, although we tend to refer to industrial buildings allowances, that extended to hotels, so that is a particular sector which is especially affected by these changes.

Q10 ***Lord Sheppard of Didgemere:*** People like CBI, who are coming in to see us next Monday, may find it particularly difficult to comment because the impact would vary a great deal between their members.
Mr Gammie: It will do, although I would expect, as a general matter, that they would regret the reduction in allowances because I think for the majority of their members it has some impact.

Q11 ***Chairman:*** Could I just finish on this with one pretty simple question. If the Chancellor were sitting where you are sitting and we said, "Come on, tell us about this simplification, because we ain't heard too much that has been impressive so far about simplification" what answer would he give? Why does he think what he has done is simplification?
Mr Gammie: To the extent that he has removed allowances for buildings, he has simplified the system. There will be a degree of repealed legislation. As I say, companies will no longer have to do all the calculations.

Q12 ***Chairman:*** That is the main simplification.
Mr Gammie: That seems to me to be the main simplification.

Q13 ***Chairman:*** Let us move on to managed service companies. You have quite rightly said to us that this really comes out of the IR35 of before. In the Inland Revenue's view, the IR35 proposals were not

adequate for the task and they had to move to this one. Was that because the Inland Revenue did not pursue the IR35 hard enough to collect the Revenue they thought they were going to collect and they therefore needed further powers? Was the previous attempt inadequate or did they not really try to make them work sufficiently?
Mr Gammie: I suspect it is because the degree of resource needed to police the IR35 rules was probably greater than the Revenue were prepared to commit to it or even had available to commit to it. The IR35 rules were introduced very much against the background of the information technology business, where a lot of IT specialists had incorporated themselves and they were effectively one-man or one-woman companies supplying their services essentially to one particular group. I suspect what happened with managed service companies was that there was an expansion in the number of people who saw this as a way of providing services where probably a number of the managed service company providers were not actually prepared or conscientious in applying the IR35 legislation. As I say, it would have been particularly resource intensive for the Revenue to deal with all that.

Q14 ***Chairman:*** Let me put it in another way. When people come along and tell us they do not like what the Chancellor is doing, presumably one of the arguments will be that there are people whom potential employers will not take on as employees; they insist that they provide their services by means of a self-employed or company basis. What would the Revenue say to that? Why will they say that is not a problem?
Mr Gammie: That is certainly the situation in a number of occupations where employers 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. So long as you have a tax system which is going to tax employment income, dividends, self-employment income differently, you have to address somehow the situation of people who are to be viewed as essentially employees but who are operating through a different organisational structure which gives them the opportunity to reduce their tax liabilities. Whilst the IR35 provisions were controversial and to an extent the managed service company provisions are controversial, certainly most comment I have seen has probably accepted that the managed service company provision is a necessary change because of the way in which it was circumventing the personal service company provision.

Q15 ***Chairman:*** Because there is still a tax advantage to being self-employed.
Mr Gammie: Absolutely, yes, or certainly through operating as a company.
Chairman: I am afraid we have a division.

The Committee suspended from 4.28 pm to 4.36 pm for a division in the House.

Q16 ***Lord Barnett:*** Could I clarify how tax avoidance has been working between workers and a managed service company. I had assumed that we were mainly dealing with self-employed moving into a managed service company. Am I wrong?
Mr Gammie: No, I think that is probably a mixture of individuals who would either ordinarily be employed and those who could be self-employed. I do not think it is necessarily one or the other.

Q17 ***Lord Barnett:*** Is it that some people are setting up as managed service companies to avoid national insurance contributions? If I am a self-employed consultant, I pay my tax not under pay-as-you-earn. If I am a director, I pay it under pay-as-you-earn, although I understand that some directors have been turning themselves, or perhaps even with others, into a managed service company. Is that correct?
Mr Gammie: The essential way in which it works is that you are employed by a company but your services are provided by a company to a third party and the third party pays the company.

Q18 ***Lord Barnett:*** Gross.
Mr Gammie: Gross, yes. The company then does not have to pay you any salary at all, or, at least, can pay you a very small salary and will then pay the balance of its profits out to you as dividends. You will effectively receive part of your earnings in the form of dividends, which will not attract any liability to national insurance contributions.

Q19 ***Lord Barnett:*** You could even, presumably, have your wife as a major shareholder receiving some of the dividends as well.
Mr Gammie: That is possible as well, yes.

Q20 ***Lord Barnett:*** Is it possible or has it happened?
Mr Gammie: Yes, that has certainly been the case.

Q21 ***Lord Barnett:*** We have the figures of growth in managed service companies from 2002–03 to 2005–06. Obviously it is a bit early to know the figures for 2006–07 but do we have a feeling that it has grown a lot further since?
Mr Gammie: If you mean in terms of the number of companies being incorporated, the indications are that there has been a very significant increase in the number of incorporations since the managed service company provisions were announced in the Pre-Budget report in December. The supposition is that is

being driven by the situation in which there have been several individuals in one managed service company each setting up their own personal service company. One feature of these particular provisions is that, to the extent that people migrate through the managed service company regime into the personal service company regime, the personal service company regime will apply to them. The supposition is that people have been making that particular move. To go back to your initial question, it may well have been the case that a large number of individuals who were employed through managed service companies were strictly subject to the personal service company regime but, because that regime operates on a contract-by-contract basis, so you have to look at the contract and ask yourself: "Is this ignoring the intermediary really an employment contract?" That was very difficult for the Revenue to police, very resource intensive, and the persons who were operating the managed service company were potentially not particularly careful to examine and ask themselves the question as to whether or not they should have been applying the personal service company provisions, the IR35 provisions. This really comes about through the increase in the number of individuals who were going into this arrangement and the difficulty with policing that.

Q22 ***Lord Barnett:*** I thought I heard you say that the issue may not have arisen if the Revenue had been more effective earlier.
Mr Gammie: That is certainly a comment that was made in relation to the announcement of the managed service company provisions in the Pre-Budget Report and I think it must be true, to the extent that, if individuals operating through managed service company were really subject to the IR35 provisions then, in a sense, they were obtaining no advantage. The advantage they were obtaining was purely one that arose from the failure of the Revenue actually to police the existing IR35 rules. But, as I say, that would be particularly resource intensive and I suppose there comes a point where, from the Revenue's perspective, you have to say to yourself, "Actually, we need a different solution to this particular problem because the amount of resources this is going to demand to deal with the existing legislation is too great."

Q23 ***Lord Barnett:*** Will the current legislation work effectively?
Mr Gammie: I think the answer to that is yes, in this sense: 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?

Q24 ***Chairman:*** That is the right question, if I may intervene, but the answer is really the other way round. I can see from the Revenue's point of view this is easier for them to handle, but the question we would be interested in is whether, as a result of this movement and dealing with things, they are going to disadvantage some people who genuinely were running a business, who genuinely were operating—whose wife, if you like was genuinely playing a part—who were self-employed, who were running a business? Will they now be swept into a new system, which may be very convenient for the Inland Revenue and require much less resources but which is jolly unfair on some individuals? Are there people in that situation whom we need to consider?
Mr Gammie: To an extent I think that is recognised in the Finance Bill provisions—and I suspect this may be what the Revenue would say to this. If an individual with or without his wife involved is just taking ordinary accountancy or legal advice (for example, to help them with the payroll and running of the company) then there is an exception to the definition of a managed service company which says that does not come within the regime. There are also powers to make regulations, effectively, taking particular companies out of the regime. The Revenue have effectively addressed that to an extent by giving themselves the power to take particular cases out of the provisions if it is inappropriate for them to apply.

Q25 ***Lord Sheldon:*** Incorporated companies have increased following the introduction of the managed service companies. What are the numbers involved? Could you give me an idea of the increase?
Mr Gammie: It is quite significant. I think I have some figures.

Q26 ***Chairman:*** The figures I have—I do not know if it helps or not—are that for 2002–03 it was 65,000, and for 2005–06 it was 245,000.
Mr Gammie: The number of incorporations was obviously dramatically affected also by the zero corporation tax rate which was eventually removed last year. But the figures I have suggest that in the first four months of 2007 the number of new companies being formed has increased from approximately 7,000 per week in December 2006 to over 15,000 per week in April 2007. In terms of the short-term effect of the announcement of managed service company provisions, there has been more than doubling in the number of companies being incorporated. I am not sure if anybody has been able to get to the bottom of it, but anecdotally it is thought that that is people migrating from managed service companies into personal service companies.

Q27 ***Lord Sheldon:*** Is it likely to increase much further?
Mr Gammie: One assumes there is a finite number of individuals who are affected by this, so at some point 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.

Q28 ***Lord Sheppard of Didgemere:*** That has really been despite the fact that the Inland Revenue are being extremely active with companies, and asking questions of a particular company, or whatever, why they are doing it in that way. At least that is my experience of companies. With some of them, the correspondence has gone on for years, though it has not got anywhere.
Mr Gammie: Yes, obviously the Revenue have sought to be active in terms of discouraging managed service companies. With the announcement of the legislation, they will be increasing their activity in that area. I am not sure that necessarily answers the problem they face with the increase in incorporations.

Q29 ***Chairman:*** Now shall we take the third subject, which is the investigation into the online filing and these items. It is quite obvious that there are all sorts of methods and incentives, and difficulties with penalties and things, to encourage companies to file their stuff online and individuals to file online. That seems to me to be a perfectly sensible way for the Inland Revenue to operate. I would like to probe a bit any suggestion that people will not have the option. With big companies I can see how you could make it an option and say, "You have to do it this way" but there is no suggestion that the shoemaker or cobbler or anybody else has to file his tax return online even if he has never seen a computer in his life, is there? Or is there going to be pressure for that?
Mr Gammie: My understanding is that for business taxpayers at least it will be towards compulsory e.filing of returns, whether it is PAYE returns, VAT returns or ordinary corporation tax or self-assessment returns. The pressure, certainly on the business side, is for compulsory e.filing.

Q30 ***Chairman:*** But not, so far, for individuals.
Mr Gammie: So far as I am aware, it is not proposed for ordinary individuals—not at the moment anyway.

Q31 ***Chairman:*** Are we going to get many witnesses coming to tell us that this is unreasonable and we should be sympathetic to them?
Mr Gammie: To the extent taxpayers are represented in one way or another—and probably most businesses are represented by their accountants or rather tax consultants—it may be that it does not have a significant impact and therefore you may not hear a great deal of complaints. I am sure for most well-organised tax advisors, probably they are as supportive of e.filing as the Revenue would be. It assists them, as much as anything. Inevitably there is a range of small businesses out there—I suppose quite a significant number in terms of the absolute number—who perhaps do a lot of their own tax affairs and therefore may be affected by compulsory e.filing. But I suspect that one of the answers, in an age where electronic banking and Internet banking is encouraged—

Q32 ***Chairman:*** It encourages a lot of crooks, as far as I can tell!
Mr Gammie: In a sense it seems entirely sensible to encourage e.filing. There is just that element as to whether or not it should be compulsory or whether there should continue to be options to paper file.

Q33 ***Lord Sheldon:*** It is quite right to encourage online filing. That is perfectly right. However, I know of some people who are computer illiterate and it is very hard to see how they are going to acquire the kind of literacy that is needed here. Some of them would have great difficulties in dealing with that. It may be that there would need to be a lengthy period of progression from what we have now to online filing—over many years, in some cases.
Mr Gammie: In some cases. I personally would have a great deal of sympathy with that point of view. In terms of PAYE filing, I seem to think that for small businesses a date has been set, maybe 2010–011, sometime around then, to try to achieve filing of PAYE electronically. These are obviously dates which can be deferred, depending upon the reaction from taxpayers.

Q34 ***Lord Sheldon:*** I am thinking of some people who have set up their business without any knowledge of any of these things. They have a very good idea and it works very well but then they are suddenly faced with this about which they know nothing. They may need a longer time to deal with this.
Mr Gammie: I would not disagree with that.

Q35 ***Lord Sheppard of Didgemere:*** We are talking about a minority group. I realise that is what human rights is about. The majority of people have their accountants or whatever and they are already sending it somewhere to do it. Their accountants have been chasing them already to come into line.
Mr Gammie: I am sure that is right. In the business sector, one would have thought the majority would not only find it easier but be encouraged by their accountants, as you say, to participate in electronic

filing. I must say that to an extent it depends upon the Revenue systems and just how easy it is to achieve all this through the Revenue's website and their electronic filing systems that they have installed there. I am obviously aware that is an area where some of the specialists in this field question to what extent, for example, systems are secure and taxpayers can be assured that they have been able to do things properly through the Revenue's website. One assumes that is an area to which the Revenue is giving very considerable attention and will make it as easy as possible for people to achieve electronic filing which, by itself, may solve a lot of the problem.

Q36 ***Chairman:*** One last word on this process. You said something about the consultative process. I go away with the impression that you thought there might be some legitimate complaints that it has been too quick and the Revenue recognise this by the delay in which they implementing. Am I summarising correctly?
Mr Gammie: Certainly the measures in this year's Finance Bill have been implemented quite quickly, in the sense that the consultation dates were December and January this year so to have legislation in this year's Finance Bill is a relatively short period. To the extent that these measures will only come into affect at a later date gives additional time if it appears that there is some amendment or further consideration needed to what is enacted in this year's Finance Act.

Q37 ***Lord Sheppard of Didgemere:*** Might I ask a further question going away from that broad question. I will be careful how I word this before the Chairman rules me out of order on the question before you have had a chance to answer. On the subjects we have looked at over the last three years, or whatever period it is, particularly on tax avoidance—and we have not put that down because there is not any change, it is more of the same—is there any aspect of what has happened in the past which in your view has been quite wrong? Or has it worked fairly smoothly?
Mr Gammie: On tax avoidance.

Q38 ***Lord Sheppard of Didgemere:*** Yes. Then I was going to ask a second question on pensions, but stick with avoidance.
Mr Gammie: This year's Bill in relation to avoidance contains a series of changes to the detailed legislation to address particular avoidance of which the Revenue has become aware, and it makes changes to the disclosure regime to deal with particular problems that have emerged through non-disclosure of avoidance schemes under the existing regime. The changes that have been made to the disclosure regime reflect a problem that was promptly pointed out to the Revenue initially in relation to disclosure, that, when you have a regime which requires people to disclose, when they do not disclose you do not know that they have not disclosed. It is one of those problems that the Revenue faces. The need to enact provisions in this year, I think, reflects that particular problem or that inadequacy of the disclosure regime and the way it operates in practice. The other aspect, of course, of the disclosure regime is that it is inevitably driving continued legislation on particular aspects of the tax system because, inevitably, as the Revenue become aware of particular tax saving or avoidance devices there is a pressure on them to address that through legislation. At some point, I think there will have to be some reflection as to whether this is the right way to deal with avoidance or whether or not we have to reconsider a general anti-avoidance rule or some other approach to the problem.

Q39 ***Chairman:*** That is a good note on which to end. We are not going to deal with that this year. I would like to thank you very much for getting us off to such a good start. It has given us a good feel for the subject we are going to be discussing in detail with the various witnesses. It has also helped to make us better informed when we do that. We are very much in your debt and grateful to you for coming.
Mr Gammie: I am pleased to have been here, my Lord Chairman.

MONDAY 30 APRIL 2007

Present	Barnett, L	Powell of Bayswater, L
	Blackwell, L	Sheldon, L (Chairman)
	Paul, L	Vallance of Tummel, L

Memorandum by the Institute of Directors

Clause 2. Corporation tax main rate. We warmly welcome the reduction in the main rate of corporation tax to 28 per cent. Such a reduction has become essential to the maintenance of UK competitiveness, in the light of rate cuts in other developed economies. But this should be the start of a programme of rate cuts, not the end. It should also be noted that the rate cut does not represent a tax reduction. It has been paid for by changes to capital allowances, so that the tax burden is moved around but not reduced.

Clause 3. Corporation tax small companies rate. The increase in the small companies rate, and the proposed increases for future years, have given rise to justifiable concern. However, we understand the Government's problem. Imbalances between the tax treatments of incorporated and unincorporated businesses have led to tax-motivated incorporations, and increasing the small companies rate is one way to tackle that issue. When the rate eventually reaches 22 per cent, a marginal pound of gross profit for someone who is already into the higher rate income tax band will yield the same net profit, whether or not the business is incorporated. When changes are made like this, in order to tackle specific problems, it is vital to ensure that the overall tax burden on the affected population (in this case, smaller businesses) is not increased. Ideally it should be reduced, in order to minimise the number of losers. In that context, the proposed new £50,000 a year investment allowance may not be generous enough.

Clause 4. Inheritance tax rates and bands. We welcome the continuation of the programme of increases in the nil rate band. However, these increases are not likely to keep pace with the rise in the value of housing. More drastic reform, ideally the abolition of inheritance tax, is needed.

Clauses 17 to 21. Environmental measures related to homes. There is a striking contrast between clauses 17 to 19 on the one hand, and clauses 20 and 21 on the other. Clauses 17 to 19 threaten detailed regulations, necessitating careful checks by taxpayers of exactly what money has been spent on, or of the environmental results achieved. Clauses 20 and 21 offer straightforward exemptions, allowing taxpayers simply to ignore administrative requirements with which they would otherwise have to deal so long as they meet a few basic and obvious requirements. The latter type of measure is much more efficient, saving both the time of taxpayers and the wages of officials. It is also much more likely to be taken up by taxpayers.

Clause 25 and Schedule 3. Managed service companies. We appreciate the Government's concerns about managed service companies, so we are not opposed to legislation in this area. However, we doubt that the proposed approach will be anywhere near completely successful. Many people who have up to now used managed service companies will switch to personal service companies. HM Revenue & Customs will then have to aim at a much more diffuse target than that presented by the current small number of large managed service company providers. And the personal service companies legislation has already proved to be impossible to apply effectively.

We have serious concerns about the debt transfer provisions in section 688A (Finance Bill, pages 96 and 97), as follows.

— Subsection (1) will make a debt transferable if an official considers that it should have been deducted by a managed service company. This is too broad, even if as a matter of legal construction the word "considers" would import appropriate requirements of administrative law, such as reasonableness. The words "an officer of Revenue and Customs considers" should be omitted, so that a debt is only transferable if it should in fact have been deducted. This is not just a point about the operation of this specific provision. We have a general concern about the underlying attitude, which we see as being one of "trust me, I'm a Government official". The same attitude is evident in the use of the words "HMRC think" in the penalty provisions (Schedule 24, paragraph 1(1)(b), Finance Bill page 260, line 33 and other places). It is not easy to square such legislative recognition of the significance of officials' opinions with the spirit of

the Bill of Rights of 1689 or of the standard preamble to a Finance Act, both of which make clear that decisions on who pays what taxes rest with Parliament rather than with the Crown.

— Subsection (2)(c) encompasses too wide a range of people. It means that people could have tax debts passed on to them even 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. The reference to active involvement does not amount to a culpability test, and no permanent reliance should be placed on any Ministerial or official expression of intent that it will be interpreted as a culpability test.

— The subsection (3) exclusion from subsection (2)(c) is very narrow. It refers to legal or accountancy advice, which contrasts with the reference to legal or accountancy services in section 61B(3) (Finance Bill, page 90, lines 35 and 36). "Advice" must be meant to be a good deal narrower than "services".

— Subsection (7) confers a Henry VIII power to impose some people's tax debts on other people by regulation. This is unacceptable, despite the use of the affirmative procedure.

Clause 32. Lloyd's corporate members: restriction of group relief. While we do not have comments on the substance of this section, we are astonished that it has taken so long for the Government to take this action. The issue has been well-known, and clearly understood, for several years. We are also concerned about what happened to the related Budget Note (BN 10). This was first issued immediately after the Budget speech, with a clear statement that the measure would apply from the date of Royal Assent to the Finance Act. Then in the evening, BN 10 was re-issued with an amendment, stating that the measure would take effect from the start of Budget Day. It is always unwise to undertake tax planning measures on the morning of Budget Day, just in case there are relevant announcements which will take effect from the start of Budget Day. But in the afternoon, when there has been a clear official statement that a measure will not take effect for several weeks, taxpayers ought to be able to rely on that statement. We do not hold any brief for those who were using the arrangements which clause 32 is intended to tackle, but we are concerned at the idea that it is alright to amend official statements after publication in ways which may retrospectively disadvantage some taxpayers. Paragraph 14 of the Explanatory Note on this clause looks as though it may well have been written specifically to justify the way in which the mistake in the Budget Note was dealt with. The difficulty could have been avoided by announcing, on the evening of 21 March, a start date of 22 March instead of 21 March.

Clause 35. Industrial and agricultural buildings allowances. We agree that the immediate withdrawal of balancing adjustments is a sensible accompaniment to the broader policy of phasing out these allowances. That broader policy must however be seen as a levelling down rather than a levelling up. The unwarranted distinction between industrial buildings and other commercial buildings could have been addressed by extending allowances to those other buildings. However, we do accept that the computations under the current system were very complicated, and that a building plus its land rarely fall in value.

We are surprised that the other capital allowances measures set out in the Budget, including the abolition of industrial and agricultural buildings allowances and a reduction in the main plant and machinery rate from 25 per cent to 20 per cent, have not been included in this year's Finance Bill. They form a vital part of the whole package. Some of them will lead to very substantial increases in the tax take, countering the effects of rate cuts and making the whole package broadly neutral. Parliament should have been given an opportunity to debate the complete package in a single Finance Bill.

Clause 47 and Schedule 15. Controlled foreign companies. The proposed changes represent a significant tightening of the controlled foreign companies regime, and will also present difficulties in practice. It is not clear who "works for a company" (section 751A(7)(b)). How much direction by the company is required to pass the test in section 751A(9)(b)? Why should it be incumbent on the taxpayer to produce evidence and satisfy officials? (This requirement may make the proposal incompatible with European law. Compare CJEC case C-250/95, *Futura*, on the imposition of administrative burdens.) The exempt activities test is significantly tightened by the new Taxes Act 1988, Schedule 25, paragraph 8(5) and (6). For all of these reasons, the proposals can only be regarded as a stop-gap. A much more satisfactory controlled foreign companies regime needs to be introduced in Finance Bill 2008.

Clause 49. Research and development tax relief. The changes to limits, and particularly the increase in the limit on the number of employees, will benefit a significant range of companies with a little over 250 employees. However, this extension has been achieved at the cost of a new layer of complexity in the legislation, with the introduction of the new category of "larger SME". As a general rule, we continue to favour a simpler tax

system with lower tax rates and fewer special reliefs. The proper function of taxation is to extract money from the private sector, not to micro-manage the economy.

Clause 50 and Schedule 16. Venture capital schemes. The £2 million a year limits imposed by Part 2 of the Schedule will have a significant effect. AIM companies typically raise amounts of the order of £5 million on flotation, of which a large proportion comes from venture capital trusts

Clauses 87 to 91. Filing dates. The proposal is to impose tighter filing deadlines for paper tax returns than for electronic returns. This is perfectly reasonable, so long as absolutely everything that can be notified on a paper return can also be notified on an electronic return. In recent years, some taxpayers have been unable to use electronic filing because they have items of income which can only be notified on paper returns. We seek a Ministerial assurance that this failure to allow everything to be notified electronically will be remedied, in every respect, for all years that are affected by the new filing date regime.

Clause 94. Payment by cheque. The power to make regulations to treat a payment by cheque as made when the cheque clears should be limited so that HM Revenue & Customs cannot take advantage of this provision to charge any interest or penalty unless they have banked the cheque in question promptly (which should be defined precisely, eg within two days of receipt).

Clause 96 and Schedule 24. Penalties for errors. In general we welcome the new penalty regime. It is a significant improvement on the current regime. However, as indicated in our comments on Clause 25 and Schedule 3, we have grave concerns about the use of the words "HMRC think that" in Schedule 24, paragraphs 1(1)(b) and 2(1)(b). In both places, the words "HMRC think that" should be omitted, so that penalties are only due if the conditions are in fact satisfied. The words should also be omitted from each sub-paragraph of paragraph 10. In paragraph 11(1), "If they think it right" should be changed to "If it is right".

24 April 2007

Memorandum by the CBI

1. The CBI welcomes the cut in the headline corporation tax rate to 28 per cent from 30 per cent, but only as a first step to help improve international tax competitiveness. Accompanying restrictions on the value of capital allowances will create "winners" and "losers" in the early years, with no overall cash benefit for the business sector as a whole in that time. In addition, many SMEs will be adversely affected by the rise in the small companies' corporation tax rate to 22 per cent by 2009, from 19 per cent currently, even though some may benefit from the new annual capital allowance.

2. The CBI also has significant reservations about some of the plans:

- Failure to rein in a little further the overall public spending totals for the next four years, making a net reduction in the overall tax burden unaffordable in that time.
- Accelerated rises in the landfill tax and aggregates levy, above-inflation increases in fuel duties, and abolition of business rates empty property relief. The result is that, overall, the Budget imposes a net cost on business in the next three years, in addition to the cost imposed by the Pre-Budget Report.
- The possibility, raised in the Lyons review, of local supplementary business rates being imposed with or without broad support amongst affected businesses.

3. Some of the spending measures will benefit business and the economy:

- Education— confirmation of a greater share of the public spending total in coming years, an increase in the school/training leaving age and new training incentives.
- Science and research—improvements in the R&D tax credit for large and small firms and announcements concerning the public science budget.

4. The Treasury forecast for GDP growth this year, of 2.75 per cent–3.25 per cent, looks realistic, though we see the forecast of 2.5 per cent–3 per cent for each of the following two years as mildly over-optimistic, given the present, relatively small degree of spare capacity in the economy. The CBI forecast is for growth of 2.9 per cent this year and 2.6 per cent next.

5. The CBI is also concerned that the underlying position of the public finances is slightly weaker than reported in December. Planned spending is a little higher throughout 2007–08—2011–12 and this has resulted in a relaxation of borrowing of some £2–3 billion per annum over the period.

The Overall Impact on Business Costs and Goverment Revenues

6. Table 1 sets out the arithmetic impact of the new policy announcements for the coming three years. Overall, the CBI is disappointed that there is once again a net additional cost for the business sector. Specifically:

— The corporation tax changes are broadly revenue-neutral over the three years, with the reduction in the main corporation tax rate offset by the changes to capital allowances and increase in the smaller firms' tax rate.

— Other tax rises—affecting fuel duty, environmental levies and business rates bills for empty properties—will add to business costs.

7. The overall impact is to push up the business tax bill by some £2.8 billion over the three years (excluding "revenue protection" measures). By contrast individuals will gain modestly in aggregate, if the knock-on impact of the business tax measures is ignored. The package of changes to personal taxes, tax credits and benefits amounts to just over £4.6 billion for the three years. Even allowing for offsetting changes to various duties, the household sector tax bill has been reduced a little at business' expense.

Table 1

TOTAL IMPACT OF BUDGET 2007 POLICY CHANGES

Approximate £m yield (+) or cost (−) to Exchequer relative to baseline[1]	*2007–08*	*2008–09*	*2009–10*
Main rate of corporation tax cut to 28 per cent from 30 per cent	−140	−1,385	−2,230
General plant & machinery capital allowances cut to 20 per cent	0	+1,490	+2,270
R&D tax credit increase (SMEs and large firms)	0	−70	−150
Small Companies Rate of Corporation Tax raised to 22 per cent	+10	+370	+820
Other changes to capital allowances	0	−85	0
Measures mainly benefiting SMEs[2]	−35	−250	−810
Rationalisation of empty property relief	0	+950	+900
Increase in aggregates levy and landfill tax	−10	+215	+370
Fuel and vehicle duty measures (business share)[3]	−68	+280	+362
Measures directly affecting business	**−243**	**+1,515**	**+1,532**
Personal taxes, tax credits & benefits	−15	−2,105	−2,510
Minor changes to the tax system	+45	+10	+75
Protecting tax revenues[4]	+215	+290	+280
Duties changes (alcohol, tobacco, gaming)	+10	+20	+25
Fuel and vehicle duty measures (consumer share)	−137	+559	+723
Spending from special reserve	−400	0	0
Other largely non-business measures	**−282**	**−1,226**	**−1,407**
Total fiscal impact	**−525**	**+280**	**+125**

[1] The baseline includes up-rating many duties and levies in line with inflation.
[2] Covers changes to Venture Capital Schemes, one year extension of 50 per cent First Year Allowances for small enterprises and New Annual Investment Allowances for small enterprises.
[3] Including changes to Vehicle Excise Duty, increased road fuel duties, increased rebated fuel duties and continuation of differential to 2009–10 for biofuels and road fuel gas and the renewal of the reduced pollution certificate scheme for lorries.
[4] Measures to counter missing trader fraud, strengthening the disclosure regime, loss-buying in the Lloyd's insurance market, life insurance companies: financing arrangements.

8. Though the Budget itself was broadly fiscally neutral, taking the Budget and Pre-Budget Report together there has been a modest fiscal tightening. The overall impact of the two packages is a net revenue increase of just under £7.4 billion over the three years 2007–08—2009–10. Of this, measures directly affecting business amount to over £6 billion.

Summary of CBI Views on Specific Budget Measures

9. Table 2 summarises the CBI's views on specific Budget measures, which the rest of this paper covers in more detail.

Table 2

BUDGET REPORT MEASURES: CBI REACTION

Measures that the CBI welcomed	*Measures of concern to the CBI*	*Measures that the CBI was disappointed not to see included*
Reduction in the headline rate of corporation tax to 28 per cent from 30 per cent to improve international tax competitiveness.	Increase in the small companies' rate of corporation tax from 19 per cent to 22 per cent by 2009–10.	Commitment to a slightly firmer grip on total public spending, which is a pre-requisite for a much-needed reduction in the UK tax burden.
Early CSR settlement for education spending in England amounting to 2.5 per cent per annum in real terms over three years. Also raising the school leaving age and encouraging 16–18 year olds into training programmes.	Restrictions on capital allowances, meaning a net cashflow cost for some sectors in the early years.	Support package for small employers to mitigate the cost of compulsory pensions.
R&D tax credit for SMEs increased to 175 per cent from 150 per cent and for large firms to 130 per cent from 125 per cent. Also announcements relating to the public science budget.	Further small increase in the profile of total government spending, relative to Pre-Budget Report projections (mainly funded by yet another relaxation in the borrowing targets).	Failure to tackle various longstanding tax anomalies facing SMEs and other firms.
Various initiatives to encourage action on climate change both domestically and globally.	Sharper than planned rises in the landfill tax excalator and aggregates levy in 2008 until 2010–11, and above-inflation rises in fuel duties.	
Progress on the deregulatory agenda including employment tribunal rule reform.	Restriction of business rates empty property relief.	
	Uncertainty over the implementation of the Lyons Review recommendations, which allow for the levying of local supplementary business rates.	
	The continued intention to proceed with the planning gain supplement on property development.	

Corporation Tax

10. The CBI views the cut in the main corporation tax rate as only a welcome first step to improving the UK's international tax competitiveness. While the reduction moves the UK up the OECD-30 corporation tax "league table"—to having the 12th lowest rate from 19th—our rate remains above that of the Netherlands (25.5 per cent) and Ireland (12.5 per cent) amongst other competitors. Within the EU-27 the UK would have the joint 9th highest corporation tax rate rather than 7th highest. But our rate would still be above the EU average, even in the absence of further reductions elsewhere. More needs to be done to improve the UK's tax competitiveness to protect jobs and investment.

11. Furthermore, the potential benefit of the rate cut is reduced by the fact that it is mainly funded, in the early years, by a reduction in the major capital allowance rate. This will create many cashflow "losers" in that time, especially in the more capital-intensive sectors. Other changes include the complete phasing out of the industrial buildings capital allowance, the rationale for which is unclear. The CBI is very concerned that many SMEs will be adversely affected by changes affecting them (see further below). We also note that the tax rates applied to the North Sea oil and gas sector have been left unchanged, following the adverse changes of recent years. Overall the business sector will be no better off in cashflow terms over the next three years.

12. We do however recognise that business cashflow would benefit from the corporate tax package after three to four years, as long as new and offsetting revenue-raising measures were not introduced in the interim.

13. We warmly welcome the further consultation on the tax treatment of foreign income including proposals to modernise Controlled Foreign Company rules and the follow up to the Varney Report. These are important components in enhancing the international competitiveness of the UK's tax regime. On managed service companies we will need to ensure that the finance bill prevents liability for non-payment of tax from being transferred to end clients. With regards to the review of HMRC powers and penalties we await publication of responses to the consultation and draft finance bill clauses.

Education and Skills

14. The CBI supports moves to raise the education/training leaving age to address the lack of basic and employability skills amongst many young people entering the labour market. Raising the leaving age must, however, be part of a wider package which also includes government funding for reformed, "fit-for-purpose" qualifications and high quality careers advice.

15. The skill levels of many young people leaving secondary school remain poor despite almost a decade of rising investment in schools. Basic skills remain a weakness in terms of the UK's competitiveness. As employers and taxpayers, business expects spending increases in this area to deliver improved competitiveness. We therefore welcome the new proposals aimed at encouraging 16 to 18 year olds into training who are currently outside the education system.

Science, Technology and Innovation

16. The CBI welcomes the increase in the R&D tax credit for SMEs to 175 per cent from 150 per cent and for large firms to 130 per cent from 125 per cent from 2008–09 (subject to State Aid approval). The impact of these increases has to be considered in light of changes to corporation tax rates that will affect both the value of the tax credit and the value of the 100 per cent tax allowance for R&D.

17. For large firms, the 150 per cent tax credit from 2008–09 equates to a reduction in R&D costs of 8.4 per cent (from 7.5 per cent today). However, the overall cost of conducting R&D will *increase* slightly because the change to a 28 per cent main corporation tax rate reduces the value of the 100 per cent allowance. This means that from 2008–09, the effective cost of £100 worth of R&D for large firms will rise from £62.50 now to £63.60. We expect that this increase will be more than made up by the lower corporation tax burden. For SMEs the improved tax credit equates to a reduction in R&D costs of 10 per cent for fiscal year 2007–08, 15.75 per cent for 2008–09 and 16.5 per cent for 2009–10 (from 9.5 per cent today) as changes to the small business rates of corporation tax are also taken into account. The overall effect of the tax credit and corporation tax rate changes will be to reduce the effective cost of £100 worth of R&D from £71.50 today to £61.50 by 2009–10 (subject to State Aid approval).

18. The Budget also announced that, again, subject to State Aid approval, the small firms' tax credit rate (and the option of a payable cash credit for loss-making firms) will be extended to companies with less than 500 employees. This is likely to provide a significant boost to R&D-led firms seeking to grow.

19. The UK has a strong scientific base, which the increases in the science budget will help to sustain. The Science Budget will now grow in real terms by 2.5 per cent annually to £6.3 billion by 2010. We would expect much of this growth to be directed to business-relevant research and development initiatives including the enhanced Technology Strategy Board and the new user-focused research strand for universities from the Funding Councils.

Small and Medium-sized Enterprises

20. The CBI is concerned about the tax package affecting small businesses, which centred on a rise in the small firms' corporation tax rate from 19 per cent to 22 per cent. A claimed rationale for this decision was to reduce the differential between incorporated and unincorporated businesses. But in this case it is not clear why the corporate tax rate will end up above the personal income tax rate, rather than being aligned with it. The aim to refocus investment incentives for small business is welcome, but many small firms will simply be unable to benefit. The improved SME R&D tax credit is of course welcome too, but state aid clearance needs to be gained, and SMEs will not benefit until 2008–09.

21. The Budget announcement that grants of £2,000 to £3,000 would be available for small firms to undertake staff training is also welcome. The government has committed to continue the funding of enterprise education, through DfES, at £60 million per year over the CSR period. The National Council for Graduate Entrepreneurship will work with the government and other stakeholders to assess establishing an "enterprise foundation".

22. The Budget Report also provides an update on the ongoing government initiative to simplify business support. The DTI-led, government backed, business support simplification programme has the full support of the CBI. This should not be an exercise in reducing the funding available to businesses; efficiency savings identified through the simplification exercise should be ploughed back into the programmes. By 2010 the CBI wants to see a business support system that provides seamless and targeted support to businesses through their

life cycle; particularly those seeking to grow their companies. All government departments, agencies and local authorities need to work together to achieve this result. The CBI welcomes the increase in funds available to small businesses related to environmental information, available through the Business Link and RDA network.

Environment and Transport

23. Climate change is a threat to the economy as well as to wider society, so business strongly supports incentives to help change patterns of behaviour and encourage households and businesses to reduce emissions and waste. (For example, new enhanced capital allowances for investment in energy/water efficiency equipment, financial incentives for households to become more energy efficient, streamlined resource efficiency advice for businesses through RDAs, tax relief on electricity sold back onto the grid from micro-generation.) These measures are generally welcome, and some, like stamp duty relief on low carbon houses, have been specifically called for by the CBI in the past.

24. A competition to select a demonstration carbon capture and storage (CCS) power plant for government funding is positive news and must be moved forward with urgency. This technology has potential to play a big role in enabling power companies to reduce emissions, and progress with a commercial-scale scheme is vital. However, there are questions over whether there is sufficient urgency (the results of the competition will not be announced till next year), and whether public funding is needed. More detail is promised in the postponed Energy White Paper.

25. The Climate Change Levy (CCL) is to rise in line with inflation. We still see the CCL as a blunt instrument of limited environmental value, but the inflation-only increase at least limits the impact and was expected. The various incentives to promote action to tackle climate change internationally including an £800 million international environmental transformation fund are broadly welcome given the need to stimulate global rather than unilateral action.

26. The sharp increase in the annual landfill tax escalator to £8 per tonne from 2008–09 through to 2010–11 will merely add to the tax bills of business with little environmental benefit. In contrast to previous rises in the landfill tax, the additional revenues are not being recycled to business through the Business Resource Efficiency and Waste programme (BREW). While we had accepted the need for the existing escalator (£3 per tonne per annum) to rise, the planned rise in the escalator will take the new rate close to £50 per tonne by 2010. Failing to recycle the revenues to business risks reducing the incentive for diversion of waste from landfill and leaving hard-pressed manufacturing firms with higher costs. And the increase by itself will not bring forward more investment in the waste treatment facilities needed unless the planning system allows more waste facilities to be built.

27. Similarly, the inflation-busting increase in the aggregates levy to £1.95 per tonne from 2008 (from £1.65 per tonne) represents an additional cost for the construction industry. We do not believe that levy has had a significant environmental benefit and the increase has simply added to the business cost and tax burden.

28. The increase in the Vehicle Excise Duty rate for high emitting vehicles (band G) to £400 per annum over the next two years has been partially offset by reductions in lower emissions categories and enhanced support for biofuels. The above-inflation rise in the main road fuel duties from next year will not help UK hauliers competing with foreign haulage companies paying significantly lower fuel taxes. Meanwhile, October's further sharp rise in duties in red diesel and heavy fuel oil will again add significantly to some firms' costs, although there will be some relief at the commitment to raise these duties in future in proportion to the main road fuel taxes.

Planning and Property

29. The more we learn about how the proposed Planning Gain Supplement would operate, the less workable it looks. It is one more tax for business and risks undermining development with serious consequences for UK competitiveness, not to mention the supply of new homes. The Treasury should drop this proposal.

30. The CBI is also concerned at the recommendation in Sir Michael Lyons' Review to empower councils to levy a supplementary business rate to fund new infrastructure. Firms must have a vote on any plans to levy a supplement, as they currently do with Business Improvement Districts. Any project must be clearly defined and businesses will only agree to pay higher supplementary taxes for a limited time period.

31. We are however pleased that Sir Michael has chosen not to propose a return of business rates to full local authority control, though we are concerned that this remains a long-term option. Business needs certainty and we welcome the recommendation that future rises in the uniform business rate should not exceed inflation.

However the restriction of Empty Property Rate Relief may limit the flexibility of businesses in how they organise their operations, given that changes to property use can take some time. The measure will cost business just under £1 billion per annum from 2008 onwards.

Employment Tribunals

32. The 2004 dispute resolution regulations failed to reduce the number of tribunal claims or cut down on vexatious claims so employers will be glad to see them go. But the government must not replace one unsuccessful, process-heavy system with another, so a risk based approach is right. It needs to ensure that the replacement focuses on the issues that matter and encourage early resolution of disputes wherever possible. And if early resolution is not possible, employers must not be penalised or made to jump through pointless hoops before the tribunal case is heard.

Projections for the Economy and Public Finances

33. The forecasts for economic growth are unchanged from those published in the December Pre-Budget Report. The Chancellor still expects the economy to expand by 2.75-to-3.25 per cent this year and the forecast range for 2008 and 2009 is unchanged at 2.5-to-3.0 per cent. The CBI forecasts GDP growth of 2.9 per cent for 2007 and 2.6 per cent for 2008. We view the Treasury forecast as realistic for this year, but mildly optimistic for 2008 and 2009, given the relatively small amount of spare capacity in the economy.

34. The Chancellor announced as expected that the golden rule has been met in the economic cycle now coming to an end, though only by virtue of revisions to cycle's starting point. Of more interest is the new economic cycle which the Chancellor has decided will begin in 2007–08 and run to 2011–12. On this new cycle the Chancellor expects to meet his golden rule with a surplus on the current budget of some £27 billion. However, had he included the last fiscal year of the previous cycle of 2006–07—as has been previous practice—the forecast margin would be £17.5 billion.

35. Despite the Budget package being broadly revenue neutral, and the golden rule having been met, the underlying position of the public finances is slightly weaker than reported only in December. Borrowing is projected to be a cumulative £11 billion higher over the next five years than set out in the Pre-Budget Report, and this is a concern.

36. The further relaxation in the borrowing targets mainly reflects small additions to planned public expenditure in 2007–08, and in the three years beyond that—the Comprehensive Spending Review period for which total spending (the so-called "envelope") is now described as "confirmed". By contrast, revenue projections have been left broadly unaffected, taking the Budget decisions and other recent developments together. Tax revenues are still set to level off at 38.1 per cent of GDP. This is up from 34.8 per cent in 1996–97, 35.2 per cent in 2003–04 and 37.2 per cent in 2006–07. It compares with the latest OECD average of 36.3 per cent and will be the highest ever with the exception of the early 1980s.

Table 3

THE 2007 BUDGET AND THE PUBLIC FINANCES

£ billion	*2004–05*	*2005–06*	*2006–07*	*2007–08*[1]	*2008–09*	*2009–10*	*2010–11*	*2011–12*
HMT forecast of PSNB[2]—December 2005	38.8	37.0	33.5	31	26	23	22	–
—March 2006	39.7	37.1	35.9	30	25	24	23	–
—December 2006	39.2	37.5	36.8	31.3	27	26	24	22
—March 2007	39.1	37.8	35.0	33.7	30	28	26	24
Change (Dec 2006 to Mar 2006)	−0.1	0.3	−1.8	2.4	3	2	2	2
Of which: Rise in planned spending	–	0.6	−2.4	1.5	3	3	2	4
Fall in projected revenues[2]	–	−0.4	0.8	0.8	0	−1	–	−2
Due to economy, etc	−0.1	0.3	−1.8	2.0	2.5	2.0	1.5	2.0
Due to Budget policy decisions[3]	–	–	–	0.5	−0.3	−0.1	−0.5	−0.5

[1] For 2007–08 onwards, figures are available to the nearest £billion. Some calculations may be affected by rounding.
[2] A negative figure implies a rise in revenues.
[3] A positive figure implies a negative yield to the Exchequer. (See Table 1 for a breakdown).

THE PUBLIC EXPENDITURE PLANS

37. Total government spending is expected to come in £2.4 billion lower than previously set out in 2006–07, helping the outturn for borrowing this year. But an extra £1.5 billion has been added to the 2007–08 total, in contrast to the CBI view that £2 billion could and should have been shaved off that aggregate. The overall effect is to push spending growth in 2007–08 to 6.2 per cent—above the growth of money GDP and some 3–3½ per cent in real terms. The 2007–08 total does however include small additional provision in the security and related fields, which the CBI would support.

38. For the CSR period, £3 billion has been added to each of 2008–09 and 2009–10, and £2 billion to 2010–11. With the 2007–08 "starting point" also higher, average annual expenditure growth over the three years is similar to that set out previously at 4.7 per cent in cash terms, or around 2 per cent in real terms.

39. This degree of restraint is sufficient for total spending to edge down as a share of GDP, from a peak of 42.6 per cent in 2007–08 to 42.0 per cent in 2010–11, but insufficient to fund a net tax reduction, given the need to consolidate the public finances. In real terms spending will still be some 49 per cent higher in 2010–11 than in 1999–2000, compared with growth in the wider economy of perhaps 33 per cent over that period. The CBI had argued that, by 2010–11, spending should be lowered by £9 billion compared with the PBR projection, to allow a net cut in the tax burden rather than the revenue-neutral package we have seen.

40. The spending profile has also been altered to push some of the relative restraint further into the future. Cash-terms growth is now set at 5.0 per cent in 2008–09, easing to a more clearly below-GDP 4.7 per cent in 2009–10 and just 4.5 per cent in 2010–11.

41. The final allocation of funds between spending departments and functions will be unveiled with the Spending Review itself later in the year. However, some departments have settled already, and new announcements in the Budget were:

- Current spending to increase by an average 1.9 per cent per year in real terms, with net investment edging up relative to GDP, to 2.25 per cent of GDP.
- Education spending in England, and total public spending on science (via the DTI and DES together), to rise by a real 2.5 per cent per annum (see earlier sections).
- All savings delivered under the CSR value-for money programme to be net of implementation costs and cash-releasing, to maximise resources for frontline services and new priorities.
- Real-terms year-on-year reductions in spending of 3.5 per cent by the Attorney General's departments, and of 5 per cent by the Office of Fair Trading.

42. The announcements that net investment, and spending on education and science, will be protected relative to the overall total is welcome, as is the continued focus on the achievement of further administrative-type savings.

26 March 2007

Further memorandum by the Confederation of British Industry (CBI)

CBI members comments on Draft Legislation/Regulations on Managed Service Companies (Sent to HMT/HMRC in March 2007—updated for Finance Bill 2007 Clause references).

- Business understands that HMG wishes to make clear that the new provisions do not apply to personal service companies.
- Business also understands that HMG does not wish to transfer tax/NIC debt/liabilities to third parties who receive the services of managed service companies but are not themselves knowingly involved in the avoidance of PAYE/[NIC] via the MSC in question.
- Put another way an end client which merely receives the services of a MSC would no more fall within new Section 688A than a person providing advice as described in new Section 688A(3). (FB 2007, page 96, line 21).
- Business believes it is 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) (FB 2007, page 96, line 16). Unfortunately business does not think that the current wording meets this shared objective and urges that the new Section be amended. Some possible wording designed to clarify the intended protection is attached.

— Experience of previous tax cases leads business to the firm opinion that it is the primary legislation which needs to provide the relevant protection. Anything less—regulations, guidance notes, assurances are not seen as adequate alternatives.

— By ensuring that the primary legislation is clearly and precisely targeted and worded businesses will be spared the compliance costs of contract by contract examination of the other parties to their services contracts. This provision of certainty would be in line with the Government's broader policy objectives on burdens and compliance as set out in the Varney Report and the KPMG Report on Tax Compliance Burdens and its follow up.

— Provision needs to be made for the situation where an MSC changes hands so that any actions/inactions of the vendors or other predecessors cannot be visited on the successors by way of the recovery provisions in new Section 688A—unless the successors are themselves complicit.

— More generally we await HMG's response to the concerns expressed, especially by [recruitment] service providers, about possible impacts on the flexibility of labour markets.

— Next Steps—Business would like to see how the draftsman intends to meet these points by sight of a revised new Section 688A as soon as possible.

Managed Service Companies—Draft Clauses	*F Bill 2007*

CBI Suggested Amendments (March 2007)

"688A Managed service companies: recovery from other persons

(1) PAYE regulations may make provision authorising the recovery from a person within subsection (2) of any amount that an officer of Revenue and Customs reasonably/to the best of his knowledge and belief considers should have been deducted by a managed service company ("the MSC") from a payment of, or on account of, PAYE income of an individual. [Page 96, line 10]

(2) The persons are—

(a) a director or other office-holder, or an associate, of the MSC,

(b) the scheme provider,

Where HMRC have been unable to obtain recovery from persons under (2) (a) or (b) above then they will consider recovering from the following persons: [Page 96, line 15]

(c) a person who (directly or indirectly) has knowingly for the purposes of avoidance of PAYE encouraged, facilitated or otherwise been involved in the provision by the MSC of the services of the individual, and [Page 96, line 16]

(d) a director or other office-holder, or an associate, of a person within paragraph (b) or (c).

(3) A person does not fall within subsection (2)(c) merely by providing advice in a professional capacity.

(4) A person does not fall within subsection (2)(c) merely by receiving the services of a MSC or individual within subsection (1) above. [Page 96, line 22]

Examination of Witnesses

Witnesses: Mr Richard Baron, Head of Taxation, Institute of Directors, Mr Ian McCafferty, Chief Economist, and Mr Mervyn Woods, Head of Tax, Confederation of British Industry, examined.

Q40 ***Chairman:*** Thank you for coming. We welcome to the Committee Mr Ian McCafferty, Mr Mervyn Woods and Mr Richard Baron. This is the Sub-Committee's second evidence session looking at the technical aspects of the Bill from the point of view of tax administration, clarification and simplification. We look forward to hearing your views on the three topics of the Sub-Committee which it has chosen to investigate. Those are the business tax reform package, the managed service companies and the powers, deterrents and safeguards of the HMRC. I suggest we take the three topics in order and ask your views on each of those. Please feel free to answer or add anything you want in connection with those. Would you like to make any opening statement?
Mr McCafferty: Simply to introduce ourselves. My name is Ian McCafferty. I am the CBI's Chief Economic Adviser. To my left is Mervyn Woods who also works for the CBI and is the head of our Taxation Policy Committee and Group, and to my right is Richard Baron from the Institute of Directors. I do not think we wish to make a lengthy opening statement of any sort. We thank the Committee for the opportunity to give our thoughts to this inquiry this afternoon. I do believe that the 2007 Budget raised a number of relatively complex issues as far as business taxation is concerned and it is perhaps better to deal with those individually in answer to questions. Perhaps I should simply say that, on the part of the CBI at least and at the risk of starting our evidence with somewhat of a cliché, we did find as far as business is concerned that the elements of the 2007 Budget and the subsequent Finance Bill represented something of a curate's egg.
Mr Baron: On behalf of the IOD I would concur with that view.

Q41 ***Chairman:*** This is not uncommon as a commentary on all Budgets and Finance Bills. First of all we will look at the business tax package. The Budget was a simplification of the underlying tax structure; that was the whole purpose of it. I am not sure how successful that was but the question I want to put to you is, does the business tax reform package deliver what was intended, that it would be a simplification of the underlying tax structure which was claimed by the Chancellor?
Mr McCafferty: The Budget and the Finance Bill elements of that?

Q42 ***Chairman:*** Yes.
Mr McCafferty: Perhaps I ought to ask Richard afterwards if the IOD differs in any way but certainly from our point of view we would argue that the measures contained in this Finance Bill offer only what we would call a superficial element of simplification. It is clear that the abolition of the agricultural buildings allowance and the industrial buildings allowance does offer some element of greater simplicity but in terms of the other allowance changes, the changes to plant and machinery, the simple change to the relative calculations rather than simplifying the nature of the allowances and introducing a new category, that of plant integral to a building, if anything they add a further modest complication or complexity to the system. It is also true that the fact that we have seen these changes in the different allowances creates significant short-term additional compliance costs and complexity and as such does not fully meet the claims that it represents a significant simplification. We would argue that a much greater simplification of the tax system as a whole could be offered if we were to deal with more substantive issues, such as the nature and future of the schedule system, the issue of tax notices and other issues such as CFCs (controlled foreign companies) and so on, rather than simply making the changes in the rate versus allowances that were made in the Budget itself.

Q43 ***Chairman:*** Are there any further comments?
Mr Baron: From our point of view, yes, I would agree with most of what has just been said. I think that the abolition of agricultural and industrial buildings allowances was a simplification though not one that will be welcomed by the people who spend money on that kind of building. However, the computations for them had got horribly complicated and it was time to do something. The modification of the rates of capital allowances does not come across as particularly simplifying; it is just changes in the percentages, and, of course, as part of the package we are going to see, though not in this Finance Bill, the new 100 per cent allowance for £50,000 worth of investment on plant and machinery just to tweak the package for smaller companies, so we do tend to see this as perhaps a broad trend towards simplification but with tweakings around the edges just to try and keep everyone happy. If I can comment on two particular areas, first, research and development tax credits, the more generous credits that are available to smaller companies are being extended to a wider range of companies. In particular the limit for the more generous credits of 250 employees is shooting up to 500, but as part of that, and I believe partly because of European Community rules on state aid, they are having to introduce this new category of larger SME (larger smaller company) which is yet another complication. Ian has just mentioned controlled foreign companies. That, of course, is a whole other

agenda to try and get the international aspects of the tax system sorted out and we are promised a consultation documentation on that. It is going to have to cover CFCs and taxation of dividends coming into the UK and probably one or two other things as well. What is in the Finance Bill in relation to CFCs actually makes life harder and more complicated for businesses in the short term, but I think it must be seen as a stopgap measure in response to the *Cadbury Schweppes* decision of the European Court which meant the Government had to do something and was not ready to go the whole hog and come up with a final long-term solution immediately.

Q44 ***Chairman:*** But is it not normal that these solutions take a long time to mature and that this is, rather than a stopgap, perhaps just a first step?
Mr Baron: I think I would say stopgap rather than first step. Yes, they do need to take time to get these things right and we are glad that they are taking a certain amount of time, but we are concerned that they are taking a bit more time than is necessary and meanwhile thinking, "This will do for now".

Q45 ***Lord Powell of Bayswater:*** Obviously you are sceptical about simplification. Are you equally sceptical about progress made in reducing administrative burdens on business?
Mr McCafferty: What we would say again there is that the intent and findings of the Varney review and, following up, the KPMG report point in a very positive direction. Where we have worries is in the implementation, and the specific worry that I have is that with the staff cuts now under way within HMRC as a result of the Gershon review, the internal review on staffing of the Inland Revenue, we are slightly concerned about whether the resources, the staffing resources in particular, would be available to deliver the sorts of changes that Varney in particular has suggested. Yes, in principle I think the will is there and we have welcomed the Varney report as a very positive step in the right direction but, as is normal with these things, the devil is very much in the detail and we wait to see the implementation in practice.

Q46 ***Lord Powell of Bayswater:*** But has the volume of complaints from business in any way increased or is it running at familiar levels?
Mr Woods: It is running at familiar levels. I am not aware of any diminution. Indeed, one only has to turn to this year's Finance Bill to see another N pages of legislation, most of which are additional rather than substitutional or subtractory, so that is evidence of the continuing trend. The system gets more and more complicated so life gets more and more complicated for taxpayers who have to comply, and, of course, this is all bedevilled by the fact that this is set against, as Richard has already mentioned, the EU background which imposes its own constraints on our ability to tackle things in the way that we might optimally hope to.
Mr Baron: Our view is yes, they are going in the right way. HM Revenue and Customs are doing the right things. Certainly they seem to be on the right track in their relationships with larger businesses, by which I mean roughly the top 15,000 economic entities. That is what they mean by "larger". If they carry through with their intentions on that it will be all to the good. Yes, there is an issue about staffing. There is an issue, I think, about how the smaller taxpayer gets handled because from the Revenue'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 pressures on costs there has been a certain amount of deskilling. Now, if you phone up the Revenue, you will get put through to someone on a helpline who will be working from a script and who does not actually know the subject, so there are concerns about how a smaller taxpayer may get treated. The targets which they have set to reduce the administrative burdens following the detailed study that KPMG did, which was published about a year ago, to reduce burdens of different sorts by 10 or 15 per cent over three to five years are better than nothing. They are pretty unambitious targets, I would say, but I can understand why they are. It is because, while the Revenue would dearly love to make things simpler for everyone, they are working against a background of a policy set by ministers and ministers are inclined to come up with complicated policies.
Mr McCafferty: The final point to be made is that clearly in addition to the Varney review looking at large businesses and the KPMG review of administrative burdens, some of the relationship with business and the complexity is going to involve the interaction between those and other issues such as the powers, the deterrents and the safeguards issues that are currently ongoing. We would rather look at those, as it were, holistically, some of which we cannot make a decision on yet because they are still under way, but it is the whole package that needs to be looked at as well as these other two that we have already discussed.
Mr Woods: Based on evidence to date of dealings by officials with the Varney report, et cetera, we have had a number of very constructive meetings with officials and they have not only been conducted in good spirit but the outcome seems to have been constructive inasmuch as we have got quite a lot of common understanding of areas that could be addressed but, as has already been mentioned, at the end of the day the question will be whether there are enough staff and sufficiently skilled and trained staff, I might add, to be able to deliver the goods.

Q47 ***Lord Blackwell:*** On the same theme, if I could go back to the 2006 review of links with large business that set out the aim of creating a modern, responsive tax administration, could I ask whether you have views on the extent to which the delivery plan that was published on Budget Day is going to achieve that?
Mr McCafferty: The delivery plan certainly is in line with the answer I have already given, that I think the aim of the exercise is responsive as far as business is concerned. We simply wish to see it applied in practice.
Mr Woods: As I say, to date our evidence of how HMRC are taking forward Varney is very constructive. At the end of the day though will there be sufficient staff, for instance, to turn round transfer pricing inquiries within 18 months? These are difficult questions. We are still in the throes of consultation on all these matters but I think the spirit and intent is there on both sides. It is just a question of whether we will be able to meet all the targets on the set dates, but definitely the intent is there.

Q48 ***Lord Barnett:*** I suppose the only true simplification would be to abolish capital allowances, but in practice I assume you are not in favour of that because they do have some incentive basis. In those circumstances, given the various changes the Chancellor has made as far as small companies are concerned, he has argued that the increase in corporation tax is offset to a substantial effect by the increased capital allowance on the research and development tax credit in particular. He has said that on pre-tax profits of £150,000 and £100,000 the effective tax rate would come down quite a bit. Do you agree with the Chancellor?
Mr McCafferty: I think it is a very complicated question. We are certainly still in the process of doing our own internal calculations and consulting with our membership, but the evidence that we have so far, or at least the calculations that we have made so far, cast doubt on that. Our view is that there are two groups of companies that will not benefit net from the changes between the R&D tax credit and the total of the corporation tax rate for SMEs: those clearly who are running in loss, who are therefore not able to claim the tax credits in the same way, and, secondly, so far our estimates suggest that for companies to benefit they have to invest more than 30 per cent of their profits in R&D type activities in order to benefit from the swings and roundabouts of the calculations. Again, that is only a tentative finding at this stage but it does suggest that there will be a good number of SMEs who do not benefit net from these changes.
Mr Baron: Certainly from our point of view we can see that there are winners and losers. The package directed at small business looks roughly revenue neutral overall. If you look at the figures in the Red Book with the pluses and minuses you can see that they balance out, but very clearly it is going to shuffle the burden around from one business to another. I do not think that that shuffling around in any way meets the simplification agenda. I would not claim that it was meant to. I think 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 per cent achieves a certain balance for people who are already in the higher rate taxpayer bracket. I think that is what is driving it and then you make these tweaks around the edges to try and keep everybody happy by giving bits back in other ways.

Q49 ***Lord Barnett:*** I take it you have no particular constructive proposals that would truly simplify the tax system for other small or large companies.
Mr Baron: You did mention the abolition of capital allowances.

Q50 ***Lord Barnett:*** I was only referring to it as something you would not want to do.
Mr Baron: It is a proposal that was floated in the corporation tax reform programme that the Government launched in 2002 and then the Government explicitly backed away from it in Budget 2004, so we know they are not going to do that. The idea was to say, "We will just allow accounts depreciation instead". It is not clear, particularly now that the capital allowances rate has been reduced to 20 per cent, that the argument that capital allowances are enormously more generous would still hold true. In fact, in the long term it should not really matter what your allowance rate is because each year you will get an allowance for one year's worth of capital expenditure one way or another. The really significant point is that you do not have to take all your capital allowances each year; therefore you can avoid putting one company in your group into loss in a particular year in which you do not have other group companies that could absorb that loss, because if you have a company going into loss and you cannot move the loss to somewhere else in the group then it is trapped within that company, so you can just claim the capital allowances and take the loss when it suits you, when you can get it relieved elsewhere, and if you just said, "We will take accounts depreciation", you would not have that facility. That is probably the real sticking point, the reason why people want to hang on to capital allowances rather than just taking accounts depreciation, despite the obvious simplification of saying, "We will just take the number in the accounts".

Q51 ***Lord Barnett:*** Is that what your members are telling you?

Mr Baron: That is not something we have heard directly from our members. The majority of our members come from small and medium sized companies and they tend to be single companies rather than groups. Obviously, we do have members who are from large groups, and certainly from talking to other people in the tax field that is an important concern.

Q52 ***Lord Barnett:*** In the case of truly small companies, of course, a bit of creative accounting would enable them to get their tax figures down quite low.
Mr Baron: I could not possibly comment on creative accounting.

Q53 ***Lord Barnett:*** But have your members said anything to you about the abolition of the industrial buildings allowance and the agricultural buildings allowance?
Mr Baron: We have not so far had comment on that. We have had more comment on the changes to the small companies rate.
Mr McCafferty: We have had some comment in terms of industrial buildings allowance, particularly from those who have been most adversely affected, as you would imagine. Clearly for some companies it has had a very significant effect. It does seem that of the winners and losers from the changes in allowances in this Budget there is a significant number of winners, all of whom have gained a small amount, and a smaller number of losers but they have individually been much worse hit.

Q54 ***Lord Paul:*** With regard to your comments on the simplification of the underlying tax structure, from what you have said so far I am not very clear. Are you saying that there has been no simplification or there is simplification but perhaps you want more?
Mr Baron: There has certainly been simplification on the income tax front, if that is not moving too far away from this Committee's business tax agenda, with the proposal to bring the 22 per cent rate down to 20 per cent, although the Chancellor has slightly spoilt it by keeping the 10 per cent rate for savings income which has reduced to some extent the prospect for simplification there, but I think we can expect to see the tax computation form that comes with the tax return getting smaller, so to that extent there has been simplification. On the business front, yes, the abolition of ABAs and IBAs represents a simplification but as for the rest one cannot see a really clear simplification strategy there.

Q55 ***Lord Paul:*** So what you are really saying is that you want more simplification?
Mr Baron: There is certainly scope for a lot more than has been done, yes.

Q56 ***Lord Paul:*** And, whatever simplification has been done, how do you see this encouraging growth through investment and innovation?
Mr Baron: I suppose simplification is going to encourage growth in the sense that if it is obvious to the investor how their returns are likely to be taxed then it makes them more likely to say, "Okay, I know what the deal is. Therefore I am prepared to put money in it", but that, I think, is as far as simplification goes in terms of encouraging investment and growth.
Mr McCafferty: I would argue that there are two areas. The first is that some of the changes, in particular the reduction in the headline rate of corporation tax, may well encourage a number of businesses who are now becoming increasingly internationally mobile to maintain their operations in the UK and perhaps encourage investment in the UK that would otherwise perhaps have been shifted offshore in order to deal with the lower marginal rates of corporation tax that we are now starting to see come through in a number of other countries, so from that point of view, I think, some of the changes should be beneficial for growth in this country. In terms of the investment and innovation package more narrowly, certainly as far as the area of SMEs is concerned, just to repeat largely what I said earlier, we do not see that the changes in the R&D tax credit relative to the changes in corporation tax rates for SMEs are necessarily going to be of significant benefit, and to that extent the comments that I have had from the CBI small and medium sized enterprise members have been quite critical of this Budget, not least because of the specific changes but more generally because they see it as a change in the previously very supportive stance taken by this Government towards enterprise.

Q57 ***Lord Vallance of Tummel:*** There were two other main objectives associated with these reforms. One was to improve the international competitiveness of UK business and the other was to ensure greater fairness, whatever that is, across the tax system. Do you think that they have hit the button on those two?
Mr Baron: On international competitiveness, the biggest contributor has to be the reduction in the main corporation tax rate from 30 per cent to 28 per cent, which is great but it looks like it is not going to be enough. We would certainly be in favour of an ongoing programme of reduction to bring it down to something of the order of 25 per cent simply to keep up with the competition. As for fairness, I think you said it all when you said, " . . . fairness, whatever that means". 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.

Mr McCafferty: The only points I would add to what Richard has said is 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. It is clear from the Treasury's own arithmetic that this Budget is at best revenue neutral when it comes to business. In fact, we could argue that over the course of the next three years on the Treasury's own calculations in the red book the amount of money taken from business has risen as a result of this Budget in spite of the cut in the corporation tax rate from 30 to 28 per cent. Overall we would see that the reduction in the marginal rate is a first step but probably only a first step to improving the competitiveness of British business.

Q58 ***Lord Vallance of Tummel:*** And fairness?
Mr McCafferty: In the short term any change in the tax system is going to create winners and losers and the losers will always say it is unfair and the winners will simply not thank you. To that extent the worry I have is more to do with 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 that 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.
Mr Woods: It does raise the question of how investors and business in particular are going to judge the UK in terms of stability. As was said earlier on, it is good for investors to know that if they invest X the tax treatment they are going to get will be whatever it is and they are going to calculate their returns on that basis. Some other regimes are prepared to guarantee tax treatment for a particular number of years.

Q59 ***Chairman:*** Following the question from Lord Barnett about the small companies, have you anything further to say about the package and how it might affect small companies?
Mr McCafferty: The other element that we have been concerned by, away from the changes in capital allowances and the change in the corporation tax rate as affects SMEs, the amendments to the different ways of raising capital as far as SMEs are concerned, the enterprise investment schemes, the venture capital trusts and so on, is that the comments that I have had from CBI member companies on those changes suggest that the changes will significantly reduce their use by SMEs in raising capital. Again, I have little detail at this stage. We are still working our way through that but certainly that is a negative element.

Q60 ***Chairman:*** The Economic and Fiscal Strategy Report does say that the reforms are going to "build a relationship [based] on greater trust". Do you see any evidence of this happening?
Mr McCafferty: We would want to see how some of these changes are put into practice. As with the Varney review, I think there are a number of signs that HMRC are starting to try and rebuild trust with business and some of the changes that we have identified as being retrograde in recent years, particularly in terms of attitudes and treatment of individual companies, are now being reversed, but I would say that we would want to see this in practice for some time before making a considered judgment.
Mr Woods: If you think that stability is an element in trust then you have to judge what is done on the question that I have just referred to about stability as an element of whether you judge it as successful or not. I would not have used the word "trust" in relation to policy decisions of this nature; rather the relationship itself on a day-to-day working basis between HMRC and taxpayers. As far as the Treasury is concerned, trust, of course, can be built up by having open and transparent consultation before policy changes are made and that is something we have been advocating for a long while.

Q61 ***Lord Powell of Bayswater:*** Can I pick up one question which was raised on consultation? As I understand it, there are two or three areas proposed for detailed consultation that are rather technical: the implementation of the annual investment allowance changes to treatment of integral fixtures and payable enhanced capital allowances for energy efficient and water efficient technology, whatever that means. Could there have been consultation over other areas? Are there areas which have not been selected for consultation where it would be better to have it?
Mr Woods: I think that all policy changes should be preceded by consultation, if for no other reason than ministers would then be able to make their policy decisions based not just on ideas which have come up from one side but also on the views of businesses, how they will impact in practice if implemented in one way or another. There is often more than one way of doing something, one of which might prove to be quite burdensome to implement and another way which might be very easy to implement from a business point of view, but you get to the same thing at the end of the day. For instance, if, in introducing a policy change, you are able to build on documentation and systems that business already uses, that is obviously far less costly for business than if business is required because of a change in tax law to go out and pay for software changes to introduce tax-driven, tax-specific new software packages and systems in order to meet compliance obligations. I

think consultation across the piece is beneficial to all concerned.

Q62 ***Lord Powell of Bayswater:*** I suppose it is always open to the CBI and the IOD to take the initiative themselves and approach HMRC with their thoughts on these sorts of things and say, "We hope you will take account of these", the sorts of factors you have just mentioned. I do not think one can look to government to start the whole Budget process by sitting down and talking to the CBI.
Mr Baron: Yes indeed. I would concur with what Mervyn has just said but I would add that my feeling is that on the whole Treasury and HMRC do a pretty good job of consultation. There has been the odd slip-up where something has been sprung on us and has turned out retrospectively not to have been very clever, as, for example, the proposals in the 2006 Budget on the inheritance tax treatment of trusts, which all got very messy and could have been consulted on in advance but for some strange reason were not. However, apart from the odd slip-up I think they do a pretty good job and they do want our views because they do not want to have to explain to ministers why a proposal fell flat on its face when it was launched without consultation.

Q63 ***Chairman:*** Our next topic is managed service companies. Before we had IR35 employment income could be kept in a company or paid out as a dividend. How is this issue being dealt with?
Mr Baron: Obviously, the IR35 personal service companies measures were a main weapon in taxing employment income and obviously they have not been entirely successful; otherwise the Government would not have been back for another bite of the cherry with managed service companies. I think their main problem has been that the personal service companies proposals, in order to bite, in order to get the extra tax and national insurance out of you, have to show that if we imagine away the personal company through which you are supplying your services you really would have been an employee. There is loads of guidance on what constitutes an employee. There is case law and so on, but when you have got to go through hundreds of thousands of taxpayers, trying to work it out for each one of them, it has just not been practical for the Revenue to carry through that process successfully.

Q64 ***Chairman:*** How do you see it developing?
Mr Woods: Just building on what Richard has said, as I think your questions may come on to later, the contract-by-contract approach obviously is extremely difficult for both sides. It creates a lot of work. I would have thought the whole thrust of the brief that was given to Sir David Varney when he took over as Chairman was to try and move away from that type of approach, notwithstanding the fact that strictly speaking it is the correct approach. One ought to be looking at it contract-by-contract to see what the legal relationship is in a particular case and, as Richard said, it is not always easy to see whether somebody is an employee or not without looking at the terms and conditions concerned. As regards the effectiveness of what has been done to date, the point has been made that you would not be coming back to Parliament a second time if you had got your weapons in your armoury the first time, so that speaks for itself. It is, of course, a question of much greater reform significance as to whether there should be a huge difference in the tax treatment of employed and self-employed people, or indeed whether people should be able to voluntarily opt for one treatment or another and take all the consequences that come with it. Unfortunately, at the moment there is no uniformity, not just within the tax laws because one has to do it on a case-by-case basis, but also different arms of government have a rather different concept of what is employment and what is not. If you are dealing with those, talking about disability or benefits of one sort or an other, you will not necessarily be going before the same tribunals which will be deciding tax cases and which will be looking at tax implications and might come up with a different answer.

Q65 ***Lord Powell of Bayswater:*** What do you think the Government is really aiming at here? Is it aiming at getting rid of managed service companies altogether, is it just aiming at reducing their tax advantages or is there any difference between those two objectives?
Mr Baron: I think it is aiming at taking away the tax advantages and, as has already been mentioned, doing it effectively by having a strategy of, "You are caught if we can tick the following boxes" in a very easy, mechanical way. It is back to the mass production end of the tax system for business. They want to get through lots of these cases in one go, so it is aimed at taking away the tax advantage but I am pretty sure the effect will be to make these managed service companies disappear. Particularly with the provisions about transfer of tax debt from one party to another people are just going to think the game is not worth the candle and they are not going to do it, and I believe that at least one of the very large providers of these managed service companies has already shut up shop and is saying, "We are not doing that business any more".
Mr McCafferty: 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.

Q66 ***Lord Blackwell:*** You mentioned the difficulties in operating existing IR35 legislation on a contract-by-contract basis, and obviously this is taking a different approach by defining them as managed service companies. I suppose if managed service companies disappear you can say it will have been effective, but do you think that in the way the Government has gone about this have they listened to the consultation? Have there been issues here that have been raised and taken into account or is it a blunt approach to deal with the issue?
Mr Woods: I think it is fair to say that consultations are still in progress inasmuch as there are still meetings going on between HMRC, HMT and the private sector to iron out some of the detail that is in the Bill before Parliament at the moment. These discussions focus on a number of key areas, one of which is trying to make clear that the vast bulk of what one might call non-aggressive and ordinary business relationships will not be caught by the new rules, and a subset of that is what is meant by providing a professional service, et cetera. There is quite a lot of debate still going on about particular exemptions. The second aspect of it is to try and make sure that innocent third parties, ie, the end clients, do not get clobbered as being the people who have got the money and therefore people to whom HMRC turn to pay the bills of the reluctant, first-time payers who formed these companies or participated in them or actively promote them but then disappear when it comes to paying the bills. One is very anxious to make sure that legitimate business does not accidentally fall foul of this and I do not think there is any disagreement in principle between the Government and the private sector on this. It is just a question of perhaps tweaking the statutory language to make it abundantly clear on the face of it because one of the key things we want to avoid if we can is business having to look at their relationships on the old contract-by-contract basis. It is far better if you know you are a legitimate end user to know, "It is nothing to do with me, guv. I am not in the category that is caught".
Mr Baron: I would say that the consultation has gone pretty well and the officials involved have put a lot of effort into going out and talking to people to try and establish what will work, what will not work, what the side effects are going to be, but obviously, under the general principle that they have to get this one cracked,—and having scored it in the Pre-Budget Report at something of the order of £350 million revenue each year—they have got to stick to that, they have got to make it happen. 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.

Q67 ***Lord Blackwell:*** Are you hopeful that the end result will be a simpler tax system or will this be more complex to try and interpret?
Mr Baron: There will be complexities of interpretation. Already one can see, looking at the legislation as it is put forward in the Finance Bill, that there are going to be places where there will be arguments, but I suspect to a large extent the problem will go away because, as has just been said, people will give up and these companies will just disappear.

Q68 ***Lord Barnett:*** I am not altogether clear from your answers whether you are agreeing with the fact or accept the fact, and I am not sure whether it is a fact, that most managed services companies have been set up to avoid tax and national insurance, VAT and so on, or whether there are other practical reasons, and whether you have any amongst your members, for example.
Mr McCafferty: We have some and I think the answer is that I do not believe that the majority have been set up purely as tax avoidance vehicles. A number of them, and I mentioned the recruitment consultants and agencies, certainly provide a very useful function in the labour market by providing a good deal of flexibility. It is a way of providing that flexibility between a full-time employee and a wholly outside contractor. To that extent they provide a useful function which could well in certain sectors be heavily missed.

Q69 ***Lord Barnett:*** I know the huge growth in recent years of managed service companies may not have resulted in your having any new directors of these companies in the Institute of Directors, and perhaps you could tell us but, more importantly, the CBI say in their document that it is imperative to protect innocent taxpayers. You have indicated that not everybody who has come into an MSC is doing so to avoid tax, and I emphasise "avoid" rather than illegally evading tax. You, that is, the CBI paper, go on to say that you understand that the draftsman of the new section 688A believes that the protection is achieved by the new wording but you did not agree with that. You agree with the objective but not with the wording. Have you discussed it with HMRC?
Mr Woods: Yes. That is why I am saying the consultations are still ongoing. We actually were at a meeting last Friday week with the Treasury and HMRC. They had taken legal advice and they were advised that the position was covered. We were saying that it was not as apparent to the private sector that on the face of the statutory language it was as covered as the official legal advice suggested and therefore would it not be in everyone's interests, seeing there was no disagreement between us on policy, to ask the draftsman to revisit his language to make it abundantly clear on the face of it. That was so that those who are innocent of what we were talking about clearly know they are not caught and will avoid

this contract-by-contract examination, the need to take professional advice, "Are we caught or are we not caught?". You know perfectly well if you are innocent that you are not in it at all. That is what we were trying to achieve, which we thought would be beneficial to both sides.

Q70 ***Lord Barnett:*** Mr McCafferty, you said you did not think the majority of managed service companies were set up to avoid tax and national insurance, but why again has there been the large increase in incorporations that we have heard about? We have not got the figures for this year yet but can you tell us whether you know what the increase has been this year?
Mr McCafferty: I do not know what the data is for this year, I am afraid. I think there are two reasons. One is very broadly the changing nature of the economy and the need for greater flexibility and the fact that we do have a number of areas of activity now in which people offer specific skills to a number of different businesses in a number of different sectors and therefore the particular set-up suits them better than the prior set-up. The second is, of course, that a number of years ago the Chancellor encouraged the incorporation of small businesses and these, I think, have been caught by part of that too.

Q71 ***Lord Barnett:*** But you have not explained why there was this substantial increase in recent years.
Mr McCafferty: As far as I remember, as of four or five Budgets ago there were changes in the tax treatment of small businesses were they to incorporate, moving away from sole traders, which encouraged a good number of businesses to incorporate, and this latest proposed legislation is essentially trying to roll back on that, so the Treasury and HMRC, or through the Chancellor, encouraged the incorporation of a number of previously deemed sole traders to incorporate and are now moving back on that legislation.

Q72 ***Lord Barnett:*** How many of them are members of the CBI?
Mr McCafferty: Those that are sole traders, not many. We tend to have membership amongst the slightly larger organisations which are covered by this particular tax definition.

Q73 ***Lord Paul:*** There was a lot of consultation. Was it effective in your view?
Mr Baron: I think it was in the sense that the legislation has certainly shifted a little bit through that process. It has not shifted far enough. One reason is that they need to make this work and it is going to be very hard to make it work, so there is a limit to how much they can give. Another reason is that there are areas where it is genuinely difficult, whatever words you come up with, to define the precise target. If you make it too precise then people will fall just outside your definition. What has not really struck home with the Government side in the consultation is serious concern on our side about this notion that if you are innocent you should not get caught because, given that there were a lot of these companies out there, okay, many of them managed by a small number of large-scale providers, the Government really is thinking in terms of, "Tick the boxes. Right; all the boxes are ticked, you have this tax debt", "Tick another couple of boxes when you do not pay it. Right, so-and-so over here has to pay it", without really a question of guilt or innocence. Guilt or innocence do not appear to be coming into it, which is a very serious concern to us because we feel that you should not have to pay money if you did not get into something knowingly or deliberately or with the wrong kind of motive.

Q74 ***Lord Paul:*** After that consultation, are you content with the way in which comments on the draft legislation have been taken into account?
Mr Baron: We still have concerns, particularly, as was said, about what the reach is, where professional advisers sit in all this, to what risk people who were not really in any sense guilty are exposed to having someone else's tax debt dumped on them. We certainly have not got as much as we would like to get, but such is the way of these things.
Mr Woods: That, I think, my Lord, is one of the reasons why we say the consultations are still going on. The ball was left in the court of HMRC and HMT last week and we hope that they will come forward with some amendments to meet the type of point that we have raised, but only time will tell. The problem, of course, is that once the Finance Bill process starts, as you all well know, the time frame is so rigid and tight that it is very difficult to fit everything in. Ministers are busy, officials are busy, dealing with so many things in such a short time that ideally one would have a different legislative process where one did not have everything compressed into such a narrow time frame, but that is where we are.

Q75 ***Lord Vallance of Tummel:*** What are your views on the transfer of debt provisions when a managed services company fails to pay PAYE tax or national insurance?
Mr Woods: This is a serious issue from two points of view. First of all, the concept of transferring one taxpayer's debt or liabilities to another taxpayer is not something to be considered lightly. It is quite a significant step. Secondly, the point that we have alluded to before is the absolute imperative of making sure the wording of the primary legislation is such that no transfer could occur so as to penalise what I am going to call the innocent end client or

third party involved. Even if they happen to have the deepest pockets, there is no shortcutting of processes and saying, "At the end of the day we want to get the money from someone. You, end client, happen to be a very big company. You may have used somebody without knowing that they were one of the offenders but nonetheless your very use of them is such as to deem you to be privy to the naughtiness involved".
Mr McCafferty: We would have hoped that there would be no such issues unless the end client, as it were, were proven to be in some way collusive with the arrangements that had been made.

Q76 ***Chairman:*** As far as the number of incorporation in Great Britain is concerned, it increased from 7,000 to 15,000 in the first four months of this year, a very large increase in incorporations. This is a result presumably of the announcement of the MSC provisions in the Pre-Budget Statement. If this is so, how effective is incorporation going to be?
Mr Baron: I think that the MSC announcement is the most likely explanation. I cannot be sure it is the explanation for that rise in incorporations but nothing else very obvious comes to mind. To the extent that they have been set up as personal service companies where they will be managed by the people whose services are being supplied by them, or more likely managed by their computer-literate teenage children who will get a package to do this for them, I think they will get away with it simply because although they will fall within the personal service companies regime, as we have already heard, that is a very difficult regime to administer in practice.

Q77 ***Chairman:*** Are there any further comments on that?
Mr Woods: The official statements to date suggest that there is clear ministerial determination to tackle what ministers perceive as an abuse in this particular instance, no matter how people seek to get round it. As I say, we are concerned to balance that ministerial aim against protection of the innocent who could so easily be caught by the Parliamentary draftsman's language unless one is very careful to avoid that result.

Q78 ***Lord Powell of Bayswater:*** Are there sufficient safeguards in this for the genuinely self-employed people who are quite properly using those arrangements? Are they likely to be at risk and harassed as a result of this?
Mr Baron: They will not be at risk from the managed services companies legislation if they manage their own companies and do all the work themselves rather than having it applied to them by a big operator. They will be in no worse a position than they have been up to now with the personal services companies legislation.

Q79 ***Lord Powell of Bayswater:*** They are not going to find themselves under particular pressure or investigation to ensure that they are doing this or that when they are actually doing it perfectly legally?
Mr Baron: I just do not think HMRC will have the staff to devote a lot more effort to the personal service companies legislation.

Q80 ***Chairman:*** Perhaps we can now turn to powers, deterrents and safeguards, including on-line filing. How well has the consultative process worked so far and how are we getting on with it?
Mr Woods: We would like to make clear at the outset that the officials concerned with the consultation process have engaged in a very genuine consultative process. Certainly in meetings I have been involved with there has been a very free and constructive dialogue. I am not entirely sure that we are happy with the process itself, however, inasmuch as the very fact that we have got this legislation in this Bill, the introduction of part only of what is a much bigger picture, before we have seen the total product that is going to arise from what one might call the post-O'Donnell relationship between HMRC and taxpayers. In our view this goes much wider than just the aspect that is before the House at the moment on the penalties for wrong returns, et cetera. It incorporates Varney. It incorporates whether or not, and if so in what terms, there will be a new Taxes Management Act which sets out basic obligations and how much commonality between the VAT side of things and the direct tax side of things, bearing in mind that the VAT rules are, of course, EU in origin so we cannot tinker with those, inter relates with the question of the reform of the tax tribunals, which your Lordships may be aware of. Those of you who have encountered or know of the old-style General Commissioners will know that they are to be abolished and tax appeals will now be confined to a number of set venues, so this in itself is going to impact on the taxpayer's local day in court. He might find himself travelling from, say, Cornwall to Bristol if he wants to complain about something. There is also the question of the taxpayer's charter. We used to have a charter, and indeed some of your Lordships may have been involved in advising on its contents or suitability at the time. We no longer have a charter. Other fiscs around the world do. One might say that the taxpayer's 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. 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 when you have decided everything else and then you say, "In order to best give effect to ministerial intent, to HMRC's intent . . . " In order to build this relationship of trust which, my Lord Chairman, you referred to earlier, everyone needs to have all the cards on the table face up before you decide which ones you are going to play first. 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.

Mr Baron: If I could briefly add to that, on the consultative process, yes, I think that has gone pretty well except that there is a bit of concern about the extent to which it has been fragmented. There has been a powers consultation group which has been of selected people by private invitation and then there has been more open consultation with each representative body on some other aspect and so on, so that may be something worth looking at. The fragmentation of the introduction of the different parts of the package I am rather less concerned about than Mervyn except for this point about the new tribunals because the new penalties regime is going to mean that in certain circumstances, and one may feel that these are undeserving of sympathy, such as people who have deliberately made mistakes on their tax returns, it will no longer be possible to negotiate penalties down to a very low level. There will be a floor of 35 per cent, or 50 per cent of the tax if you have set out to conceal your deliberate error, and in those circumstances one needs to be confident that the tribunal system will be effective because if you have penalties being imposed by officials on the basis of, as the legislation disturbingly says, what they think, and those penalties cannot be negotiated down below a certain level, it is very important that the taxpayer should have easy access to an appeal procedure. That part of the fragmentation does concern us, but the other ways in which the package has been fragmented and is being introduced in stages I do not think is such a serious concern.

Q81 ***Chairman:*** You do have this problem in the consultative process of on-line filing. There will be a very large number of smaller companies who find it very difficult to deal with the on-line filing with corporation tax, VAT and PAYE and to suggest that you can overcome this in one year is pretty optimistic, is it not?

Mr McCafferty: I think it is and I think we would push forward a number of principles on which the issue of on-line filing should go forward. In particular we believe it should be optional rather than compulsory and also if the HMRC wishes to encourage it that encouragement should be through the form of carrots rather than through sticks. So, yes, it is going to be difficult to ensure that on-line filing works well in such a short timeframe, we also have some concerns as to whether the necessary systems within the HMRC will be ready on time. As we have seen with some of the on-line filing of personal taxes there have been some teething problems and I would be very optimistic if I were not to expect similar teething problems on the corporate side. I think there are a number of areas where we have concerns in terms of the administration and the implementation of this, and we look forward to further discussions with the Revenue to ensure that these are taken account of.

Mr Baron: The Government did announce at the time of this year's Budget that they would be allowing an extra year before the compulsory on-line filing of corporation tax returns, which was probably a sensible decision, but their main problem is that you need to get a lot of people filing a year before it becomes compulsory so you can find out where any of the difficulties are. People are only going to do that if the on-line filing package is within their standard software package that they get off the shelf to run their little business and the software providers may be reluctant to put that facility in until the year in which they know it is going to be compulsory because when it becomes compulsory their market will be 100 per cent of the companies. If they put the effort into preparing it a year earlier, their market will be correspondingly smaller because it will only be the volunteers. Wherever they set the deadline they are going to have that problem and I think more thought perhaps needs to be put into getting people to have a go early, a year before it is compulsory, wherever the compulsion deadline is.

Mr McCafferty: I think there is a certain modest irony, perhaps, in a system in which we are moving towards on-line filing of corporation tax returns and yet there are still some difficulties in communicating with the HMRC by way of email.

Mr Woods: Yes, indeed, that is a point which has been raised several times, that perhaps the easiest way of introducing more taxpayers to the concept of e-communication with Government is to start with emails because more people are used to private email than they are dealing with official bodies. As I understand it, HMRC is not yet in a position to offer email communication to every taxpayer who wants it. That easy start is still not available nor, might I add, is the official HMRC website very helpful as it currently stands. We know it is under review and reform and, again, I think if one is thinking of moving to e-communications then one has to see the picture in the round, much as I said before, and therefore Government has to set its own stall out by saying, "Look, here is our wonderful site, it provides all the answers you need. All you need to do is interrogate it", I do not think we are in that position.

There is also the point which was touched on earlier by your Lordships about the follow up to the KPMG report on administrative burdens. One of the points that is still of concern is that until we are clearer about how many of the current obligations are going to be modified or removed as a result of that KPMG report, the question arises is it sensible to build in software packages based on existing legislation with the thought that before we even press the button "go" the KPMG follow up would have said that particular obligation—let us say for the sake of argument form P11D on benefits in kind—has been removed because it is no longer thought to be one that Government wishes to impose on taxpayers? So then the software and the system you would have introduced as a business will immediately be obsolete. One would have liked to see all of these things joined up together before making anything compulsory. Optionality, certainly, those who want to do things on an optional basis should be encouraged to do so and, as Richard has already said, that would provide HMRC with a very good insight as to practical difficulties that needed to be ironed out before a greater mass of taxpayers would be involved in e-filing. I am not at all sure that the Government is entirely aware of the numbers of people who are actually not at all IT literate, either they know nothing at all about it or they have not got easy access to computers or whatever, or a combination of both. Again, I think one has to bear that sector of the community in mind before introducing compulsion in taxpayer/government relationships.

Q82 ***Lord Powell of Bayswater:*** What view do you take of the new criminal investigation powers and safeguards, in particular the extension of the Police and Criminal Evidence Act?
Mr McCafferty: It is not an area that we have a great deal of expertise in, and certainly talking to our membership they have reserved views on that. They have very little experience.
Mr Woods: Yes, I think it is fair to say, my Lord, that the members that we have dealings with have little or no experience of the Police and Criminal Evidence Act—

Q83 ***Lord Powell of Bayswater:*** You have to be very careful how you select your members.
Mr Woods: —and have felt that there are other professional bodies such as the Law Society or the Bar Council, and the accounting profession who might be better placed to comment on that. Some at least of their practitioners will have that as meat and drink of their everyday work but for us, I am afraid, may we pass?
Lord Powell of Bayswater: We will report your comment faithfully to them.

Q84 ***Lord Blackwell:*** You previously said that you thought it odd that penalties were being defined at this stage rather than at the end of the process. To the extent they are set out in the legislation do you have particular concerns about the way penalties are defined or where some of them will be imposed you should draw attention to?
Mr Woods: I think it is fair to say that since the consultation started HMRC have moved, so, for instance, there now appears to be a willingness to recognise the concept of materiality which is very important for large businesses because something which is equivalent to tuppence ha'penny to a large business might to a smaller one be a much bigger event, as it were. Secondly, in this legislation they have recognised our request that the concept of a third party agency filing a return on behalf of a taxpayer should be taken into account. For instance we suggested that if any one of us as a taxpayer had a valuation problem it would be perfectly natural for us to ask an expert valuer to give an opinion on that value and for them to submit a return with that value in it, and it would be wrong to land the taxpayer with a penalty if the agent had got something wrong in that valuation because, to our mind at least, the very fact that one is willing to employ an expert to help you get your tax return right shows that you are on the side of the angels, ie the compliant or would be compliant taxpayer.

Q85 ***Chairman:*** Is there anything further you want to say? It will not be worthwhile coming back here.
Mr McCafferty: I do not think so. We have covered, certainly from our point of view, everything we want to say.
Mr Baron: Only very briefly—

Q86 ***Lord Barnett:*** I have one or two on penalties. You refer to compliant and non-compliant taxpayers as your main concern on penalties. Speaking as a compliant taxpayer, you said earlier you understand the influence of trying to apply different penalties. Does that mean you agree with what the Government is trying to do or am I reading too much into your comment?
Mr Woods: I am sorry, I was unable to hear you.

Q87 ***Lord Barnett:*** I was saying you say in your introduction that you understand the Government's approach on penalties. Does the word "understand" mean you agree with what they are trying to do?
Mr Woods: Yes, I think we do. I think those who are compliant, or seek to be compliant, should be very firmly segregated from those whose intent is not to comply. Speaking, like your Lordship, as a compliant taxpayer I have no sympathy with those who

deliberately seek to flout the law. We want to make sure that the end product in all this is a relationship that does build up the trust and confidence that your Lordship referred to earlier and that those who are compliant or would be compliant know full well that they have nothing whatsoever to fear from the new regime.

Chairman: Thank you very much for coming and answering our questions today. I am sorry we have to end so suddenly.

Supplementary evidence by the Confederation of British Industry (CBI)

CBI'S Lambert sets up task force to examine whether UK business tax regime is still fit for purpose CBI Director-General Richard Lambert today (Monday) launched a new Tax Task Force to examine whether the UK's corporate tax regime is still fit for purpose and to make recommendations for future policy.

The group will be chaired by Charles Alexander, President of GE Capital Europe and National Executive of GE in the UK, and is made up of finance directors and heads of tax from UK firms across all key sectors and of all sizes—including Pfizer, Rolls Royce, BP, Cadbury Schweppes and Barclays.

The Task Force is the latest move in the CBI's ongoing campaign on business tax, and follows the recent cut in the headline rate of corporation tax. It is tasked with evaluating whether the current UK corporate taxation regime is fit for purpose over the long term, and drawing up proposals for how it should adapt to ensure the continued competitiveness of UK-based companies.

CBI Director-General Richard Lambert, who has brought the group together, said:

> "The need for the UK's headline rate of corporation tax to be at a competitive level is widely acknowledged—including by the Chancellor, if the cut in corporation tax in the Budget is anything to go by.
>
> "What is less well understood is how globalisation may be fundamentally changing the way in which businesses think about tax. Multinational companies with long supply chains and staff in many countries are increasingly able to choose where they headquarter and where they pay tax. Alongside this they are faced with highly complex juggling acts, both within the complex UK tax system and in the way our tax system interacts with those of other nations.
>
> "We could continue to stumble along, responding every time the European Court of Justice rules on an international tax case, or each time we fall sufficiently far down the world tax league tables that the Treasury is forced to act. That's the ostrich approach.
>
> "To help UK businesses stay ahead of the competition, the CBI is proactively taking a strategic look at the whole issue so that our tax regime can become sustainable for the long-term.
>
> "Tax may not be the most political or obvious of global challenges facing us, but it is very real. It needs to be high on the agenda of the next Chancellor if he or she wants to foster a successful, growing UK business sector that provides a reliable tax revenue stream over the long term."

The Task Force will hold its first meeting later this month and will produce its final report in around nine months' time. Its recommendations will be put to the Treasury and the wider government and circulated internationally.

The members of the Task Force are:

Charles Alexander, President, GE Capital Europe, and National Executive, GE in the UK (Chairman of Task Force)

Geoff French, Executive Chairman, Scott Wilson Group

Philip Gillett, Group Vice President Tax and Treasury, ICI Plc

Adam Little, Head of UK Tax & Business Tax Services, BP

Jim Marshall, Director of Taxation, Cadbury Schweppes

Ian Menzies-Conacher, Senior Taxation Advisor, Barclays Bank Plc

Christopher Morgan, Head of International Corporate Tax, KPMG

Will Morris, Senior Tax Counsel International and Director, European Tax Policy, GE

Frank Overtoom, Finance Director, Pfizer

30 April 2007

Allan Pelvang, Head of Group Tax, Fidelity
Mike Sufrin, Director of Tax, Rolls Royce
Ian McCafferty, the CBI's Chief Economic Adviser, is Project Director for the Tax Task Force.

14 May 2007

WEDNESDAY 2 MAY 2007

Present	Barnett, L	Sheldon, L.
	Blackwell, L	Vallance of Tummel, L.
	Powell of Bayswater, L	Wakeham, L. (Chairman)

Memorandum by The Law Society

MANAGED SERVICE COMPANIES

CLAUSE 25 AND SCHEDULE 3

The Managed Service Company provisions have been consulted upon through two consultation papers, the first published on 6 December 2006 at the pre-budget report, and a further consultation paper in February 2007 concerning transfer of Pay As You Earn and National Insurance Contributions debts to various persons involved with MSCs and MSC providers.

The proposed MSC provisions basically describe certain components which if satisfied have the effect that an entity is treated as a managed service company ("MSC") and is required to account for PAYE and National Insurance on payments made to certain individuals by that company. If PAYE and National Insurance is not accounted for, other persons involved with the MSC or the MSC provider can be required to make payment of PAYE and National Insurance Contributions. The provisions have been introduced because of the ineffectiveness of the provisions which apply to services provided through intermediaries (chapter 8 of part 2 of the Income Tax (Earnings and Pensions) Act ("ITEPA") 2003, commonly referred to as "IR35"). MSCs are companies or groups of companies which hire individuals and provide their services to third parties. Concerns arose that the rise of MSCs meant that the IR35 legislation was sidestepped; the concerns were twofold. The first was that the structure of IR35 requires an analysis of the relationship between the individual and the end client who hires the services of the worker from the personal service company. The second concern was that IR35 operates retrospectively and so it is often difficult to establish liability. If an arrangement is one of employment, then the IR35 provisions apply and require PAYE and NIC to be accounted for by the intermediary or personal service company. The position of HMRC is that in the case of a MSC arrangement the relationship between the employee and the client is highly likely to constitute that of a employer/employee relationship so the tests are different from those which apply to IR35. There is a difficulty in practice collecting PAYE and NI contributions from MSCs and so a new regime is required to deal with this.

While appreciating the policy objective the Law Society made representations that if IR35 could not be adequately enforced there should be some initial safe haven in such a regime, so that it was not the case that the mere provision of the services of individuals would give rise to MSC status and a requirement to account for PAYE and National Insurance when the underlying circumstances might mean that HMRC was not prejudiced or that it was inappropriate for the MSC regime to apply. HMRC have responded to this by introducing clause 61B(1)(c). This is in addition to the other tests for the existence of an MSC, namely that the business consists wholly or mainly of the provision of the services of an individual, that the greater part of the consideration received is paid to that individual (the worker) and that the company is run by a person who carries on a business of promoting such services (the MSC provider). Clause 61(B)(1)(c) requires that the way in which payments are made to the worker would result in the worker receiving amounts, net of tax and National Insurance which exceed those amounts, also net of tax and National Insurance, that the worker would receive if every payment made in respect of the services provided were employment income of the worker.

It is not clear over what period this test is applied. It is considered that it should apply to a year of assessment.

Position of Accountancy and Legal Services

Various liabilities arise for an MSC provider under the proposed MSC legislation. The definition of an MSC provider is a person who carries on a business of promoting or facilitating the use of companies to provide the services of individuals. Where an MSC provider is involved with the MSC, liabilities potentially arise for it. The involvement includes influencing or controlling finances, the provision of the services or the way in which payments to individuals are made. This could cover a wide number of advisers including legal and accountancy professionals. There is a safe haven for the activities of lawyers and accountants in clause 61B(3), provided

they act in "a professional capacity". This requires some modification to cover a wider category of adviser than, for example, individuals regulated as accountants. However, at the same time it should be clear that if a person providing legal or accountancy advice goes beyond this role he could become an MSC provider.

Partnerships

The provisions relating to Managed Service Companies apply primarily to corporate entities. Section 61(C)(3) provides that "company" means a body corporate or partnership. However, the provisions do not apply particularly clearly to partnerships. This comes across particularly when the definition of a MSC provider is considered. This is defined as a person who carries on a business of promoting or facilitating the use of companies to provide the services of individuals. If, however, the MSC provider is simply a partner in a partnership (which is the MSC) it is unlikely that this person will carry on a business separate from that of the partnership, which will be the provision of services of individuals to clients. The model envisaged by HMRC is based on a corporate structure where there is a company which engages workers and pays out money to them in the form of dividends, which company is managed by a separate entity which is an MSC provider. It is considered that sub-section (3) should be elaborated to make the provisions effective for partnerships.

Deemed employment payments

In the case of an MSC there is calculated the amount received by the worker which can reasonably be taken to be in respect of the services. So, for example, if the worker receives a dividend from a company which is in respect of the services provided to the client, the payment will not be earning and will form part of a "deemed employment payment" in respect of which PAYE and NI has to be accounted for. Under the provisions the deemed employment payment is treated as arising in circumstances where a worker, in respect of services provided, receives a payment which is not earnings. In these circumstances the MSC is treated as making a payment which is to be treated as earnings. There are various steps carried out to calculate the deemed employment payment. The first of these steps is to define the amount of the payment or benefit "mentioned in section 61D(1)(b)". However, this paragraph covers all payments received by the worker from the MSC, whereas the deemed employment payment should only relate to those payments received by the worker which are not earnings. Accordingly, the references in Step 1 to section 61D(1)(b) should be a reference to 61D(1).

Meaning of "Associate"

The definition of "associate" is relevant to two circumstances in the MSC legislation. The first circumstance is the recipient of payments relating to the services of the individual. A condition for a company to qualify as a managed service company is that payments are made directly or indirectly to the individual or associates of the individual. The legislation could be effectively avoided if payments could be made to a third party in relation to services provided by an individual but the individual benefits.

The second relevance of the definition of associate is in relation to the recovery of PAYE and National Insurance Contributions from third parties where these are not properly accounted for by the MSC or the MSC provider. As a matter of principle, tax liabilities should only belong to the persons who are liable for the tax and receive the income out of which they are to be discharged. To make other parties liable for tax liabilities gives rise to a need for very closely focused legislation. For example, if an individual is an MSC provider, that individual's spouse should not in principle be liable for the tax merely be reason of having married that individual.

The definition of "associate" is contained in clause 61I and the definition seeks to serve both circumstances described above.

The definition defines "associate" in relation to three categories of person, individual, company and partnership. As regards the first category, an individual, companies are not associated with individuals. It would therefore appear that if an individual is engaged by an MSC through his personal service company in circumstances where the MSC provisions would otherwise apply (thus displacing the IR35), the MSC provisions would appear not to apply because the company (on the assumption it is owned by the individual) would not be an associate of the individual. This may be intended by HMRC, as in this circumstance it may be intended that IR35 applies.

In relation to a partnership, it is provided that an associate means an associate of a member of the partnership. It is also provided that if an MSC is a partnership and a person is an associate of another by virtue of only being a member of the partnership, then he is not to be treated as so associated.

In relation to a company model, the rules relating to recovery of PAYE seem to work reasonably well. An associate of the MSC would be other companies in the same group, shareholders who have control or who with persons connected with them have control and directors and office holders. There is also caught an associate of an MSC provider other than an associate of an individual—therefore the spouse of an MSC provider who as an individual would not be caught.

With partnerships the position does not appear to work so well. In relation to a partnership an associate means any associate of a member of a partnership, which could include a spouse of any partner of the MSC. This would seem to be too wide.

A partnership does not have directors or office holders. The provision and the way the definitions work appears to treat the partnership as an entity and therefore a managed service company. If this is correct, the partners do not appear to be associates of the MSC. However, they would appear to be caught on the basis that they have encouraged or facilitated the activity of the partnership.

Liability of clients and workers

The proposed MSC provisions allowing PAYE and National Insurance debts to be claimed from third parties appear to provide that the worker could not be a person from whom the PAYE and National Insurance can be collected. In the case of the worker the provisions are phrased so that the worker is either not on the list of persons from whom amounts can be claimed or the provisions indicate that the worker is not someone who is anticipated to be within the category of person who has "encouraged, facilitated or otherwise been actively involved" in the provision by the MSC of the services of the individual—the implication is that the worker is a different person from those who have been involved in providing his services. For a client the position is by no means so clear. If a client has requested that the services of a worker is provided via an MSC then that client could be liable under these provisions. It is considered that there should be a clearer safe harbour for a client so that a client should not have a liability to account for PAYE and National Insurance of a worker unless the client is involved with the MSC in a similar way to some of those criteria applied to an MSC provider, such as influencing or controlling the provision of the services the way in which payments are made or finances. On the other hand the worker himself is not liable when in principle it could be thought that he should be—if PAYE and National Insurance is not accounted for on employment income due to him then he should be liable by direct assessment. This perhaps should be more explicit.

POWERS, DETERRENTS AND SAFEGUARDS

Criminal Investigation Powers: Powers of Revenue and Customs

Clause 81

The Law Society recognises and fully supports the need to tackle crimes against the Exchequer. The Society acknowledges that there has been a full consultation on the modernisation of these powers during which HMRC has taken care to take account of representations made to it by representative bodies.

1. In the process of consultation relating to the Criminal Investigation Powers the starting point of HMRC was entirely reasonable, namely that following the amalgamation of the Revenue with Customs, their powers needed to be amalgamated across the board, as otherwise they would not be able to carry out their functions satisfactorily. Customs already had powers of arrest in relation to VAT and PACE powers were already applied to Customs through section 114 of PACE and a statutory instrument applying the relevant sections of PACE to Customs' activities. In August 2006 when the consultation paper came out on the amalgamation of powers and providing the same powers to the former Customs and Revenue sides of the organisation, the proposal at that stage was that powers should all be "upgraded" to the highest level of the existing powers. The main example of this was that under the proposed Revenue and Customs legislation production orders and search warrants could be applied for where there were reasonable grounds for believing an offence "is being, or is about to be" committed, as well as where the offence has been committed. Under PACE and also under SOCPA an order could only be applied for where it was reasonably suspected an offence has been committed. Following representations HMRC have moved away from this position and there are now, in the proposed legislation, only relatively few departures from PACE. The powers generally follow PACE with few exceptions, which is the approach that the Law Society supports.

2. During the consultation process it became apparent that there was and still remains a lack of trust of those officers at HMRC who carry out criminal investigations. This is particularly those officers who operate on the VAT side. This follows the highly publicised collapse of various trials, enquiries and so on where Customs officers have not acted properly with the result that trials have failed and enquiries have had to be launched. There appears to be a fairly strong distrust of how former Customs officials operate. There are steps that have been taken to deal with this. The Office of the Revenue & Customs Prosecutions Office has been created with the function of instituting criminal proceedings and assuming their conduct. This separates out the prosecution function. In addition, HMRC have created a separate directorate, the Criminal Investigation Directorate, with the responsibility for external criminal investigation of tax related offences. HMRC have made significant efforts to separate out functions so that criminal investigation activity is not confused with civil investigation activity and separate personnel are involved. HMRC have outlined the steps taken in the separation of the powers. There is no doubt that HMRC have taken this issue extremely seriously and have taken as many steps within the organisation as possible to separate out the people who will exercise criminal powers from other staff. The Law Society fully supports and recognises the steps that have been taken. There is no statutory basis, however, for this separation of functions; it may be appropriate to consider whether there should be such a separation.

3. The basic position of the Law Society is that tax fraud and tax offences are no different from other criminal offences and should be investigated according to the same set of powers. HMRC have generally agreed with this approach and have generally followed PACE. The remaining reasonably limited points are:

(a) In the adoption of PACE under the statutory instrument no particular grade of officer is specified to exercise the powers. HMRC have stated that by clause 81(8) of the Finance Bill which inserts new paragraphs (d) and (e) in sub-section (2) of section 114 of PACE the powers can be exercised by officers of Revenue and Customs acting with the authority (which may be general or specific) of the Commissioners for HMRC. HMRC have stated that the persons to whom these powers will be given will be supervised and properly trained. The personnel on whom the relevant powers will be conferred will be about 2,000. The process with be documented and subject to external scrutiny, by HM Inspectors of Constabulary—the power of inspection is conferred by section 27 of the Commissioners for Revenue and Customs Act 2005 and through regulations. The regulations allow inspection into the actions or omissions of an officer of HMRC in connection with offences. This and the actions taken by HMRC are to be welcomed. Our residual concerns are first, that there is no specific grade of officer who is assigned important powers, such as the power of arrest. During the consultation process we had the impression that this was regarded as too difficult because of the changes in grades and finding equivalent grades for HMRC officers to those of police officers exercising equivalent powers. The second is 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 the personnel within that directorate who can use the powers available to HMRC. HMRC have taken these issues seriously but it may be appropriate for a legislative framework to exist as well.

(b) We considered that the powers vested in CID 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. In the light of the reports to be given by HM Inspectors of Constabulary this may not be immediately necessary, but given the prosecution failures in recent years there may be a case not only of the scrutiny of how an investigation is run (which is done by HMIC), but also of other matters, such as funding, training, and so on.

4. The effect of the bill will be that, through amendments to section 114 of PACE and the statutory instrument, PACE powers will become available to HMRC to both the former Revenue and Customs arms of the organisation. As mentioned the powers were already available for former Customs based activities. These powers allow, for example, search warrants and production orders to be applied for by HMRC officials using PACE constraints, which basically means that the application has to be made to a circuit judge, there must be reasonable grounds for believing an offence has been committed and an application for a production order and search warrant could only be available if "special procedure material" was the material to be sought. Special procedure material is material which is acquired or created in the course of an trade business or profession and held subject to an express or implied undertaking to hold it in confidence. This actually limits the value of the production order and search warrant power. Hence new section 14A inserted by clause 81(6), which preserves existing production order powers where "special procedure material" is not involved. We considered that this would be a useful power to have and support it. As a general principle production orders

should be encouraged as a first step before the use of search warrants, which are a more intrusive investigative tool. It is noticeable that section 20BA of TMA (as it will apply to non-special procedure material) has not been altered to change the phrase "is being, has been or is about to be committed" to simply "has been committed". This should be done as it is then in accordance with PACE. (The same should apply for VAT (paragraph 11(1)(a), Schedule 11, VATA 1994). These provisions do not appear amended by Schedule 22).

5. Clause 81(8) includes the additional power, not contained in PACE, that where premises are being searched, persons on the premises can be searched without being arrested. HMRC seem very keen on this power. We could not understand why and consider that if it is to be retained then it should only be retained in so far as it is in line with PACE—so that persons can be searched if there is a power to arrest them. We thought this was reasonable.

6. The Customs side of HMRC have had these powers for a number of years, but the amalgamation of Customs and the Revenue does give the opportunity to consider carefully the powers when they are being rolled out to the entire organisation.

Penalties for Errors

Clause 96 and Schedule 24

There is a new drafting departure in Schedule 24 in that word "think" is consistently used throughout the Schedule. This appears to be a deliberate policy on the part of the parliamentary draftsman to describe the process of considering whether a penalty should be levied on a taxpayer. "Think" is used to describe the (at least partially) subjective process of considering whether a penalty should be levied on the basis of the behaviour of the taxpayer and is to be distinguished from the appeal process (for example) under which the tribunal considers whether the decision to levy the penalty was correct and has the ability to review that decision. We understand that the use of the word "think" is designed to indicate that the decision can be reviewed by a court.

We disagree with this approach. We consider that in certain places in Schedule 24 the use of word "think" is inappropriate—for example, in paragraph 1(1)(b) it is simply the presence of the relevant conditions that is needed, there being no need to state that HMRC thinks the conditions are satisfied. Furthermore, if the word "think" is used, in our view this may indicate both that the decision making process can be casual and that a tribunal may be less able to review the decision. If all that is required is HMRC "thinking" that a penalty should be imposed rather than a more objective assessment of the behaviour of the taxpayer, leading to the implication that a penalty ought to be imposed. We therefore consider that paragraph 1 ought to be amended and in the remaining part of the Schedule the word "think" should be replaced with the word "consider" or "considers", as appropriate.

The use of the word "think" is particularly important in the light of the appeal provision in the Schedule. As currently drafted, certain decisions of HMRC (in particular the decisions to suspend a penalty or reduce it for special circumstances) can only be appealed if the decision of HMRC was flawed and could therefore be susceptible to judicial review. This can only succeed if the decision were objectively unreasonable. This is, legally speaking, a very steep hill to climb. When the opening wording of the paragraph 11 (reduction of a penalty for special circumstances) is considered "If HMRC think it right . . ." the task becomes virtually impossible. These words should be amended to reflect a requirement to carry through an appropriate decision making process.

We would note that the penalty provisions have been consulted upon by HMRC through a very full and well run consultation process. The proposed amendments which we put forward in relation to this process are a reflection of various issues relating to the imposition of penalties where the Law Society believes that improvements can be made.

Losses

Paragraph 7(2) of Schedule 24 introduced a new principle to deal with losses. There are various ways of dealing with losses which were consulted upon by HMRC. Generally, so far as a taxpayer is concerned, a loss has no benefit until it can be used by setting it off against a profit. However, if the loss is overstated and is set off against a profit many years later (as can easily occur with, for example, capital losses), HMRC, and the taxpayer are disadvantaged. Both will have to investigate whether the loss was or was not overstated in relation to the period in which it arose, which could be many years previously. The taxpayer may not have

adequate records and HMRC may therefore not be in a proper position to either challenge its calculations or agree the loss. Hence the alteration to a system where the taxpayer has to evaluate the loss effectively in the year in which the loss arises. If the loss is set off against profits then the understatement is dealt with in accordance with the normal principles for understated profit set out in paragraph 5 (that is the penalty relates to understated tax lost). However, if a loss is overstated without being used, a new regime is introduced, treating 10 per cent of that loss as potential lost revenue to which the penalty provisions could apply—so if this represents merely a careless overstatement, 30 per cent of that 10 per cent could fall to be treated as giving rise to a penalty. The Law Society agreed with the policy approach of HMRC in this connection because of the need to agree, within the self assessment framework, the position of a taxpayer as rapidly as possible. However, when a business makes a loss which cannot be relieved against profits, the business will not be in a good commercial position, generally speaking. Any penalty in these circumstances will put a significant additional strain on the business and will therefore have a disproportionate effect. Accordingly, in our view, a relatively small penalty would be sufficient to produce an effective regime. We therefore consider that the figure of 10 per cent is too high and that 5 per cent would be sufficient on the basis that any penalty in respect of a loss will focus a taxpayer's mind very closely on agreeing the level of loss at the time.

Group relief

Under the new penalty provisions in Schedule 24 group relief is generally not taken into account. So if a company within a group understates its profits and this leads to a penalty being exacted against that company, it is not possible for the group to arrange for losses arising from another company within the group to be set off against those profits, so that there are no profits by reference to which the penalty could be exacted. (Such a possibility exists currently). Under the new provisions this is not possible so understated profits may lead to a penalty for a group company even though there might be losses elsewhere in the group, which the group might be able to use after the event against these profits. There is a limited exception to this rule. This is that where a group is overall loss making, so that HMRC is not out of pocket as a result of an overstated loss, group relief can be taken into account in reducing any liability to tax within the group when computing the potential lost revenue. The principle behind this is acknowledged and the proposed amendment is purely technical. The phrase "an aggregate loss recorded for a group of companies" is not particularly clear and should be replaced with something which is more closely defined.

Special circumstances

The penalty regime has certain minimum penalty levels contained within it to prevent HM Inspectors being able to mitigate penalties below certain minimum levels, save in special circumstances. 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. The original purpose behind the provisions was to prevent Inspectors agreeing to low penalties which would not be in the interests of taxpayers as a whole. However, there would be no harm in allocating personnel within HMRC, who are different from the Inspectors handling the assessment of the penalties in the first instance, to exercise the power to review penalties further should that be appropriate.

While the ability to pay is not a ground which would be taken into account in ordinary circumstances, it could be relevant on some occasions, for example, where a taxpayer makes a simple mistake on a form but the mistake is in relation to a very large matter, with the result that a very large amount of tax is understated. In addition, we consider that the fact that there is a loss of revenue which is balanced by the payment of tax by another taxpayer ought in principle to be taken into account in computing a penalty. There are two examples that could be relevant in these circumstances. The first is the *Demibourne* case. In that case a hotel paid a caretaker without deducting PAYE on the assumption he was self-employed. He turned out to be an employee. However, the caretaker had accounted for income tax as if he was self-employed, so the loss to HMRC while being the amount of national insurance on his income was not that significant. Should not the tax paid by the waiter be taken into account in these circumstances? Another example is between groups of companies. The reduction of tax bill by one will normally be matched by an increase for another. We also consider that in determining what might be "special", some guidance could be given to HMRC. All the circumstances of a particular case should be taken into account as well as whether the penalty is proportionate.

Appeal rights

The appeal rights against penalty decisions are limited by paragraph 15, 16 and 17. To summarise:

(a) If a taxpayer appeals against the decision that a penalty is payable, the tribunal can affirm or cancel the decision by HMRC;

(b) If an appeal is taken against the amount of a penalty the tribunal only has power to substitute a decision that HMRC could have made (so the minimum penalty levels remain) and can only use paragraph 11 relating to special circumstances to the same extent as HMRC have used that paragraph. So if a penalty is at the 70 per cent level and HMRC, because of special circumstances, mitigated it to 10 per cent, the tribunal could reduce the penalty to 50 per cent but could only mitigate it by the same relative amount—so that the tribunal could only reduce the penalty by 6/7. More importantly if HMRC have decided not to mitigate the penalty at all under paragraph 11 the Tribunal has no power to reduce the penalty below the minimum levels prescribed in paragraph 10 unless paragraph 17 (3) (b) applies. Paragraph 17 (3) (b) has the effect that the only other basis on which paragraph 11 (special circumstances) can be applied differently from HMRC is where the decision of HMRC could be judicially reviewed—it would be extremely difficult to demonstrate that HMRC acted so unreasonably so that their decision could be subject to judicial review.

(c) Decisions to suspend. Where HMRC has taken a decision not to suspend a penalty an appeal can be made against the decision not to suspend, but only if the decision of HMRC in this respect was flawed and could be judicially reviewed. This is again highly unlikely to be successful. The position is similar where a decision has been made to suspend and the appeal is against the conditions of suspension. The tribunal only has power to confirm the conditions or vary in circumstances where the suspension conditions could be judicially reviewed.

In the view of the Law Society an appellate tribunal should be given power to substitute its decision for HMRC's in all circumstances. The restrictions on the right to appeal to a tribunal are considered to be an unnecessary protection for HMRC.

Liability for penalties

Paragraph 19 applies to cases of deliberate inaccuracy and provides that an officer of a company as well as the company is liable to a penalty. For a body corporate, "officer" means a director, shadow director and a secretary. For any other case (which means an unincorporated association), "officer" means director, manager, secretary and any other person managing or purporting to manage any of the company's affairs. In the case of an unincorporated association there is unlikely to be anybody who is appointed as a director. A manager is too remote. We therefore think that the categories of person should be more closely associated with the type of body.

Record keeping

Schedule 24 throughout refers to documents and operates by reference to documents handed to or served on HMRC. "Document" is extended in paragraph of 28(h) to include any other form of communication to HMRC including by telephone or otherwise, which would include a meeting. It is now possible to make filings by telephone and information is often provided to HMRC through meetings. However, where there is a communication of this type a taxpayer should only be subject to a penalty if the communication is recorded in some way that can be referred too—it would be easy for HMRC to misunderstand what a taxpayer had said and vice versa. It should therefore be a requirement that if information is provided orally a note is taken and sent to the taxpayer.

ON-LINE FILING

Clauses 87 to 95

1. *Making online filing a universal real option*

In our view there are certain key things that have to be addressed before *any* pressure can legitimately be imposed towards e-filing for personal self-assessment. These are:

— HMRC need to extend their free software to encompass all the available supplementary pages. Even where people do have the necessary hardware and internet connection already, it is wrong to force them over to a system which they cannot use without involving them in extra annual expenditure for commercial software; that might be for the purpose of making just one single entry on a supplementary page that HMRC do not provide.

— Even more significantly, HMRC must make available the facility to submit attachments (in common file formats) with online returns, in the same way as is already available with corporation tax online. The "white space" on the return form itself is sometimes simply insufficient to provide adequate explanation or disclosure, or may be incapable of presenting information in a sensibly formatted way (eg information in a table). There should be no limitation on the number of attachments that can be included.

— Public confidence must be gained in the absolute security of the system. A single breach of security, such as was publicised not very long ago, takes a long time to live down.

— Parliament should consider whether the systems and circumstances are such that mandatory e-filing should be imposed.

2. *Incentivising online filing*

Differential filing dates

The Law Society was opposed to the introduction of differential dates for online and paper filing but recognises this is Government policy. This will disadvantage those people who, for whatever reason, wish to continue filing on paper, and who require information from third parties to enter in their own tax returns, where the third parties (eg partnerships issuing details of individual partners' shares of the partnership computations, or trustees issuing tax deduction certificates to beneficiaries), or their agents, choose to move to online filing. Taxpayers who rely on information from third parties for their returns may have to use estimates if they wish to file using a paper return.

Alternative proposal

We have no objection—once the basic issues identified at 1 above have been satisfactorily resolved—to the provision of an incentive to encourage a switch to online filing. But one of the main gainers from online filing is HMRC, through a reduction in the staff/time needed to capture information from returns, and for this reason the incentive should in our view be a financial one. There is a good precedent for this in the context of PAYE filing for smaller employers, where credits to the employer's PAYE account are available of £250, £250, £150, £100 and £75 in the first five years of the scheme. (But for clarity we would be opposed to mirroring, in the self-assessment context, the compulsion to use online filing that is involved in the PAYE context once the incentive period for small employers has expired.)

We would suggest that for individuals a similar pattern of financial incentives, claimable against the tax liability for the year in question (though possibly capped at the amount of their tax liability for the year), should be available for the first five years of the scheme, or for the first five years in which they are required to lodge self-assessment returns if the first such requirement is issued after the scheme starts.

3. *Facsimile Returns*

We can understand in principle a feeling that if commercial software has been used to populate a tax return then there might be no reason for the resultant return to be lodged in paper form. However, any withdrawal of the facility to submit facsimile paper returns must in our view be deferred at least until the issues at 1 above (most particularly the issue about submission of attachments) have been dealt with; even that may not fully meet the point at the heart of our concern. To announce, or even propose, a date for withdrawal of the facility, before having the required replacement systems fully operational, and stable use established for a year or so, is putting the cart before the horse and will only generate ill-feeling.

Many investment managers provide their clients with capital gains schedules in facsimile format which can then be included with a paper return, whether it is (in other respects) completed in manuscript on HMRC paper or printed from a commercial software package. It would be a retrograde step indeed if a change in HMRC's requirements were to lead to taxpayers having to reproduce all that information manually; yet the

variety of commercial software packages is such that one can foresee serious problems if clients with one package wish to import into their own software an electronic file sent by the investment manager. We would suggest that it should suffice for the detailed schedules to be provided to the client in a "print-equivalent" form (eg a PDF file) and submitted as an attachment with an online return; any transcription into the client's package would then be limited to the key totals.

4. *Mandatory Electronic filing*

We are concerned that the Bill provides (in clause 93) for regulations to be made to extend mandatory electronic filing to all taxes for which HMRC is responsible. Whilst it may be justifiable to require business to file returns electronically, we object to changes being made to extend this to personal taxation by regulations. There are still many taxpayers who do not have the ability to file electronically and to impose such requirements on them will inevitably mean that they incur unnecessary expense in having to instruct intermediaries to do so on their behalf. We strongly recommend that any extension of the mandatory filing requirements to other taxes should be a matter for debate in Parliament.

In the case of electronic returns, the taxpayer is dependent upon the HMRC IT system accepting the return when it is submitted. There have been occasions when the HMRC IT systems are unavailable. The Bill should be amended to ensure that the time limits will be relaxed when electronic returns cannot be submitted by reason of a failing of HMRC IT systems. Similar provisions apply in relation to payment by cheque. Regulations will allow payment by cheque to occur only when cleared funds have been received by HMRC so there is no advantage over electronic filing.

5. *The enquiry window*

Having voiced objections to changes in the date for filing paper returns, we feel we should conclude by applauding one of them, namely to incentivise early filing, where that is in fact possible (as indeed it will be in a good number of cases), by linking the 12-month enquiry window to the date of actual filing rather than to the deadline for filing.

May 2007

Examination of Witnesses

Witnesses: Mr Richard Stratton, Chair Tax Law Committee, Law Society of England and Wales, Mr Ashley Greenbank, Chair Corporation Tax Sub-Committee, Law Society of England and Wales, and Mr Alan Barr, Member Tax Law Committee, Law Society of Scotland, examined.

Q88 ***Chairman:*** Good afternoon. I recognise somebody who has been here before.
Mr Barr: But not "Professor". I have been promoted; my university will be very cross. I am a mere "Mr".

Q89 ***Chairman:*** You were not "Professor" last time?
Mr Barr: And I am not now.

Q90 ***Chairman:*** I was going to say to your two colleagues if they work as hard as you did they might get promoted!
Mr Barr: I take it that this Committee can award the chair.

Q91 ***Chairman:*** Anyway, professors or not, you are extremely welcome. We are very grateful to you for coming. I think in terms of parliamentary procedure, although Mr Greenbank probably does not know it, I am actually a client of his firm.
Mr Greenbank: Oh, dear.

Q92 ***Chairman:*** I think I ought to record that. One of his partners tries to keep me out of trouble as best he can. We have, as you know, had some written evidence and that is very helpful to us. We will ask you some questions, most of which I hope you have got but there may be supplementaries. I am always told to say to witnesses who come forward, and this applies to us as well, if one can speak up and speak relatively slowly we will get an accurate account of what you have to say, which is very valuable to us. We have got the written evidence so it is not always necessary to go into absolute detail if you have already submitted it in writing, nevertheless please give the answers you want to give. We have got three subjects which we are considering as a Committee: the business package, particularly in relation to simplification and so on; the second one is the powers of the Bill; the third is the managed service companies, and we have got some questions on that. Some of them you have included in your written evidence but, nevertheless, I wonder if we could start

first by taking the business package one and see whether you can help us there and then we will move on to another one. If I can start the ball rolling, so to speak. The Economic and Fiscal Strategy Report talked about simplification of the tax structure and I just wonder if you can tell us the way you think the business tax form package has delivered "simplification of the underlying tax structure" as is claimed in the report?

Mr Greenbank: We would say that it is difficult to say the changes are a simplification of the structure, whether you regard that as a motivation for the changes or as a result of them. If you just look at the capital allowances provisions and the allowances for capital expenditure generally, when you start counting up you will end up with more regimes at the end of the process than you had at the start. I can run through them but inevitably, as a result of having more regimes, you will have more boundaries between regimes and that is where complexity comes into the system. The same thing really applies to rates. We have the changes to the small companies' rate and the corporation tax rate in this Bill but then you exclude the ring-fenced profits, the oil profits, from those changes, which again creates another boundary which you have to police effectively because those are where the distortions in the system come in.

Mr Barr: We would go further. We think any claims to simplification that there have been over the last few years, perhaps particularly in relation to the business package, is a joke. It is not simplified at all. If you include in the assessment of the process the changes and very swift changes back, the hokey cokey effect, "We will take the tax rates down and then we will put the tax rates up again" for businesses—

Q93 ***Chairman:*** For instance, like the corporation tax for small companies.

Mr Barr: Small companies in particular, yes. We are moving to a situation where—I have not assessed it—the difference between the small companies' corporation tax rate and the mainstream corporation tax rate will be only 6 per cent after the implementation of the rate changes. Perhaps we are heading—we do not know—for a unification of those and, therefore, the abolition, and that would be a simplification, but particularly small differentials make for greater complication and there is a good deal more scope for marginal difficulties.

Q94 ***Lord Powell of Bayswater:*** I deduce that you are a bit sceptical about simplification in this tax package, being a perceptive sort of fellow. Are you equally sceptical about the reduction of the administrative burdens which stem from the package?

Mr Greenbank: There has been some progress in the reduction of administrative burdens. It is quoted in the Red Book. Look to the changes made to Form 42, which was the form that you had to fill in when you provided share incentives to employees. That was a huge administratively burdensome form when it started off and the Revenue listened to business on that, the form has come down in size and it is more manageable than it was, but it is still true in administrative terms that there is a tendency to ask businesses for a lot of unnecessary information in these forms. SDLT was an example of that when it first started out and Form 42 was a classic example. Even with the changes to Form 42 we have guidance notes which last for 52 pages to fill in one form. As regards the rest of the administrative package, I think we would say the jury is still out. There is a big process to go through if you look at the delivery plan in the current year and we will have to see where we end up at the end of that process. We are particularly interested in advance rulings and the extension of clearance procedures which could deliver an awful lot more certainty for business 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. We look forward to that bit of the package. The package also contains a lot of assurances about guidance and consultation. We will just have to see if any progress is made in relation to guidance. I think we would say that our experience of consultation recently has been pretty mixed. There have been some good bits of consultation but broadly it has been not that good. I think in particular, although it is not on business tax, of the trust changes last year. There was little or no consultation followed by a massive scrambling around at the end of the process to get it all back together again. The same thing happened with the capital losses rules where new rules were announced without proper consultation to start with and then there was a massive scrambling around to get things back together.

Mr Barr: On electronic filing and various things, which I think will occur later in our agenda, obviously there is enormous scope for reducing the administrative burden. Continuing the example that Ashley gave of SDLT, electronic filing of SDLT is now available. When it works, it works wonderfully well and cuts down the administrative burdens but the trouble we have found among Scottish solicitors is they have not yet enough faith in the integrity of the electronics to use it to the extent that would bring the

greatest benefits. That is both an opportunity and a problem in the increased use of electronic means of communication and particularly filing with Her Majesty's Revenue and Customs. It is something that we will return to.

Q95 ***Lord Blackwell:*** If you go back to the 2006 Review of Links with Large Business, that talked about delivering a modern, responsive tax administration. Listening to what you are saying, to what extent, therefore, do you think the delivery plan published on Budget Day will achieve that? If it will not, what are the missing bits that you think a Budget should include, or you would like a Budget to include, to live up to that promise?
Mr Greenbank: To some extent we have partly answered that question. The package contains four things really. One is the advance ruling and clearance systems, the procedures that we have talked about. If those can be extended and give greater certainty to business in terms of the tax treatment under particular legislation that will be an enormous help. We have talked about guidance and I think the jury is out on that a bit. I suppose what we ought to say in the context of guidance is that there is a tendency in recent legislation to draft wide legislation which captures an awful lot of taxpayers and then to cut it back through guidance. That leaves tax payers reliant all the time on Revenue interpretations, and actually tax payers' interpretation of their guidance, rather than the law. As a Law Society we think that is not a correct approach to be taking. It does not give people certainty in relation to their treatment and I think produces the risk of greater disparity between taxpayers in similar situations because they are reliant upon Revenue inspectors either enforcing the guidance or being a bit more relaxed about the guidance in order to get to an acceptable tax treatment. Rather than relying on guidance, I think we would say that we would prefer to see detailed, properly thought out legislation in the first place.
Mr Stratton: Yes. If you look at the point that we have been making about welcoming a new clearance system, that is actually a function of the rest of the process and where it now is. You have wide legislation cut down by guidance, a taxpayer has difficulty relying on the guidance in many cases and you are then forced to apply for a ruling to obtain the certainty that you need. We welcome the ruling system because it gives certainty, but that is a function of what is happening in the background that leads to that process.
Mr Barr: There is also the possibility of de-skilling HMRC in relation to the guidance. When you ask for guidance directly from HMRC there tends to be just reference to the published guidance, but the whole point of asking is that the answer is not given in the published guidance and the people you are speaking to do not have the expertise to take it further. If there is more of a move to both electronically and paper published guidance and less skills among the people who have to answer the questions, I can see that as a growing problem.

Q96 ***Lord Vallance of Tummell:*** BNO2 states that the package is designed to achieve three main objectives. The first one I think you have already answered, and that is to enhance the international competitiveness of UK-based business, although you may want to add to that. The second is to encourage growth through investment and innovation. Do you think the package does that?
Mr Greenbank: I will just add a point on international competitiveness. Although it is perhaps disproportionate, I do think the reduction of the headline rate is important in that a lot of international businesses will latch on to that when they are looking at the attractiveness of a tax system. It probably has a disproportionate benefit because they do not look at what the other constituent elements of the tax base are in as much detail as they ought to. I think reduction in the rate is quite important, particularly when you look at the way in which the UK's rate has actually become quite a high rate when compared with the rest of our competitors, shall I say, in Europe. When the 30 per cent rate came in that was significantly towards the bottom end of the range of mainstream tax rates across Europe but now we are definitely in the top quarter with the 30 per cent rate against other EU Member States. As regards your other question which was about investment and innovation, I am not sure that we are the best people to answer that question as lawyers. Clearly the capital allowance changes will very broadly, I would have thought, discourage capital investment in that they largely reduce the rates available to businesses and the R&D credits will promote innovation, I suppose you would say, in the form of increased credits. What it does overall is disadvantage capital intensive businesses and, combined with the rate changes, improve the prospects of non-capital intensive businesses, I suppose like ours, service businesses. That is the overall effect I would have thought.

Q97 ***Lord Vallance of Tummell:*** Our primary concern is on the administrative burden side of simplification rather than rates.
Mr Greenbank: I am not sure how an administrative burden affects innovation.
Chairman: I think you have answered it pretty well, I do not think we need to press you any further on that.

Q98 ***Lord Sheldon:*** How will simplification and administrative change bring about fairness across the tax system?

Mr Greenbank: I think we struggle with the fairness concept, to be honest, because we are not really that sure what comparators you take to describe what fairness is, other than being taxed in accordance with the law. There is a justification in the Red Book for the corporation tax rate changes, for example, that it has eroded the balance between providing low rates of corporation tax and encouraging business investment and they needed to balance the two up. It just depends what sort of comparators you are taking. If you are taking, as the Red Book does, a comparison between having a company and, because of the context of other subjects you are going to be talking about later, which is managed service companies and people using small companies to obtain what is otherwise employment income, then you can see that balancing the rates up to 22 per cent is a sensible thing to do. But when you are talking about a small company doing its normal business and not in the context of a managed service company then encouraging a small business by having a lower rate of corporation tax is possibly a justifiable objective.

Q99 ***Chairman:*** Is not the way the argument has traditionally been put been slightly different and that is this? People have said through the years that our system is very complicated because our system is very fair and that all sorts of complications in the tax system were there to stop somebody getting away with something they should not get away with. Therefore, if you now make it simple (the complications being to make it fair), the question has to be asked that if you are making it simple are you tending to make it less fair than it would otherwise be because there will be a broad level of tax that the Government will go on doing and will not make exceptions for people who are in this situation? I think that is the question we have to wrestle with.
Mr Barr: I think we have to accept that absolute fairness and absolute simplicity are mutually incompatible. I think you are absolutely right that some of the complexities have developed, but only some, out of an attempt to make it fairer in the sense of bringing in the taxpayers and the amount of tax that was intended. I do not think the necessary increase in fairness has to be entirely at the expense of simplification. In other words, I think it can be brought together but 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.

Q100 ***Lord Barnett:*** I am not clear whether you really want to see or expect to see simplification because if you got it properly you would be out of business, I assume. As the Chairman said, the tax system has got more and more complex in response to the demands for encouragement or incentives on companies buying more and more plant in order to get greater investment, greater productivity and so on, so can you really expect to see simplification in the true sense of the word without doing away with virtually the whole of the capital allowance system, for example?
Mr Greenbank: I think we can expect to see some simplification. We have various different regimes of capital allowances which operate on different principles with different funny rules here and there for particular sorts of assets, and if you had the same basic system for all the different sorts of assets and just applied perhaps different rates to particular types of asset then you would have a simpler system instead of having all these different rates and all these different regimes. Equally if we branched off into other areas like the loan relationship rules, which are hideously complex as they currently stand, whereas a system which was more a simple accruals system would be more easily understandable and more easily operable than the current system. 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.

Q101 ***Lord Barnett:*** I do not know whether a firm like Macfarlanes, being the size you are, has many small company clients or whether the Law Society have members who handle small companies. Perhaps you could tell us.
Mr Barr: My own firm, Brodies in Edinburgh, has many small company clients, certainly, and certainly the definition of "small company" affects all of us.
Mr Greenbank: All of us have a few, yes.

Q102 ***Lord Barnett:*** Perhaps we had better have a definition of "small".
Mr Barr: Indeed.

Q103 ***Chairman:*** I can confirm as a client of Macfarlanes that they handle small impoverished peers with great expertise.
Mr Greenbank: We do.

Q104 ***Chairman:*** Let us move on to the managed service company. I wonder if I could start by asking a question which I think goes right to the heart of some of our worries and that is this. The Revenue have, quite rightly, pointed out the very sharp increase in the number of incorporations that have taken place and they argue that this is the result of the workers reverting to offering their services through personal service companies, but the underlying relationship between the end client and the worker is

still that of an employer and employee relationship and so these issues were extremely difficult to work out and the IR35 and all of that. Are they not going to have exactly the same problem of dealing with managed service companies if they are going to treat them fairly and yet they claim it was resource implications that drove them in this direction with the Inland Revenue? I just wondered if you had a comment on that.
Mr Stratton: Your point is correct. Yes, there has been a rise in the number of incorporations. The thinking is that that rise is because of the managed service company regime making managed service companies unattractive or of no benefit; hence workers, because of other circumstances, may then start forming their own personal service companies to provide their services to third parties. That then puts the Revenue in exactly the position that they describe in their consultation paper, that to apply the IR35 regime to those personal service companies you have to analyse each contract between the company and the end client, determine whether it is employment and apply the rules accordingly. The effect is that the MSC regime is cut back and the advantages are eliminated but it looks like there is then a rise in personal service companies chasing people back into IR35. The question then is, will they be applying IR35 and accounting for the tax, as they should do, on those companies? It is a very difficult question to answer. The effect of the publicity attached to managed service companies and the previous publicity attached to IR35 and the message that HMRC have put out by the steps they have taken may well have that effect.

Q105 ***Lord Powell of Bayswater:*** I was going to ask whether you think MSC providers are going to find a way round this one. Are they going to succeed? Are you going to help them?
Mr Stratton: The legislation is framed by reference to a series of components. If you satisfy those components you fall within the legislation. One of the components that is missing is an employer relationship between the individual and the end client. There are other areas where people who promote MSCs may start looking to see if they can fall outside the regime. There are some fairly obvious areas. There are maybe other more sophisticated ones but the Revenue have in the last two or three weeks put a notice on their website about the accountancy services exemption (which is in the legislation; you are not an MSC provider if you provide accountancy services) saying, "Do not think that covers anything other than genuine accountancy advice", so it indicates that immediately people are looking for the gaps in the legislation. I suppose inevitably, yes, the effect of the legislation is that you move from one battlefield to another if you are in this arena and you will be looking at different cracks and crevices in it.

Q106 ***Lord Powell of Bayswater:*** So we may be looking at this again next year?
Mr Stratton: It is possible, yes. It is designed, I think, to target a particular structure, a particular arrangement with companies with single employees in them or companies with a number of employees or workers contracted with them with shares reflecting those workers' efforts managed by a separate entity. It is designed with a sort of two-entity concept behind it and it may be that people come up with other ideas that may be different, so that is possible, yes.

Q107 ***Lord Blackwell:*** This is obviously a very complicated area to get right in the detail. How well did HMRC consult on this and take views and try and work their way through it? Do you get the impression that they are trying to find a solution that will allow genuine participants to operate or is it really a blunt approach to eliminate it altogether?
Mr Stratton: You have to start with the position that this is anti-avoidance legislation and HMRC have consulted upon it, which we welcome. From our perspective I would say that is an extremely helpful step. That is not always done and is in fact more often not done than done. I thought the paper that HMRC put out to describe the sort of thing they were after and the difficulties that they encountered was a thoughtful paper. They were also aware in that paper of the rather complex employment law background which exists in this area as well, which you have to face when you add the tax to the employment regulations, so I thought the paper was quite well considered. They also reacted to comments made about the structure of the legislation and have made some changes, so the Law Society said, "Can you have another component in the definition of managed service company?", because when the first paper came out there were an enormous number of entities that were just all straight within the definition and they would then have to work out whether they were caught and go through all the steps to work out the tax liability, but they put in an extra component to basically act as a further sift. I think it will still catch some entities which are genuine business service providers. They have a power to exclude other entities from it but in general, yes, they have tried to react to the comments made on it.

Q108 ***Lord Blackwell:*** Against your earlier criteria that what one wanted was in a sense less a simple tax system as one that gave certainty, how far has this achieved certainty?
Mr Stratton: There are a number of areas in it where there is not that much certainty, I suppose it is fair to comment. When you get a feel for the legislation you

have a reasonably good idea what it is after, the sort of target it is going for in terms of a structure, so to that extent there is a certainty there. There are uncertainties as to who becomes liable for tax if the tax is not paid by the entity. There are uncertainties in some other areas of the legislation dealing with things like associates and the type of vehicle attacked in my view. In answer to your question, how far has it created certainty, it creates another level of uncertainty in one sense. This reflects one of the other questions. 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. One of the main points that is raised on the MSC legislation is that if somebody is not paying PAYE can we attach that liability to somebody else? Obviously, for tax it is a fundamental concept that it is only the person who makes the profit or is obliged to make the deduction who is normally liable. You do not normally visit liabilities on third parties. You could change IR35 and take it and put some of the third party obligation rules from the MSC legislation into IR35 and achieve a similar effect but the down side of that is that that would then affect everybody who is within IR35, and in a way it is better to have a separate regime which targets the culpable and isolates them for special treatment than is an across-the-board worry for people who are properly operating IR35. This may be another instance where we have a degree of extra complication to isolate those who are behaving properly and try and target those who are not but with uncertainty and complication in the process as the normal additional by-product.

Q109 ***Lord Vallance of Tummel:*** A lot depends on how robust is the definition of an MSC, and you have touched on that, and specifically is it robust enough to distinguish absolutely clearly between an MSC and a personal service company?
Mr Stratton: It probably does distinguish between an MSC and a simple personal service company, a man who owns his own company, owns all the shares in it, which provides his services to third parties, the distinguishing feature being that there is no MSC provider in such a case. The definition is based upon there being two components, the MSC, an entity which provides the services and an individual passes the greater part of the amounts received through to that individual, and the passing through of those sums produces a lower tax take than had those sums been subject to PAYE. Those are the components of the MSC. That would cover a personal service company as well but you then have the extra component of there being another person, an MSC provider, who is in the business of providing the services of individuals, so that extra component, that extra entity, does not exist with the simple personal service company structure. That is the basic distinction.

Q110 ***Lord Vallance of Tummel:*** So there is no leakage between the two then?
Mr Stratton: Well, I would not go that far.

Q111 ***Lord Sheldon:*** Are you satisfied that the many comments on the draft legislation have been taken into account?
Mr Stratton: A number of the comments have been. I think there are some other comments to be made that have not yet been taken into account, some comments that have been communicated to HMRC. The ones that spring to mind are that there was a desire for greater clarity on the legal and accountancy services exemption and how that would operate as an exclusion from the regime. There was also and remains a desire for greater clarity on the circumstances in which a client, the recipient of the services from the MSC, can be asked to account for PAYE and national insurance if the MSC fails to pay it or the MSC provider fails to pay it. That is not dealt with in the legislation in any detail and probably should be.

Q112 ***Lord Sheldon:*** In the written evidence we have got here from the Law Society of England and Wales it says that there is a difficulty in practice collecting PAYE and national insurance contributions from MSCs and so a new regime is required. I take it you all agree with that proposition.
Mr Stratton: I am sorry; I was trying to reflect HMRC's view of the current position. That is what they say in their paper.

Q113 ***Lord Sheldon:*** This is the Law Society.
Mr Stratton: Yes. I was trying to reflect their reasoning in that paper, to get to the reasoning behind MSCs as an introduction. Our starting position 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.
Mr Barr: I think it is also fair to say, reverting to an earlier theme, that enforcement of IR35 has been patchy and remains patchy in the sense that some people have virtually the same kind of relationship with what would be deemed an employer but find themselves brought within the IR35 regime, whereas others who would seem to be in the same relationship do not. We have not observed any particular logic as to who is brought into this and who is not. It seems to be the extent to which their company is looked at.

With regard to whether they thought that by MSCs covering a larger number of individuals or human beings they might get more of the MSCs than through technically increasing IR35 compliance, it strikes me that that may well be a factor.

Q114 ***Lord Barnett:*** One of the reasons we have been given for the growth of MSCs is the need for greater flexibility which has been encouraged by government. Will that continue despite the legislation, in other words, will the growth of MSCs continue?
Mr Stratton: I do not think the growth of MSCs in the terms of this tax definition in the Finance Bill will continue, no. I think their tax advantages are eliminated by this legislation. You do, however, need employment businesses. 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 flexibly in the market place, but the actual tax advantage of an MSC is removed by this legislation, so I cannot see the MSC as described in the consultation paper and as covered by this legislation continuing to be a viable proposition.

Q115 ***Chairman:*** This Committee does not get itself involved in discussing rates of tax, but if you listen to all this, the whole business of IR35s and so on, it is because it does not matter what the actual rates are; it is the difference in tax between one system and another. I just wonder whether you have a view as to, if you look to yourself, —and I can perfectly understand the Revenue not wanting that to continue—have they set about it in the right way? Would not the better solution be to make sure there was not the tax differential between one system and another? Would that not have been an easier way of getting at the same solution?
Mr Barr: The short answer would be yes, given that it involves, of course, not just tax rates but also the whole national insurance structure and its links with the tax system, and given that the rates that are being avoided, if that is what is happening with IR35 companies and MSCs, are probably to a greater extent than tax derived from the national insurance situation, it would have to involve a complete look at that and either merging it entirely with the tax system or reforming it root and branch so that there was not this difference between employment NICs and other NICs.

Q116 ***Chairman:*** Then we really would be able to talk about tax simplification.
Mr Barr: Then we really would, yes.

Q117 ***Chairman:*** We are most grateful to you for those answers which have been very helpful to us and now we move on to the third and last section, which is to do with investigation, review of powers, deterrents and safeguards and things of that sort. May I just kick off by asking you how well you think the consultative process in this area has worked so far and how well you think it is continuing to progress.
Mr Stratton: We feel it has been going quite well, actually, for a consultation process. HMRC have been very keen on having workshops where they invite professionals in to discuss the types of issue and examples of possible scenarios involving penalties. They have kept up with us continuously in relation to powers discussions, so they respond rapidly and they talk to people as they are developing their thoughts, so it is very much an iterative type of process. They have responded to various representations we have made, so on the criminal side they have met criminal law practitioners and discussed aspects with them and informed them of progress. I think it has been a well-run consultation process. It is a very big consultation process, inevitably, divided into various parts, which makes it difficult to keep up with sometimes but it has been well run.

Q118 ***Lord Powell of Bayswater:*** Do you have a view on the new criminal investigation powers and safeguards, in particular the extension of the Police and Criminal Evidence Act?
Mr Stratton: Yes. I am a civil lawyer rather than practising in that area, and I am England and Wales.

Q119 ***Lord Powell of Bayswater:*** You did not run quite as hard from that question as the accountants did.
Mr Stratton: Thank you. I will run a little further shortly. We have two answers, one for England and Wales and one for Scotland. I will start with England and Wales. We have a powers sub-group and we have a mixture of people on that. I am on that and we consider the criminal powers extension. Basically, I think that where it is, as it appears in the Bill, is about in the right place. We have got a couple of minor comments on it, nothing particularly major. Because we have got PACE in England and Wales the simple starting point was that tax crime is no different from other crime. Therefore you just apply PACE. As we went through the consultation process it was quite interesting that it was not quite that simple at all for various reasons, but that is where we have ended up, which I think is ultimately the right position to be in.

Q120 ***Lord Powell of Bayswater:*** And Scotland?
Mr Barr: I have to choose my phrase carefully. 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, but, by definition we are dealing with the criminal system and particularly criminal procedure, which is a devolved matter. The Finance Bill contains substantial amendments to Scottish criminal procedure, bringing it into line essentially with the position in England and Wales under PACE where appropriate. Again, I do not practise in this area at all myself but I fear that that 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. I am not saying that it has been done badly. I just do not think it has been done at all, in particular the interaction of police powers and those of the Procurator Fiscal and the Crown Office, in other words, that already separate level at the prosecution point I do not think has been tackled. I fully confess that I may be wrong about this. It has not come through the Law Society of Scotland Tax Committee or been dealt with by the Law Society of Scotland Tax Committee perhaps to the extent that it should have been. I suspect that it is a small proportion of UK tax and UK tax criminals, so that is maybe understandable, but it is interesting that the point coming from England and Wales is that tax crime is just another form of crime. Well, if that is the case, that has not been the approach in Scotland where Scottish tax crime is just another form of tax crime and the tax crime regime, including investigations and offences and powers of arrest and that kind of thing, is all based entirely on the England and Wales precedent.

Q121 ***Lord Blackwell:*** Can I move on to penalties? I think we can assume that the penalties are there primarily to encourage appropriate behaviour and discourage inappropriate behaviour rather than to raise revenue. As I understand it, we have now got these three categories of behaviour—careless, deliberate but not concealed and deliberate and concealed. To what extent do you think those categorisations in the whole schedule of penalties are going to allow people to understand what is appropriate and inappropriate behaviour and, given the certainty of that, when they might be subject to penalties?
Mr Stratton: 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. That is deliberate because of the fact that were this to go to court if there was an appeal you then develop case law of those concepts. Also, as has been reflected in other things we have been discussing today, categorising behaviour and examples of behaviour will come through in guidance as to how HMRC are intending to operate those categories. There has been quite a lot of discussion over the concept of what is careless and what is deliberate and the border between careless and deliberate. Deliberate concealment is a category all of its own that is not really a concern to ordinary taxpayers. The one that is of concern is carelessness. When you look at carelessness there are various difficult issues that arise because it is a partially objective and partially subjective type of test. If we three, each of us, fill in a tax return and get it wrong we are likely to be careless because we should know better, if you see what I mean, because we are professionals, whereas if the man in the street does it and gets it wrong but has a reasonable stab at it he may well not be careless at all. That reflects the regime which I think is a good regime. It is a good place to go for a penalty regime when compared with the complex regimes before and it is good to replace direct tax and indirect tax with one regime. So far so good. There is quite a reliance on guidance and the guidance is yet to be finalised. It has had one draft and comments have been made and that is being developed.

Q122 ***Chairman:*** Are we meant to be happy that Parliament is asked to pass legislation when the guidance they are going to get has not yet been produced and in any case they will rely on judges to interpret when they get it? Is that not a cause for concern?
Mr Stratton: 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 for the taxpayer if he is in a court room. All you can look at are the words of the legislation. When passing the legislation the question for Parliament is, is Parliament happy with a very simple definition of what is or is not proper behaviour? The problem you encounter as soon as you face that is that it is very difficult to phrase a complex definition or give anybody any more comfort than "careless". All you can say is "not a standard that somebody would ordinarily follow in their affairs". You end up with something like that which is then practically "careless" again. It is a very difficult problem to solve.

Q123 ***Lord Blackwell:*** May I come back to this very important point that a low transaction cost tax system is one where people can understand how much tax they are going to pay and that if they fill in their forms and send off the information they can

sleep easily in their beds, and that a high transaction cost tax system is one where it is fairly uncertain and they may have to engage in lots of activity to try and protect themselves from come-backs? It may be better than what it was but it may be one where there is still potential for a lot of uncertainty, particularly if we are going to have to wait for judgments to come before people can really understand whether they have done the right thing or not.

Mr Stratton: 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 different overlapping provisions that people could fall foul of. They are expected to work out their tax return on the basis of those provisions and file it. The concept of what is not careless against that background is a very difficult concept, how you reach a satisfactory position against that. The way clarity or satisfaction for the taxpayer may be reached is through another part of the system, another part of the consultation in powers dealing with the administration of taxes and the means whereby a taxpayer can get comfortable when putting forward a return, what information to put on the return to indicate how he has done something which then renders him comfortable with the result because he has made full disclosure so a penalty would be inappropriate at that point because he has said his position. He has informed HMRC so if they choose to tax him on the basis of what he has said he cannot then be careless. A taxpayer is left looking for protections like that, which go to areas that have not yet quite been dealt with. Thought has been devoted to them but they are not yet there.

Q124 ***Lord Vallance of Tummel:*** Can I ask supplementary on this one which is specific, and that is whether you are content with Part 4 of Schedule 24 which sets out the circumstances in which a person may be charged with a penalty as a result of an action, which might be a careless one, by someone acting on their behalf?

Mr Stratton: 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. The point then becomes that you have picked the agent, so you then can be responsible for the actions of the agent. When the first draft of the provisions came out the principal was simply "liable for the agent", so if my accountant puts in a return for me at that point I was simply liable if the return had the wrong thing on it and it was a careless error. Where it has got to at the moment is that in the case of failure to take reasonable care the principal can demonstrate that if he is not careless then there is no penalty that can be exacted 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", depending on your particular standard of knowledge, so it would not be for me but it would be for most other people. I do not think I know the response of HMRC to that, but HMRC know where professional bodies stand on that point.

Q125 ***Lord Vallance of Tummel:*** Are you suggesting they are not going to do anything about it, because it sounds fairly fundamental?

Mr Stratton: I am pretty sure that the position of HMRC is what is written in that paragraph in the schedule, paragraph 18 on agents, which is that you are liable for the acts of your agent in a situation where there is carelessness but if you are a principal you are not liable for a penalty if you can prove that you are not careless. The burden of proof switches to the principal.

Q126 ***Lord Sheldon:*** Moving to on-line filing, what are your views on the implementation of the recommendations of Lord Carter on on-line filing?

Mr Stratton: We put some comments on this in our written representations. Our thoughts devolve into two parts on this. One is systems and the other is legislation. As regards systems, it is vitally important that the taxpayer is confident in the systems and that the systems are in effect free, so that if a taxpayer has to file on-line and has to use HMRC software and forms to do so, all pages and all information should be available on-line to him. He should not have to go off and buy an accountancy package for a taxpayer with simple affairs. He should be able to attach documents when sending things in so the system should be versatile enough to deal with a taxpayer's individual circumstances. I think there is quite a way to go here. I do not deal with this directly but there is not huge confidence in HMRC systems at the moment and I think there needs to be in security and how flexible they are at transparency in those systems' availability to members of the public filing. Our second concern was that a lot of this is in regulation by statutory instrument subject to negative resolution, and basically requirements to pay electronically and requirements to file electronically across taxes are not by statutory instrument. Our feeling about this is that it is fine for businesses in many ways. They are likely to have the sophistication to be able to cope with electronic filing but we do not think the public at large should be faced with that until the matter has been reconsidered

by Parliament and Parliament decides whether everything is up to scratch at that point.
Mr Barr: We considered this in the Scottish committee on this and I think we are probably more emphatically opposed to any move towards mandatory electronic filing at any level and fail to see why this is necessary. A robust system is to be encouraged for all the administrative reasons we talked of earlier but to make this mandatory seems fundamentally wrong and although we agree that there is a difference between businesses and individuals in this, there are many small businesses, in some of the areas where this is going to happen more quickly, like PAYE matters, with one or two employees. To demand that this is done electronically when we are by no means yet a completely electronic society, where broadband coverage, to bring a Scottish point, is weaker in some parts of the country than in others seems to me, to put it mildly, an outrageous demand for the state to make, that everything should be done electronically because that happens to suit the tax collector if they can get their systems working properly.

Q127 ***Lord Sheldon:*** I know some people who would simply not wish to do these things electronically because they have not got the knowledge of it and there could be so many dangers here. It is obviously going to need quite an extensive period of time to get people understanding how to operate these things.
Mr Barr: Certainly before it becomes mandatory. There is the well-publicised situation of doctors' sexual preferences this week, the example of how supposedly secure computer systems tend not to be so secure at the end of the day.

Q128 ***Lord Barnett:*** I want to turn to the issue of compliant or innocent taxpayers as compared to non-compliant. Can I follow on the point put to you by Lord Vallance about if an innocent or compliant taxpayer is found to be guilty of something because of what his account or lawyer has done? Have you all increased your insurance cover?
Mr Stratton: That is a very good point. I will take that away with me.
Mr Greenbank: There is a limit to the amount of insurance you can buy.
Mr Stratton: Yes, we are probably at the limit already. It is worse for partners in partnerships, incidentally. The agency position is better than the partnership position. If you are a partner in a partnership and another partner is negligent you are automatically deemed to be negligent at that point. On the agency position, there is some protection in the statute. Whether that is sufficient is another matter. It has been the subject of wide debate and I think there is a difference between the way the professions see this and the way HMRC see it. If you look at it from HMRC's perspective they have a difficulty at the other end of the telescope because if a careless or negligent return comes in to them they will not necessarily know who has made the mistake on the return. If the agent says, "Oops, I made a mistake", and the principal says, "I appointed an agent", they say that is not fair on other taxpayers because the majority of taxpayers get their returns right, so that is their argument. I suppose as a professional my response to that is that in principle if you do go to a behaviour system and you are not careless then you should not be visited with a penalty. It does not encourage compliance overall. That is the point.

Q129 ***Lord Barnett:*** Could I pursue this whole question of a compliant or innocent taxpayer, like everybody in this room, for example, where they are supposed to take reasonable steps to notify HMRC within 30 days of being under-assessed? Speaking for myself, if I am under-assessed to tax, and I am perfectly content with that and my accountant or lawyer is perfectly content—within 30 days? Are you happy with that idea?
Mr Stratton: That provision, it turns out, is for special circumstances which a lot of us did not recognise at the time. That is meant for an assessment which does not follow a return. If you look at all of us in this room, we file a tax return. Whether we get a penalty or not depends on that return because it is self-assessment so you self-assess yourself in putting in the return. The paragraph that you are referring to, which is paragraph 2 about under-assessments, when I first read that I thought exactly what you thought. I never check my assessment at all. I am just in a state of delirium if I get the return in on time.

Q130 ***Lord Barnett:*** Speaking for myself, I rely on you or on my own firm of accountants to look after my affairs.
Mr Stratton: Exactly, we all do. It is a victory to get the return in. You do not check the assessment. That paragraph is for people who have not put returns in, who have not declared profits to HMRC. HMRC estimate the profits, send them an estimated return. If you get an estimated return and it is an under-assessment then that provision applies, so it is for that particular circumstance. The wording of the paragraph indicates that at the start but it is hard to pick up.

Q131 ***Lord Barnett:*** But are you content with it?
Mr Stratton: In those circumstances, yes, I am content with it.

Q132 ***Lord Barnett:*** Even for a perfectly innocent and compliant taxpayer client of yours?

Mr Stratton: If he is compliant he should not end up in that situation, is the answer to that question.

Q133 ***Lord Barnett:*** You mean you would not allow him to end up in that situation?
Mr Stratton: No, I would not.
Mr Barr: They have already had a failure before it has got to that stage because they should have notified their liability and then have a return completed as a result of that notification.

Q134 ***Lord Barnett:*** There is this whole idea of a suspended penalty under paragraph 14, Schedule 24. Are you happy with that?
Mr Stratton: We thought it was quite useful as a mechanism. It is used in specific circumstances and basically may arise in a circumstance where a small business which has not got systems in place would incur a penalty for carelessness and HMRC say to it, "Get your systems in place. Get a decent accounting package in within 18 months. Do this and you will not have a penalty to pay", so we thought that was a step forward and useful. I suppose where we had concerns was in the appeals regime on things like suspended penalties and others where there is a restricted appeals regime from the imposition of penalties and we think a tribunal should have a full discretion to reconsider the penalties imposed.

Q135 ***Chairman:*** We are coming to the end and we are very grateful to you. Can I just ask a question which, if you pressed me, I would say I do not understand properly? Do you have a view on the use of the word "think" in the drafting of the legislation? Is that commonly used in modern drafting?
Mr Stratton: No, it is not. We did not like it at all. In fact, a member of my committee said to me that for the last 20 years he had been told not to use the word "think" and, lo and behold, it turns up in some legislation he is reading for clients. The difficulty with the word, and this is an administrative law issue, is, can you review an authority if it only has to think about something before it reaches a decision? You may be able to do so but we were just uncomfortable with that. We thought that it was much better either not to use the word at all and just have conditions apply before circumstances arose, or use "consider" instead. There is one clause in Schedule 4 which starts, "If HMRC think it right . . . ", to which I thought was very difficult for a court to come along and say, "We cannot see how you could have thought this right". It is a very big uphill struggle for a taxpayer to challenge that, so we have opposed the use of the word "think".
Mr Barr: We would as well. Also, the concept of HMRC as an institution thinking was a slightly disturbing and worrying one. It is very hard for a court considering in either direction who in HMRC has done this thinking, so I do not think we would approve of the word "think".
Chairman: Thank you very much. I do not think I know, but the Committee is very grateful to all of you for coming along and for being so helpful to us and enlightening us on some of the areas to which you have given a lot of thought. That is of great benefit to us so thank you very much indeed.

WEDNESDAY 9 May 2007

Present	Barnett, L	Vallance of Tummel, L
	Blackwell, L	Wakeham, L (Chairman)
	Sheldon, L	

Memorandum by the Chartered Institute of Taxation

The Chartered Institute of Taxation welcomes the opportunity to submit evidence on the current Finance Bill to the Sub-Committee. We note that the Sub-Committee has highlighted three particular areas for consideration.

Our key comments on each of these areas are set out below. In each case there is an Appendix with further detail. We can supply any additional details on these issues that the Sub-Committee would find helpful.

The Institute's Low Incomes Tax Reform Group (LITRG), which aims to give a voice to the unrepresented taxpayer or tax credit claimant, has contributed to the sections on electronic filing and penalties. This reflects the Institute's concern that those aspects of the Bill could operate to the disadvantage of those on low incomes, or without access to professional advisers, if their interests are not fully taken into account in the implementation of those proposals.

A. Overall Comments

Consultation

1. We are pleased to note this year that HM Treasury (HMT) and HM Revenue and Customs (HMRC) have carried out more consultation with us and the other professional and representative bodies than in some previous years, and we are delighted that several of the items that we have been arguing for have borne fruit in this year's Finance Bill or are commitments for the future. We believe strongly that proper consultation well in advance of changes in the tax law leads to better-conceived, better-drafted and more workable legislation.

Simplicity

2. We are also pleased to note that there has been a small but welcome step in the direction of simplification in several areas. Many of the problems with the current tax system stem from its complexity, and moves towards its simplification should be generally well received.

B. The "Business Package" from the Point of View of Simplification (see Appendix 1)

3. Businesses are impacted upon by the announcement of a phased programme over a few years of:

- changes to income and corporation tax rates, including a reduction in the basic rate of income tax to 20 per cent, an increase in the small companies rate to 22 per cent and a reduction in the main corporation tax rate to 28 per cent, and
- changes to capital allowances (net reductions for most larger businesses).

Some of these changes appear in this year's Finance Bill, and the remaining proposals, as highlighted in the Budget, are expected in subsequent Finance Bills.

4. This programme will achieve some modest simplification of tax rules (fewer tax rates, fewer tax categories of capital expenditure and less difference between the effective tax burdens on incorporated and unincorporated businesses). In our view, simplification remains an overriding priority for our tax system.

5. As the package is broadly revenue neutral, there will be "winners" and "losers". The main corporation tax rate reduction does send an important signal about the competitiveness of the UK's tax system. But a particular concern is that taxpayers who have incurred capital expenditure on industrial and some other buildings will not get the relief they expected when the expenditure was incurred. Smaller businesses in the service sector may also be among the losers. Although the volume of consultation over tax changes is greater

than it has ever been, a more consistent commitment to consultation (at the end of which the Government decides on the course to be adopted) offers the best way of minimising problems of this type in the process of reform.

C. Managed Service Companies (MSCs) (see Appendix 2)

6. We understand the need for legislation of this type. In addition, we consider that, following extensive and welcome consultation, the overall approach adopted in the redrafted legislation included in the Finance Bill is much better and more targeted than the original proposals. However, we do still have a number of concerns, especially over the definition of terms.

7. The descriptive terms used must either be defined in the legislation or be obvious from their everyday meaning. The use of the word "influencing", for example, is likely to mean that many tax advisers and others who advise small businesses risk being caught by this clause. We know this is not the intention of the legislation, and that guidance will seek to reassure, but the courts will have no regard to guidance and will only Consult Hansard if the legislation is obscure.

8. We are also particularly concerned about the scope of the exclusion at 61B(3) for a person who provides "legal or accounting services in a professional capacity". This seems to exclude tax advisers and company secretarial services; it is also unclear whether it covers professional firms, in-house activities or both.

9. The debt transfer rules in new section 688A (and regulations yet to be published) are undoubtedly necessary, but are very wide in scope. There needs to be a "proportionate" approach here, linked to the person's involvement, and, in particular, we consider that the debt transfer legislation should be clear on the point that ordinary employees of an MSC provider are not persons from whom the recovery of a transferred debt can be made.

D. Powers, Deterrents and Safeguards (Including On-line Filing) (see Appendix 3)

Investigations

10. We are pleased to note that the proposed Criminal powers and functions will be conferred on an officer only with the authority of the Commissioners of HMRC. We have received assurances from HMRC that these powers and functions will be restricted to about 2,000 officers, who will be properly controlled and trained. We consider that it would be preferable to have such rules included in the legislation, rather than introduced by "administrative procedures".

Filing dates

11. We think that the legislation should include appropriate provisions for those who are unable to file returns electronically, and for the problems that arise where HMRC's systems are down, to ensure that the Carter principles are met.

12. There are technical errors in the draft legislation which we think need to be corrected.

Other administration

13. Our comments on these clauses include a mixture of technical points which we think need to be corrected, to ensure the legislation reads as intended, plus some general comments on the operation of the proposals, including concerns about the mandation of electronic payments. We think more needs to be done to ensure e-filing systems are robust and easily available before compulsion is used—and HMRC should move towards more use of e-mail with agents who are willing to e-file. But HMRC also need to have regard to the fact that there will always be a proportion of taxpayers, particularly among the unrepresented, for whom traditional filing methods will always be preferred.

Penalties for Errors on Tax Returns

14. We strongly object to the provision in Schedule 24 that penalties are due if an HMRC official "thinks that" the conditions for imposing a penalty exist. The use of the subjective "HMRC thinks" in the legislation is inappropriate in an area where there should be more objective tests for culpability. It is not sufficient to argue, as has been put to us, that HMRC have a duty to act reasonably so "HMRC thinks" will always be applied reasonably. Penalties should not be imposed on those who are not culpable, however reasonably an officer may have thought that they were culpable.

15. We welcome the fact that there are to be full rights of appeal. We would be in favour of the suggestion in the December consultation document, to form an informal resolution process, more accessible to all taxpayers than the formal appeals process.

APPENDIX 1

DETAILED COMMENTS ON THE "BUSINESS PACKAGE" FROM THE POINT OF VIEW OF SIMPLIFICATION

1. There are three "packages" of measures affecting business:
   (i) changes to the main corporation tax rate and to capital allowances;
   (ii) changes to rates and allowances bearing on small and medium-sized businesses; and
   (iii) changes to the rate structure of income tax, affecting unincorporated businesses (and of course non-business taxpayers).

Main corporation tax rate and capital allowances

2. The main changes are:
   (i) a reduction in the main rate from 30 per cent to 28 per cent from 2008–09 (Clause 2); and
   (ii) an increase in the rate of capital allowances on long life assets from 6 per cent to 10 per cent pa; to be balanced by
   (iii) a reduction of the main rate of capital allowances from 25 per cent to 20 per cent pa; and
   (iv) the phasing out of industrial buildings and certain other allowances ("IBAs") (Clause 35 is relevant to the transition to this).

3. The reduction in the headline rate will contribute to the UK's competitiveness and directly benefit corporate earnings.

4. The changes to capital allowances are intended to finance this, but will have less impact on reported corporate earnings because of deferred taxation provisions in corporate accounts.

5. As a result, taxable profits will be, in general, closer to accounting profits, and there will be fewer "tax categories" of business expenditure. But there will still be significant differences between accounting and tax; and some categories of expenditure (including, now, on industrial buildings) will not benefit from any tax relief against income.

6. As with most changes, there will be "winners" and "losers". In general, the "winners", such as banks, will have been bearing a disproportionate amount of the corporation tax burden in the past. The announcement of some of the changes in advance is welcome in affording businesses time to plan for them.

7. The withdrawal of IBAs raises particular issues. Taxpayers will have made capital investments on the basis of the old level of relief. The withdrawal, as a transitional measure, in the current Bill, of balancing charges and allowances (previously arising on disposals of industrial buildings), is unexpected and could create windfall gains and losses. It is not always possible to prevent results of this kind when tax changes are made. However, such adverse effects can be mitigated by proper consultation.

8. To some extent, the ideas behind this "package" derive from the process of Corporation Tax Reform, initiated by the Government several years ago, but largely abandoned because of a lack of consensus as to how to proceed. The CIOT broadly supported Corporation Tax Reform, which would have led to a simpler system, with lower compliance costs (and with less need for complex anti-avoidance legislation). We are pleased that

some elements of the thinking behind it now seem to be on the agenda again. In our view, though, it would have been preferable to proceed with a fully consultative process of reform (acknowledging that decisions would have had to be made which were not universally supported).

Changes affecting small and medium-sized businesses

9. The main changes here are the announcement of:

1. a phased increase in the small companies rate of tax from 19 per cent toward 22 per cent; and
2. consequential increases in the burden on medium-sized companies (on all of which Clause 3 takes the first steps for 2007–08); balanced by
3. a move toward a first year allowance of up to £50,000 for expenditure on plant and machinery by small businesses. (Clause 36 takes the first step here.)

10. The increase in the small companies rate needs to be seen in a wider context. An unincorporated business owner faces an effective top marginal rate of tax (including National Insurance) of 41 per cent. A top rate taxpayer who incorporates his business, and takes the post-tax profit out by way of dividend, will in future suffer an effective tax rate of $41\frac{1}{2}$ per cent. (On profits of 100, there will be corporation tax of 22, and higher rate income tax of $19\frac{1}{2}$ on the remaining profit paid out by way of dividend.)

11. This will be the closest alignment of effective tax rates on incorporated and unincorporated businesses for some years. Nevertheless, there are many different circumstances, and considerable differences will remain (particularly at levels of income below those at which top rates apply). On balance, incorporation is still likely to result in lower tax burdens for many (albeit with higher compliance costs).

12. The changes will lead to "winners" and "losers". The "losers" will tend to be those businesses which either distribute more of their profit, or reinvest, but not in "plant and machinery".

13. The advance notice of the changes is welcome, although consultation would have been preferable.

Changes to income tax rates

14. The main changes here are:

(i) reduction in the basic rate to 20 per cent; balanced by

(ii) removal of the 10 per cent rate band from non-savings income; and

(iii) increased National Insurance contributions for higher rate taxpayers.

15. These changes will affect unincorporated business owners (although the main burden of the third item will be borne by the employed population). These owners are also affected by capital allowances changes.

16. Our system of tax rates had become very complex (too complex, in the CIOT's view). The changes will remove one rate (22 per cent) from the income tax scene, and substantially reduce the impact of another (10 per cent). There will be greater alignment between tax and National Insurance.

17. There have been issues about the distributional and certain other effects of the changes. These issues are not specific to business taxpayers. In general, greater consultation is often a way of helping address such issues in advance.

APPENDIX 2

MANAGED SERVICE COMPANIES (MSCs)—CLAUSE 25 AND SCHEDULE 3

1. The CIOT would acknowledge that some MSCs are responsible for significant underpayments of Pay as You Earn (PAYE) and National Insurance Contributions (NICs), as a result of the failure to apply the Intermediaries legislation (IR35) properly. We further acknowledge that this is a serious issue that HMRC cannot ignore, and we understand that the enforcement of the proper application of IR35 by HMRC is difficult, due to the vast number of contracts involved and the requirement to test each contract individually. We also acknowledge that the collection of debts which are found to be due can be very difficult, and sometimes impossible, because of the lack of assets within each service company and the problems under current law of transferring the debts to either the worker or the provider of the arrangements.

2. We consider that the overall approach adapted in the redrafted legislation included in the Finance Bill, following detailed and welcome consultation, is much better and more targeted than the original proposals. However, we do still have a number of concerns.

3. It is essential that the legislation is both clear and well-targeted. The legislation must clearly define what an MSC is, and it must not be left to guidance, which cannot be relied on in the event of legal proceedings, to indicate those "arrangements" which HMRC do not intend to pursue. The definition of all descriptive terms must be either defined in the legislation or obvious from their natural and normal everyday meaning if uncertainties are to be prevented.

4. For instance, draft section 61B(1)(d) includes three key terms:

— "a person who carries on a business of 'promoting' . . . the use of companies to provide the services of individuals";

— "a person who carries on a businees of . . . 'facilitating' the use of companies to provide the services of individuals"; and

— "is involved with the company".

Only the third term ("involved with the company") is subsequently defined in the legislation. The first two terms bear their normal dictionary definition, but "promoting", in particular, has a wide meaning and may extend to encouraging the existence of personal service companies, or advertising them or working for such companies. HMRC have suggested that there is a difference between:

— someone being in the business of promoting MSCs, who is caught by the legislation; and

— someone promoting their own services, who is not caught;

but this distinction is not obvious from the current wording.

5. Further, draft section 61B(2) defines whether an MSC provider is "involved with the company" and includes:

— "(c) 'influences' or controls the way in which payments to the individual . . . are made," and

— "(d) 'influences' or controls the company's finances or any of its activities, . . .".

"Influences" is undefined and bears its normal dictionary meaning but, again, this is a word with a very wide meaning that encompasses the effect or power or sway of one person on another, and would appear to include the advice which is provided by many of those who provide services to small companies.

6. We understand, however, that it is intended to cover situations where an MSC provider determines what is to happen, and not instances where advice is merely given, where that advice can be ignored. It is not clear that the legislation limits "influences" in this way and thus, if a tax adviser gives advice on a better way to make a payment or undertake an activity, this will amount to influencing, especially if the advice is followed! Hence, we consider that the intended narrower interpretation of "influences" should be clearly defined in the legislation. Alternatively, an exclusion should be included whereby a person is not regarded as influencing a company merely because the directors act on advice given by that person.

7. Of significant concern is the exclusion at 61B(3) for a person who merely provides "legal or accounting services in a professional capacity". The exclusion provides that professionally qualified persons will not normally be an MSC provider. However, we understand that "in a professional capacity" is intended to apply only to professionally qualified and regulated accountants and lawyers.

8. There are thus two issues:

First, there are many highly experienced individuals who have never taken a formal exam and are not regulated by a professional body, who call themselves "accountants"; and

secondly, the definition does not encompass professionals who are not accountants or lawyers. Specifically, it does not include Chartered Tax Advisers and Taxation Technicians, who provide services in their professional capacity that will not be included within this exclusion. It also excludes unregulated tax advisers, such as former HMRC staff.

9. We consider that the exclusion should not be limited to members of regulated professional bodies, and that it should be defined to include all suitably qualified persons providing services in a professional capacity, whether or not they are regulated. We also consider that the exclusion should include tax services as well as legal and accountancy services. These comments apply equally to the exclusion included in draft section 688A(3).

10. As regards the MSC debt transfer rules, draft section 688A(2)(c) includes "a person who . . . has encouraged, facilitated or otherwise been actively involved in the provision . . . of the services of the individual". We understand that this could include "ordinary" employees of an MSC provider, even though it was not the intention of the legislation to target such persons. We consider that the legislation should be clear that these individuals are not persons from whom the recovery of a transferred debt can be made.

APPENDIX 3

POWERS, DETERRENTS AND SAFEGUARDS (INCLUDING ONLINE FILING)

Criminal Investigation powers—Clauses 81 to 86

1. We continue to question whether it is appropriate for HMRC to deal with the investigation of criminal activities, and that the fact that the criminal activity is tax-related makes no real difference to the generic nature of the crime. However, we have received assurances from HMRC that they are in a better position to investigate such crime than the police, even if, as is often the case with MTIC fraud, the tax crime is only part of an overarching package of criminal activity.

2. We are pleased to note that the revised Criminal Investigation powers and functions will be conferred on an officer only with the authority of the Commissioners of HMRC. However, as this can be a specific or a general authority, that authority could be quite wide. We have received assurances from HMRC that these powers and functions will be restricted to about 2,000 officers, who will be properly controlled and trained. However, there does not seem to be anything to give effect to that promise in the legislation. We consider that it would be preferable to have such powers included in the legislation, rather than introduced by "administrative procedures", and we therefore suggest such an inclusion.

3. We would like these powers to be kept under review and, should there be any adverse reports from HM Inspector of Constabulary (HMIC), consideration should be given to transferring these powers in the future to either SOCA or the police. We understand that there was some concern in the HMIC report on HMRC's "Handling of Human Intelligence Sources", issued in March 2007, as to the training of some officers, which relied upon the "trickle effect". We understand that this weakness is being addressed. However, it does provide some concern that such officers may not have adequate training.

4. We have raised concerns in our earlier response about different procedures applying to different parts of the UK, with the consequent possible uncertainty where, for example, someone resident in England has their tax affairs processed by a tax office in Scotland. It is not clear how the proposals will ensure that there are common procedures, throughout the UK. However, we understand that the Minister has stated that any investigation would start in the place most convenient to the suspect or witnesses. We think that it would be useful to clarify this in the legislation.

Clauses 87 to 91:—Filing dates

5. Clause 87(4)(1H)(b) (and similar clauses for trust and partnership returns) effectively gives HMRC the power to decide what happens if a return cannot be filed electronically, by stating that the Commissioners "may make different provisions for different cases or circumstances". It is not satisfactory for someone who cannot file their return electronically for some technical reason to be dependent upon proving that they are covered by these "provisions", which are not even set out in the legislation. A clearer approach would be to state in clause 87 that, "where it is not possible to file the return electronically", the 31 January deadline remains for paper returns. This could always be tightened up at a later date once the robustness of systems has been proved beyond doubt. If this is not changed, we consider that the provisions should be set out in the legislation in a clear and simple way.

6. Certain individuals, such as MPs, cannot file their returns electronically, and we understand that HMRC will except them from the legislation, by permitting paper returns up to 31 January after the end of the tax year. We consider that the exception should apply to all cases where electronic filing is not possible, including those where there are technological problems, such as HMRC or third party software inadequacies, and that these exceptions should be set out in the legislation. We appreciate that HMRC have stated that guidance notes will be introduced which will indicate that the legislation will not be imposed in such cases. However, we feel that these willing e-filers should not have to rely on guidance notes to except them from the legislation. It is of immense concern that this significant sector of taxpayers who attempt to e-file, but who are currently unable to, are not even recognised in the Finance Bill explanatory notes at paragraph 15.

7. Lord Carter stated in his Review of HMRC Online Services in March 2006:

> *"We recommend that as part of their work to deliver robust, high-capacity, services HMRC should build in more rigorous testing. Each of the services should be capacity tested at least a year before our recommendations are implemented and if any tests are not successful the measures relating to that service should be deferred."*

We feel that to introduce this legislation in 2007 without an adequate fallback position in the legislation, whilst there are still significant e-filing problems, is contradictory to the "Carter principles". If the legislation is not altered, and these provisions are set out in guidance notes, we would be keen to work with HMRC in the preparation of these.

8. We believe there are some technical errors in clause 90. Clause 90 does not appear to correctly amend the Taxes Management Act (TMA) 1970 section 9(2), and gives rise to an inconsistency. Sub-clause 90(1) correctly amends sub-section 9(2)(a) to substitute the date 31 October for 30 September, being the new date by which a return has to be submitted for HMRC to carry out the tax calculation. However, sub-section 9(2)(b) also needs to be amended. This currently states that, if a return is issued after 31 July, then the return should be delivered within two months (for HMRC to perform the calculation). This leaves the anomaly that, if a return is received between 31 July and 31 August, the return would be due earlier than if the return had been issued in, say, April. We consider that there should be an additional sub-clause in clause 90, which should state: "In section 9(2)(b) of TMA 1970 (returns to include self-assessment), for "31st July" substitute "31st August".

9. There is also an anomaly in that, if a return is issued after 31 July, the taxpayer always has at least three months to submit it, yet this is reduced to two months if the taxpayer submits a non-electronic or paper return and requires HMRC to carry out the calculation. It would be less confusing, especially for unrepresented taxpayers, if these periods were both three months.

10. Clause 90 introduces, in several of the sub-clauses, the more modern Tax Law Rewrite wording such as "31st January of Year 2" instead of "31st January next following the year of assessment". However, this has not been done consistently, so that, for example, in the amendments in clause 90(1) only the date is changed, rather than substituting "31st October of Year 2".

11. Clause 91 sets out the commencement of the above provisions in clauses 87 to 90. It does not provide any leeway for ensuring that HMRC have met each of Lord Carter's principles before the implementation of the legislation. Although the January 2007 online filing capacity was admirably met by HMRC, that many of our members are still reporting online filing failure rates of up to 10 per cent is a cause for concern. We do therefore feel that further progress is required before the Carter principles have been fully met, and that provision for this should be included in clause 91.

Other administration—Clauses 92 to 95

12. Our comments on these clauses include a mixture of technical points which we think need to be corrected, to ensure the legislation reads as intended, plus some more general comments on the operation of the proposals.

13. Clause 92(2) introduces the power to disregard a return delivered otherwise than by use of electronic communications. We consider that the introduction of such a power, without a fallback position, when there are still some significant problems with e-filing, is not appropriate. There are still cases where paper filing is the only means of submitting a return. For example, we understand there have been problems in April 2007 with e-filing PAYE returns where the employer has correctly aggregated employments for NIC purposes, resulting in the inability to submit a correct return online.

Concerns in respect of low-income and disadvantaged taxpayers

14. Clause 87 sets 31 October following the end of a tax year as the deadline for delivering a "non-electronic" tax return, and 31 January for "electronic" returns. HMRC are given power to prescribe what constitutes an electronic return. This is effective where the tax year to which the return relates begins on or after 6 April 2007. Clause 89 sets out similar provisions in relation to partnership returns.

15. Clause 92 extends HMRC's regulatory powers to compel electronic filing of returns by businesses, and enables the Department to disregard a return "delivered otherwise than by the use of electronic communications". Again, HMRC may prescribe the electronic form to be taken by information delivered to the Department using electronic communications.

16. Together, FA 2002 section 135 and clause 92 of the Bill give HMRC a very wide power to require almost anybody not only to file electronically, but to file using prescribed software. In terms of very small businesses, this could entail requiring them to invest in computer equipment and systems inessential to any other function of the running of their business, or alternatively requiring them to engage a third party such as an agent to do this for them.

17. The RIA that followed Lord Carter's review of HMRC's online services indicated a one-off cost of £100 for individuals who needed to gain skills or access to online services. This is way beyond what many people on low incomes will be able to afford (individuals with incomes as low as £100 a week can be requested to file a self-assessment return). We also question whether this estimate has taken into account the 5.2 million people in the UK who are categorised as having low levels of literacy, or the likely additional costs for people with disabilities.

18. Lord Carter in his review recommended that all businesses should eventually be required to file online, but that HMRC should not implement that requirement until all their systems were fit to receive and process the ensuing volume of returns. Moreover, in framing the regulatory requirements, due regard should be had to the particular circumstances of small businesses with limited resources.

19. Some 51 per cent of individuals in the UK do not have their own online equipment. Most of those are in low-income households. Taxpayers on low incomes who do have their own access to the internet would bear an additional cost if they were obliged to purchase software other than that which HMRC will provide. This could be relevant if HMRC software, as is currently the case, did not support online filing for all types of income sources.

20. Nevertheless, a fair proportion of the 51 per cent would be able to file online if they could access online equipment elsewhere, free or at a reasonable cost. The RIA that followed Lord Carter's review suggested that many could access the Internet through UK Online services which, for the most part, are available in public libraries. However, library staff are not trained to support such transactional services; many rural libraries, are being closed; and UK Online services are situated only in England. Less than half of UK Online centres offer any private or semi-private space suitable for individuals or small businesses to deal with confidential matters.

21. People who are without their own internet access, and who lack confidence in using online technology, will quite simply be excluded from the benefit of a later filing deadline, and will have only seven months (as against ten months at present) in which to assemble all relevant documentation and prepare business accounts. This is a short timescale to collate information from third parties who may themselves have no equivalent obligation to provide it timeously. Therefore, the use of provisional figures in returns could rise, which might increase the likelihood of formal enquiries.

22. There are many people, eg those with mental health problems or physical problems, such as blindness, who may not be capable of accessing computers. Accordingly, we believe that there should be strong protection for individuals—whether in business or not—to ensure that they are not penalised by their inability to file online.

23. In conclusion, substantial investment of funds and training will be needed, by 2008, for the public and voluntary sector to provide support to those who need assistance in accessing online services. However, consultation with this sector has yet to begin. Those low-income taxpayers who will not be able to use or access online services are likely to need local face-to-face support of the type which is rapidly being reduced as part of the efficiency programme within HMRC.

All taxpayers

24. Of more crucial importance is the fact that a vast number of computers are not yet fully protected against viruses, spyware, etc, and it would be unjustified for tax law to impose a responsibility on taxpayers to acquire relevant protection to be able to file online. We also note that security—both physical and computer—at Internet cafes is not at a standard that would make it acceptable for use to complete tax returns.

Mandation of electronic payment

25. Clause 93 sets out changes to the legislation to mandate electronic payment. At a time when identity theft and theft through electronic banking are of immense concern to businesses, we are concerned that mandatory electronic payment is being proposed, if this encourages individuals and small businesses to use online banking from insecure computer systems. We understand from HMRC that "mandatory electronic payment" will include payment by cheque at a bank using the bank Giro method. We consider that this should be widely publicised, because we think that many taxpayers understand, as we did, that the phrase excludes this form of payment. We think it should be clarified that it is only the right to make a payment by way of posting or delivering of cheques to HMRC that is being withdrawn.

26. Clause 95 also appears to include a technical error. It amends the period during which a return can be enquired into. However, whilst it amends TMA 1970 section 9A(2)(a), the term "filing date" is still used in section 9A, so this still needs to be defined in sub-section 6. However, sub-section 6 refers to the "day" mentioned in sections 8(1A), and 8A(1A), yet these sections were removed by clauses 87(3) and 88(3). Therefore, it appears that section 9A(6) needs to be amended to include an appropriate new definition of the term "filing date" for the purposes of this section.

27. Clause 95: Lord Carter stated that "Different rules may need to be applied for group companies." We can understand why HMRC would want the enquiry window for all companies in a group to end on the same date. However, we consider that their enquiry window should be linked to the date that the last group return is received, or the statutory deadline, whichever is earlier. For corporate groups, if all returns due from members of the group have been delivered, there is no reason to extend the enquiry window. We appreciate that, as mentioned by HMRC, not all groups have companies with co-terminous periods of accounts, and that sometimes it can be difficult for HMRC to identify all group members. However, to exclude groups with companies with co-terminous periods of account, which is probably the majority of groups, seems unfair.

Penalties for Errors on Tax Returns—Clause 96 and Schedule 24

28. We welcome a significant number of the measures set out in the draft clauses, and appreciate the level of consultation in this area. There is much to commend in the proposals, as we have previously stated.

"HMRC think"

29. As mentioned several times in our previous responses to HMRC, we object strongly to the use of the words "HMRC think that" as used in the draft clauses. The basis for our objection is that their use in most of the clauses (particularly paragraphs 1 and 2) is either superfluous (and therefore confusing) or a wholly novel departure in an illiberal direction which, we would suggest, is likely to become embarrassing, for the Government, since it can subject to penalty items that may not actually be incorrect and which would not have been subject to penalty in the past.

30. These penalty provisions are intended to penalise actual culpable errors. We believe that such sanctions should be based upon fact, and not be left to official discretion.

31. We appreciate the assurances from HMRC that HMRC staff will have to act reasonably, and that on an appeal it is likely that, if an assessment turned out to be correct, the penalty would be quashed, even if at the time HMRC did think it was due. However, there are two problems here:

- Most people do not go to appeal, due to the likely costs of using such a process; and
- Having consulted some lawyers, we understand that there is doubt as to whether the penalty could be quashed, even if the assessment turns out to be incorrect, if at the time HMRC did act reasonably and "thought" that it was correct.

32. The following comments are also relevant:

- The summary of responses reported "almost universal disquiet about the statutory formula 'If HMRC think . . .'".
- If the Government intends to disregard such almost universal comments made in consultation, it should surely give clear and compelling reasons for doing so, particularly in the case of such draconian proposals.

— Whilst HMRC's reasons for including the phrase are that it is a modern equivalent of phrases such as "reasonably believes" (and leaving aside the question of replacing old—but hardly archaic—language which case law has to some extent clarified with new less tested language), the latter subjective phrase has not been used in existing penalties legislation. We therefore see no reason to insert a modern equivalent in the draft clauses. For example, TMA section 95 uses the phrase "Where a person fraudulently or negligently delivers any incorrect return . . . he shall be liable to a penalty . . .". It does *not* state "Where HMRC reasonably believes that a person fraudulently or negligently delivers any incorrect return . . . he shall be liable to a penalty . . .".

— The word "thinks" may be predicated on the principles of administrative law, which requires public servants to act reasonably. However, this is a new and inappropriate test for the imposition of a penalty on a taxpayer who may be objectively innocent.

— Comments in House of Lords debates justified the use of the term in other legislation: however, this referred to an issues far less fundamental than the entire HMRC penalty regime. A loose phrase such as "HMRC think" in such legislation is not something that will inspire confidence or acceptance within business or taxpaying circles.

— The phrase seems particularly inappropriate in paragraph 2, dealing with the situation where HMRC make a mistake.

— It is at least puzzling that this is felt to be compatible with human rights legislation—the imposition of a penalty on an objectively innocent taxpayer, potentially without ability to overturn on appeal, cannot be regarded as proportionate.

— The scope for an appeal against a penalty may be limited, because it will in effect be against the perception of HMRC rather than against the facts of the case.

33. In criminal law, section 1(1) of the Theft Act 1968 reads: "A person is guilty of theft if he dishonestly appropriates property belonging to another with the intention of permanently depriving the other of it." We do not think that there would be support for a change to more subjective wording such as: "A person is guilty of theft if a Police constable thinks the person has dishonestly appropriated property belonging to another with the intention of permanently depriving the other of it." For the same reasons, the words "HMRC think" should be deleted from Schedule 24.

Other comments on penalties

34. A balancing safeguard for the taxpayer or potential compensation to the taxpayer where HMRC make a mistake and the taxpayer is out of pocket should be included in the clauses.

35. We understand HMRC's suggestion 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. 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.

36. We are pleased to see that under paragraph 7(5) penalties will not be charged to a loss-making company which has "no reasonable prospect of the loss being used". Paragraph 7(5) should be reworded to include a definition of this term, to minimise future disputes.

37. Where an underpayment and an overpayment occur, and these are attributable to connected parties, a penalty can be charged on the underpayment, but there is no compensation for the overpayment. Such an instance could arise in valuation cases. Where this occurs, we consider that it should be possible to offset the over- and underpayment for penalty purposes, because there is no overall loss of tax to the Exchequer. We have previously objected to penalties where there is no overall loss of tax. We understand your concern that this could be open to abuse. We therefore consider that there should at least be a power to allow HMRC to reduce the penalty in such circumstances.

38. We are also concerned about the message provided in Schedule 24 paragraph 18. We are concerned 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. As stated in our letter of 12 March 2007, we can see no practical alternative but to the levy the penalty on the taxpayer, rather than the adviser, leaving the taxpayer and adviser to address the situation between themselves. The only exception would perhaps be where the adviser himself has committed serious offences—effectively fraud—where the taxpayer would have no reasonable way of appreciating that.

Penalties: "careless inaccuracy" and innocent error

39. We welcome the distinction underlying the penalties proposals (Schedule 24) between "careless inaccuracy", for which a relatively low penalty is exigible, and innocent error which attracts no penalty. "Careless inaccuracy" is defined in Schedule 24, paragraph 3 as "due to failure by [the taxpayer] to take reasonable care". This raises the question of how reasonable care is to be judged. We are encouraged by the extent to which HMRC have accepted the case for a subjective interpretation—paragraph 5.7 of the consultative document "A new approach to penalties for incorrect tax returns" (December 2006) acknowledged that "reasonableness is a relative term: it must be interpreted in the light of all the circumstances prevailing". We welcome the recognition that "reasonable care" must be judged not according to some standardised yardstick applicable to all, but by reference to the individual taxpayer. It is crucial, therefore, that guidance issued, and training given, to compliance officers should be very clear on that point.

Appeals regarding penalties

40. We welcome the fact that there are to be full rights of appeal against the imposition, mitigation and suspension of penalties under the proposals in the Bill. The consultation document which preceded the Bill spoke of 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.

41. The LITRG would support such a move. The type of model represented by the Internal Review Service (IRS) for the Social Fund might well prove suitable. The advantages of that model are its inquisitorial process, its speed and its cost-efficiency. Many disputes are resolved over the telephone. Most are resolved within 12 working days, and urgent cases within 24 hours, at a cost—in 2005—of £153 per decision. The fact that more than half of Jobcentre Plus decisions are overturned testifies to its impartiality.

42. We would also draw attention to the mediation facilities which are to be offered under the new tribunal structure being introduced by the Tribunals, Courts and Enforcement Bill. This can only be to the advantage of unrepresented appellants, in providing a less formal and confrontational alternative to a full hearing.

43. We are keen to assist HMRC in developing the guidance notes to accompany this new legislation.

3 May 2007

Memorandum by the Association of Taxation Technicians (ATT)

THE BUSINESS TAX PACKAGE FROM THE POINT OF VIEW OF SIMPLIFICATION

The Association of Taxation Technicians (ATT) is delighted to have the opportunity to present its evidence on this topic to the Sub Committee for their consideration.

The Budget Notes, BN02, entitled "Business Tax Reform Package" gave details of a large number of proposals which, it is stated, will apply to all businesses. Only some of these proposals manifest themselves as clauses within the Finance Bill 2007. These appear as Clauses, 2, 3, 35, 36, 48 and 49. The effect of these clauses on both the simplification of the tax system and the amount of tax payable by businesses is analysed and summarised in the Appendix.

These proposals do not give rise to much simplification of the tax system. In may instances the proposals by their very nature add complications to the calculations required to determine the tax liability of the relevant businesses. Whilst it is probably true to say that most professional tax advisers will use computerised tax packages to complete these calculations such that the complications will be catered for in the software, it will mean greater revisions will be required by the software houses than if, for example, there were not annual changes in the rates of corporation tax applicable to small companies.

A number of proposed changes outlined in BN02 do not appear within the Finance Bill 2007, either because the proposed change is delayed until a later date or detailed consultation is to be undertaken before legislation is brought forward in a future Finance Bill. It is not clear if these proposals are subject to review by the Sub-Committee, but as they are, effectively, part of the overall package of proposals for business, a few brief comments will be helpful:

(a) New annual investment allowance for the first £50,000 of expenditure is proposed with effect from 2008–09. No details are known, but if it is intended that expenditure of up to £50,000 each year can qualify for immediate tax relief, then this is to be welcomed. Without full details of the proposal it

is not possible to determine how it will fit in with existing rules for capital allowances, which it is proposed be amended, and, therefore, if there is any simplification in the new arrangements.

(b) Reduction in the rate of writing down allowance (WDA) for plant and machinery from 25 per cent to 20 per cent per annum. There is no simplification, just a change in rate. Depending upon the combined effect of the proposed new annual investment allowance and the reduction in rate of WDA, it is not possible to say if this results in any simplification overall or increase in tax liabilities payable by the business.

(c) It is proposed that with effect from 2008–09 the rate of WDA on long life asset expenditure to be increased from 6 per cent to 10 per cent. There is no simplification, but the increased rate of WDA will reduce tax liabilities otherwise payable.

(d) Subject to detailed consultation, it is proposed that the rate of WDA from 2008–09 will be 10 per cent in respect of expenditure on certain fixtures which are integral to a building. This suggests a further complication in respect of the capital allowances code as well as a reduction in the rate of WDA from a possible 25 per cent today to 10 per cent from 2008–09. The combined effect of this proposed reduction in the rate of WDA in respect of fixtures integral to a building and the phased withdrawal of IBA and ABA, see Appendix, will add significantly to the cost of new units in industry, agriculture and hotels as well as the financial sector, nursing homes etc., with no real simplification to balance these increased costs.

(e) Again subject to detailed consultation on both the design and scope of the provisions, it is proposed that there will be a payable tax credit in respect of losses resulting from capital expenditure on certain designated "green technologies". Whilst an encouragement to embrace green technologies is to be welcomed, it is unlikely to produce any simplification of the tax system.

In broad terms it is probably true to say that simplification will only be achieved if the number and complexity of the detailed rules or provisions is reduced. Even though some of these outline proposals may have laudable objectives, it is most unlikely that they will produce any simplification of the tax system, more probably the reverse.

It is hoped that the comments made in this submission will be helpful to the Sub-Committee although we shall be pleased to answer any questions which the members have.

APPENDIX

HOUSE OF LORDS SUB COMMITTEE ON THE FINANCE BILL 2007

The Business Tax Package from the point of view of simplification

Clause	*Provision*	*Effect on Simplification*	*Effect on tax payable*
2	Main Corporation Tax Rate for Financial Year 2008 reduced to 28 per cent with the exception of ring fence profits which remain at 30 per cent	Effectively a complication as there are now two rates of Corporation Tax where there was only one before.	The reduction to 28 per cent is to be welcomed as it will reduce the CT payable by large companies.
3	Small Companies Corporation Tax Rate increases to 20 per cent for Financial Year 2008, apart from ring fence profits which remain liable at 19 per cent. This is the first stage in the planned increase in the rate for small companies by 1 per cent for each successive financial year to give a rate 22 per cent in the Financial Year 2009.	This amounts to a complication, the changes will mean more complicated computations for all companies which do not have a period of account co-terminous with the Financial Year. The change in the rate of tax means ever changing fractions for calculating marginal relief where profits exceed the basic limit of £300,000, or less where there are associated companies.	Increasing rate of tax means an increase in the tax payable on same level of profits.
35	Phased withdrawal of Industrial Buildings Allowances (IBAs) and Agricultural Buildings Allowances (ABAs)-first stage.	Removes the need to calculate balancing adjustments on a relevant disposal after 21.3.2007. This does not apply if the building is in an Enterprise Zone or a written contract for its disposal was in place before 21.3.2007. In effect, the new owner takes over the previous owner's Residue of Qualifying Expenditure.	Overall likely to increase tax payable, when considered in the overall strategy.
	Note Although the rate of Writing Down Allowances (WDAs) is unchanged at 4 per cent for the year 2007–08, it is proposed that the rate will be reduced by 1 per cent per annum over the following four years, to Nil.	No immediate simplification as WDAs will still need to be calculated at varying rates for the next few years.	The loss of allowances will increase tax liabilities, particularly harsh provision for a person who acquired a new IB or AB just prior to the Budget expecting to claim allowances for the next 25 years.
36	Temporary increase in First-Year Allowances for Small Enterprises. In fact this continues the higher-rate of 50 per cent for a further year from 1 April 2007 for companies and 6 April 2007 for individuals and partnerships liable to Income Tax.	There is no simplification because nothing has changed.	As the same rate of FYAs continues there is no effect on tax payable compared to last year.
48	Relief for Vaccine Research. This corrects an unintended error in the original legislation in Schedule 13 FA 2002.	Removing the unintended error gives greater clarification, if not simplification.	Although confirmed amount of relief is less than might appear from the original legislation, it is just a correction.
49	Research and Development Expenditure—tax relief—definition of SME (Small or Medium sized Enterprise). Increases in rates of relief to 130 per cent for large companies and 175 per cent for SMEs, as newly defined.	The extension of the definition of SMEs to include a larger number of companies is helpful, but not a simplification. Claims will need to be reviewed for companies on the borderline, to see if they now fall within the definition of SME.	Increased rates of relief should reduce the tax payable by the relevant companies, or increase credits receivable as appropriate. It is understood that not a large number of companies are claiming this relief.

Managed Service Companies (MSC)

The Association of Taxation Technicians (ATT) is delighted to have the opportunity to present its evidence to the Sub Committee on this topic for their consideration.

ATT understand the need for HMRC to stop the perceived avoidance by MSC's and confirm that it is easy to see the "elephant" that is a MSC but very difficult to accurately identify the target in legislation.

ATT have concerns that the Finance Bill gives a clarification by excluding those providing legal and professional services in a professional capacity from subsection (1) (d) of s61B [see FB page 90 line 35] and by a similar provision in s688A (3) [see FB page 96 line 21]. There is no statutory definition of an Accountant. It is understood that HMRC will apply these provisions to members of certain accounting bodies and legal professional bodies. Tax Advisers provide a mixture of both legal and accounting services but would be denied relief as their professional bodies are neither exclusively "Accounting" nor "Legal". Furthermore there are many accountants and tax advisers who are qualified by experience (eg ex HM Inspector of Taxes) who do not hold any formal qualifications. There is no suggestion that the intention was to place a potential restraint upon such businesses and accordingly we submit that the references above should also include "Tax Advisers" and that HMRC should accept that membership of a professional body should not be a pre-requisite of claiming relief under those sub-sections.

The proposed legislation needs to catch the MSC providers but not to place a restraint upon the trade of genuine small business service providers. Clarity is required within the legislation, rather than by operation notes of HMRC, so as to give certainty to advisers that they can continue to help SME's. It would be easy to be accidentally caught by "promoting" the use of a company, or by "influencing" the company's finances. When advising small companies it will be the professional duty of the adviser to explain the advantages (and disadvantages) of using a company, and then when advising the Directors to explain the optimum level of salaries and dividends to be taken consistent with tax and company law; and to advise as to how the business can maximise its return from its activities.

In the same way certainty and clarity is needed to know that HMRC cannot transfer a tax debt to an adviser in normal day to day practice life. If there is any outside chance that this could occur then this would severely restrict the numbers prepared to offer services to SME's. As currently set out in the Finance Bill there is concern that the rules could be extended to recruitment companies. Furthermore it would be inappropriate to include within the debt transferred an interest charge. The person then liable would not have had any possibility to settle the liability prior to transfer and has not gained from the non-payment of the tax debt therefore this cannot be said to be commercial restitution instead it is a penalty upon the person now liable.

It must be remembered and also appreciated that this situation has developed over the last 10 years, with a huge amount of highly complex legislation which in many instances is unworkable or at least incomprehensible, for two reasons. Firstly, there is no clear definition of "Employed" or "Self-employed" workers, to use a neutral term. Secondly, there appears to be an obsession within HMRC to dictate to individuals in what form they must structure their business.

Twenty years ago an individual could freely decide if he wished to carry on his business as a sole trader, a partnership or through the medium of a limited company. At that time, there was little difference in the overall amount of tax payable. With the abolition of Advance Corporation Tax (ACT) in 1997 and the introduction of the notional tax credits in relation to dividends paid by companies, there was a clear tax advantage by trading through the medium of a company compared to an unincorporated form. However, it was, and still is, quite legal for the individual to choose through which medium they operate their business.

Successive legislative changes in relation to Corporation Tax first enhanced the tax advantages of trading through the medium of a company and subsequently reduced, but did not eliminate those advantages. Against this background of tax advantages by reason of trading through a company it is possible to appreciate why individuals would choose this medium rather than the unincorporated business. This also explains why high earners who were providing their services to large companies as employees were encouraged to set up their own companies and provide the same services to the same large companies as previously. Both the previous employer company and employee were able to make very substantial savings of National Insurance Contributions in addition to the tax saved by the former employee now receiving dividends from his own company.

The principle established long ago in the case of *Ayrshire Pullman Motor Services and Ritchie v CIR, 14 TC 754*, is still true today. The judgment in this case included the well known and often quoted comment of Lord Clyde, the Lord President of the Court of Session:

"No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow—and quite rightly—to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Inland Revenue".

The reaction of HMRC (previously Inland Revenue) to this change of modus operandi of employees was to introduce legislation known as IR35 (the number of the applicable Budget Release) which broadly stated that if the Personal Service Company (PSC) of the former employee was deemed to be removed, would there still be an Employer/Employee relationship between the individual and the user of his services. If so, then complex rules applied to effectively tax the PSC/individual as if he was an employee.

In an effort to avoid the rigours of the IR35 legislation, umbrella companies were set up to provide the services of several individuals, not just one as in the case of a PSC. Subsequently MSC's were formed as a means of providing all the management and administration services required to run a limited company, leaving the worker to do what he does best, provide his services to an end user.

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. The end result is pages of complex legislation, much of which proposed in this Finance Bill is far from clear, as demonstrated earlier, and does not address the fundamental problem at the root of the concern of HMRC. Individuals should have a free choice as to the business medium through which they operate. Their decision should be based wholly on commercial factors and, although tax will be one of those factors, it should not be the overriding factor as it has been recently. HMRC should then respect that decision and not seek to attack it as has been the case recently.

To achieve this situation, the whole basis of taxing small businesses needs to be reviewed, and revised as necessary, to ensure that there is both fairness and equality between the different forms in which it is possible to carry on business. ATT would be pleased to consult with ministers on this with the aim of simplifying the tax system.

Examination of Witnesses

Witnesses: Mr John Cullinane, President, Chartered Institute of Taxation, Mr John Whiting, Chairman, Tax Policy Sub-Committee, Chartered Institute of Taxation, and Mr John Kimmer, Past President and Technical Committee Member, Association of Taxation Technicians, examined.

Q136 ***Chairman:*** Good afternoon, if I may say so, to some familiar faces. We are delighted to see you here again to help us with our inquiry, and you know the issues upon which we are wanting to press you a bit with questions. Is there anything that any of you want to say before we start or are you happy to go straight into questions? You are happy to go into the questions, so let us start, first of all, with some questions on the business tax package. To what extent does the business tax reform package actually deliver "simplification of the underlying tax structure", as claimed in government reports and so on?

Mr Cullinane: I think very much on the plus side, if you look forward to the time when these reforms are all worked through, if you were to make a business decision, you would find it less likely that you would have to worry about big tax differences between different categories of spending and investment and you would find your tax position more driven by your commercial decisions. I say that because the consequences of the changes would be that the taxation of incorporated and unincorporated businesses would be more on a par than it has been in the past and because, in the capital allowances area, you would find less tax categories that you would have to investigate, so you would not have to worry as to whether your building was an industrial building or not because the consequences would be the same either way. Having said all that, tax simplification, I think, is not just a one-year thing. We have got to a position of having the longest tax code in the world over decades, so I think, if we are to get the benefits of simplification in a serious way, we need to take a long view at it and I think that has a couple of implications. First of all, we need to build support for it and one of the problems you have, and you have already had with this Budget, is that in any simplification there will be winners and losers, it is inevitable to some degree, and obviously the losers tend to shout louder, so I think you have to build support for it over a certain amount of time. There is no easy answer, but the best way of doing it, I think, is a consultative process and some of the proposals, including some of the key ones where some people have lost out, rather came as a sort of rabbit from the hat on Budget Day. That is probably not the best way of building long-term support, but I would give credit

for making a good move in the right direction, as far as we see it.

Q137 ***Chairman:*** Can I just perhaps be a bit provocative. We have had a witness here, I recall rightly, who said, "Well, removal of the capital allowances was a simplification", but, as far as the rest was concerned, he thought it added complication because it added yet a new system of dealing with the matters and he was not very enthusiastic about the simplification argument, but you think there is a significant simplification?
Mr Cullinane: Certainly I would say so, yes, because, as I say, we have had one less category of expenditure where the tax consequences are different than you had before. Also, 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, and I think those are plus points. However the system remains very complicated and of course on the particular matter of the industrial buildings, people who had 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. It is not saying it is not simpler; it is just saying it is another problem which is one of the problems we would have had to deal with if we were proceeding to a simplification over a long period.
Mr Whiting: I have to say that, from my perception, I do not think simplification drove this package, I think it was balancing the figures, 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 and the general impact on different sectors, as John has said.

Q138 ***Lord Barnett:*** Surely, you do not really want simplification, do you? The complex gives you lots more business. If you had a totally simple system, you would not earn anything like as much!
Mr Cullinane: I think if we had a totally simple system, yes, but, to be honest, from where we are starting, such a thing is completely unimaginable. I think 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 that is a major problem and we should give priority to dealing with it, and that is why I put these other problems in context. I think the Budget is a modest step in the right direction.
Mr Whiting: If I may say, CIOT and the ATT have had a long history of campaigning for simplification and putting up suggestions to the authorities for that.

Q139 ***Lord Sheldon:*** There have long been considerable administrative burdens on business over many years. Are you satisfied with the progress HMRC are making in reducing these?
Mr Cullinane: Well, I think again there is a long way to go. I think the measures that they have picked out and quantified the effect of are measures where we do see they have made an improvement. Again, I think it is a first step, but a move in the right direction and I think it is good that they have established a framework for estimating the administrative burdens and looking at the impact of particular changes and how much those burdens are reduced.
Mr Kimmer: You drew attention to paragraph 3.69 of the EFSR and there were five particular proposals in there which do seem to be, on the whole, working in the right direction. There was the change in the personal pension regime. There is the new form P46 which is making life a bit easier for employers who are getting questions from their employees, and the form 42, which was really a bit of a shock when that first came out. I think the removal of the provisions requiring a lot of people to complete that form is a great help. The VAT1 form is also an improvement, but I think the teething problems with that are that the volume of new forms that are going through is causing a lot of delay in actually processing them which is another problem. Then of course we have got the new CIS scheme which started this last month, in April, which hopefully will improve the situation, although I gather there are some teething problems with that in the early days of getting authorisations through. There are certainly steps there which have been taken which are working to simplify the system.
Chairman: It comes with your usual degree of optimism as to what might happen in the future, by the sounds of it.

Q140 ***Lord Vallance of Tummel:*** The 2006 review of links with large business made proposals aimed at delivering a modern, responsive tax administration. Do you believe that the HMRC's delivery plan, which was published on Budget Day, will achieve that?
Mr Cullinane: I think we are optimistic about that, but obviously it is a very ambitious programme and it remains to be seen whether it can be carried out. One of the most attractive aspects about it, I think, from a business point of view is the ability that is promised to be able to get better reassurance of the tax consequences of decisions made and better clarity. However of course it will be a kind of administrative clarity and it will not be because the underlying law is clearer, but because HMRC devote efforts to helping explain their position in regard to particular transactions. It will be a challenge for them doing that with constrained resources and with the

underlying system still very complicated, so we think they have got their work cut out, but at least it is a promise to move in a good direction.

Q141 ***Lord Blackwell:*** If we go back to the objective of the reforms, there were three of them initially set out, one to improve the competitiveness of the UK, one to encourage growth through investment and innovation, and a third one to ensure fairness across the tax system. As you look at this Budget and the measures in it against the opportunity for things which you argued for, where would you score this Budget?
Mr Cullinane: I would score it at about 70 per cent in terms of what you could achieve in one Budget. I think those are all areas in which it is almost impossible to achieve anything worthwhile in just one Budget, but you have got to start somewhere. My reason for not giving it 100 per cent, perhaps it is not in one's nature to do that, but the main reason I would give is a lack of consultation. I think it is fair to say, by the way, that a few years ago the Government had a highly consultative approach to the reform of corporation tax (which obviously just affects the incorporated sector) but that was virtually abandoned largely because they said they could not get consensus. I would say that it is actually difficult to get consensus in this area because in the area of reform there is always somebody who is going to lose out, so I do not say it is easy, but nevertheless I think a consultative approach does offer you a better way forward in the long run because inevitably opposition will build up if you spring surprises on people and some people lose out.

Q142 ***Lord Blackwell:*** Are your colleagues equally enthusiastic?
Mr Whiting: I would say that there is at least a good signal given by this Budget that the Government has heard the message on international competitiveness, that the tax system is an important shop window for UK plc and that something needs to be done because, fundamentally, our system was 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 the Government credit for that. Administratively, as we have said, it has made a start. Fairness, well, I am less impressed with the fairness as far as business is concerned because of the lack of grandfathering when capital allowances changed radically and because of the lack of a proper look at the small business sector: it seems to me continually just to dig around and make small tweaks rather take than a coherent look.
Mr Kimmer: I think I would agree with that. The tinkering is one of the big problems that we face. It does need, if you like, a much more basic look at the system to try and look at it overall rather than just look at little bits here and little bits there and change one bit one year and one bit the next. It is a courageous Chancellor who will start with a blank sheet of paper and reinvent the wheel, but I think to remove some of the problems we have got today, that is almost what you need to do.

Q143 ***Chairman:*** Could I press you a bit on that, and I am not asking you to start with a blank sheet of paper and say what you want because it is extremely difficult, but, if you were to give some guidance as to what you think is the direction you ought to go, how would you encourage him to do proper simplification?
Mr Cullinane: First of all, in the area of corporation tax reform, I think we should look in a much more thorough-going way to base the tax profit on the accounting profit that companies have to calculate anyway. I do not say it should be the same, but, where it is different, there should be very, very clear rules as to when it is different and how you calculate the difference. At the moment, that is not the case and it is far from being the case in all sorts of ways and I think the Budget is a sort of half-hearted step in the right direction, but by no means right in every detail. Small businesses is a very complicated area. One of the big issues is whether you incorporate or not and there are all sorts of commercial, legal and other factors behind that, but I would suggest it is asking for trouble if you make it too tax-driven, if there is too much of a tax advantage one way or the other. I think a few years ago there was almost deliberately, it seemed, a big tax incentive created for people to incorporate and now I think at a certain level it is more of a wash. Now, life is so complicated that there are many different permutations and it is not a total wash, in many situations it is still unbalanced, but I think my colleague is right, that you need to try and look at it in the round and try and get a more level playing field and try and move with some consistency in that direction, and also consult people widely so that they understand the direction you are trying to go in so that, even when they do not agree with decisions you have made, they do at least understand the logic of them rather than things being spring on people.

Q144 ***Lord Barnett:*** Research and development tax credits and tax allowances generally are usually intended as a sort of incentive for people to invest or carry out research and development to improve productivity. If it is very complex, will it be very effective?
Mr Cullinane: Possibly not. I think one of the problems with incentives of that type is that it seems a very good way of targeting reliefs when there is a certain amount of money to give away, as it were, but

not enough to have a major impact on the rate, so one invents a relief that is targeted and puts a lot of conditions around it and the question is: if there are a lot of tax conditions, how effective and attractive is it? 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, but I think the consequence of too many of these little initiatives is that they only stay around for a short period of time, they are withdrawn later and then people do not have confidence in them, so I think one should be very, very careful about all incentives of that type.

Q145 ***Lord Barnett:*** So you would basically prefer to have no capital allowances at all and have just one simple tax regime which would mean a lot simpler tax system?
Mr Cullinane: It would. Obviously at the moment there are many, many taxpayers who are getting a big benefit from lots of capital allowances, so there would be this grandfathering issue if you made this sudden change, which is why I say the process needs to be consultative.

Q146 ***Lord Barnett:*** I am not sure whether any of you believe that the capital allowance systems and the various changes that are made from time to time on this research and development tax credit are having any serious effect on increasing incentives for people to invest.
Mr Cullinane: With capital allowances, increasingly the policy has been, and in this Budget the statement was made, that it is taking it closer to economic or commercial depreciation, so the incentivisation argument has rather dropped out of that one. With research and development, there has been a very clear policy over a number of years that there is an activity in the UK that the policy is trying to encourage, so, given the stability of that direction of policy, I would be more understanding of that one.
Mr Whiting: If I can comment on research and development in particular, I am not convinced that the research and development credit is at a sufficient level to really influence behaviour, to really make a business say, "Because of this incentive, I will change what was otherwise a commercial decision" either not to do the research and development or to do it somewhere else. That is partly because the rate of allowance is still relatively modest: we are not up to the level that was once the case in Japan of 106 per cent of the expenditure deducted from your tax bill, never mind from your profits, and also because of the complexity, there are still uncertainties as to what will qualify; it is not as generous and as simple as it should be. I think particularly for small businesses, certainly from a survey my own firm did, there is certainly evidence around that small businesses would rather just not have these allowances, they would rather have a simple, lower rate because they, therefore, save the effort of working out whether they do or do not qualify for something.

Q147 ***Lord Barnett:*** But in your large organisations do you handle many small companies and, perhaps I can ask, how do you define a small company?
Mr Whiting: We handle companies of all sizes, certainly the firm that I work for day to day. As far as the Institute is concerned, we cover advisers for all sizes of businesses and indeed we have a significant arm that helps businesses and individuals who do not use advisers.

Q148 ***Lord Barnett:*** But what is your definition of "small"?
Mr Whiting: "Small" can be anything from the one-man band or one-woman band upwards.

Q149 ***Lord Barnett:*** To how many?
Mr Whiting: I would certainly say that "small" would be 50 employees or less.

Q150 ***Lord Barnett:*** Fifty employees or less?
Mr Whiting: That would be my cut-off point between small and medium. I do not know whether my colleagues would differ.

Q151 ***Chairman:*** I think, if I may say so, the small companies' rate of tax is nothing to do with the size of the company; it is the size of the profits and it always has been. Can I just follow up with perhaps a last question in this area. You have talked perfectly reasonably about consultation and how important it was, and I can fully understand that consultation on technical matters is very important. I have had some difficulty before and I think the Inland Revenue has in many ways a good record at dealing with that, but consultation on changes in any sectorial matters is perhaps a bit more complicated, or do you think not?
Mr Cullinane: Not really. First of all, I would have to say that the actual volume of consultation on tax matters is much, much greater than it has ever been. If you go back enough years, it was almost the invariable rule that everything on Budget Day would be a surprise, so I think they have consulted a great deal more. What that means is, when it does not happen, it makes it stick out more and I think it makes people more resentful that a change that affects them or, if you like, undermines an investment decision they have already made is made out of the blue. I think people react against that much more than they did 20 years ago they probably thought it was the norm, but now I do not see any reason why it is not practicable to consult simply because it does happen in many, many areas and then it is more noticeable when it does not.

Mr Whiting: I think one of the aspects underneath your question, my Lord, is looking at and making sure that they understand the impact of different sectors because certain business sectors, if we take the insurance sector for one, are actually quite complex and quite difficult and changes have come in in recent years that, frankly, show that maybe the people drafting the changes did not fully understand the impact on the business, so it is another reason for consulting, not necessarily on the thrust of the change, but to make sure that the impact of it is fully understood.
Mr Cullinane: The comment was made in the Budget that it is robbing Peter to pay Paul, but I do not believe they set out to do that. I believe they set out to reduce the main rate of corporation tax, to increase the small companies' rate because of the level playing field with unincorporated businesses and to make the thing pretty well self-financing to avoid, as far as they could, winners and losers issues. I think if they had been able to find a way of making nobody better and nobody worse off, then they would have gone for it, but of course that would be impossible. However I believe their 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 and calculate or foresee all the different permutations of how people will react to or be affected by the decisions you make.

Q152 ***Chairman:*** Well, let us move on to the question of managed service companies and all of that area. I think we all know that the IR35 came in and this was all because, and in a way it brings us back to the simplification argument, there were big tax differences between one way and another of dealing with the profits. Some commentators have said that what the Government has done is merely to put sticking plaster to a problem, and I think you refer to this in some of your evidence. Is there not a case for saying, or you tell me why there is not a case for saying, that, if we could get the rates nearer together, you would not have quite the same problem that you have got?
Mr Kimmer: I think that is true, that, if the playing field is more level and the tax payable by businesses in whatever form is much more equal, then the decision as to which business medium to use would not be driven by tax, which it has been over the last, say, ten years since ACT was abolished in 1997 and with the added changes which have come in in between. That forced people who were just directed on the tax side to move in one direction, which the Chancellor did not like and he then reversed it and it has gone back towards the other direction. I think we need to get back to this sort of level playing field where it is the commercial decision which the individual makes as to their trading medium and, if I may say, HMRC then respect that decision and tax them accordingly and do not say, "We don't like you going that way. We want you to go another way".

Q153 ***Chairman:*** Would you call that simplification?
Mr Kimmer: It could be simplification, but it could certainly be removing a vast tranche of anti-avoidance-type legislation which we have on the statute books now, the IR35 and the managed service companies. They could all go, I think, if that was done, but that does require going back almost to the blank sheet of paper and working it through again.
Mr Whiting: Yes, it is a good area 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.

Q154 ***Chairman:*** If a small businessman's decision as to whether he wanted to be a limited company or to be a sole trader was based upon commercial decisions and not tax decisions, that would be a better tax system?
Mr Whiting: That would be much better, yes.

Q155 ***Lord Sheldon:*** The written evidence states that consultation may offer the best way of minimising problems in the process of reform. Would not changes with winners and losers in certain areas be more difficult if the Government were to make consultation an essential part of it?
Mr Cullinane: I think in the managed service companies area, there were early drafts produced and, although it has been a very tight timescale, there has been a very consultative process and that means that the number of concerns we have about the draft are now very much fewer than they were when it was first produced.
Mr Whiting: One of the benefits of consultation is that it will flush out the winners and the losers and of course it is always possible that the winners will keep quiet and the losers will shout the loudest, but at least these will be in evidence, it will be on the table, so there is a better chance of really evaluating the impact. I think in a number of the things we have in this year's Finance Bill, there are areas where there are undoubtedly winners and losers and sometimes some of the winners or some of the losers were not always apparent when the provisions were first around, so consultation has got us to a better answer or at least to a better understanding.

Q156 ***Lord Sheldon:*** Consultation must always be an exceptionally important part of the process, must it not?

Mr Whiting: It is one of our cardinal principles that, to us, consultation should be automatic. There should be, if there is to be no consultation on a matter, a good reason for it and even then there should be consultation on the detail.

Q157 ***Lord Vallance of Tummel:*** Can we look at how effective you think the new legislation on managed service companies is going to be. Specifically, if the recent sharp increase in the number of incorporations is a result of workers reverting to offering their services through personal service companies, but the underlying relationship between end client and worker is still that of employer/employee, are HMRC going to have resource difficulties in policing the IR35 legislation which should apply in such a situation?
Mr Whiting: There are quite a few questions there, my Lord. In terms of whether the legislation is better focused, if we just look at that in isolation, yes, we think it is, as has been alluded to. It is a better set of legislation and it is better targeted because it is looking at the managed service company provider, but we have still got concerns about the detail. The first step is that it is quite promising and better targeted at tackling a problem that, we would be the first to acknowledge, definitely exists. One of the impacts has undoubtedly been that an awful lot of the individuals who see themselves affected, all the managed service company providers who are providing these managed service company rules have actually gone out and set up individual companies which, as you suggest, will now be many thousands of people, and I believe 50,000 companies were formed in February, potentially operating through individual personal service companies which may not be caught by the managed service company provisions. You then have the issue of how well HMRC is able to police them, and I think that is a very real problem because one of the problems with IR35 is that it has been a contract-by-contract, very manpower-intensive process of HMRC to run, and I think they have almost been unable to run it as it perhaps should be; it has depended on self-assessment. 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.

Q158 ***Lord Vallance of Tummel:*** So it would be fair to say that the legislation shifts the problem rather than solves it?
Mr Whiting: 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 have to 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.
Mr Kimmer: 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.
Mr Cullinane: I think the issue here is that a tax differential between an incorporated and an unincorporated business, although it is not easy to elimate, is in a sense a kind of technical differential, whereas the tax treatment of the employed and self-employed is more of a politically difficult borderline—there are more, if you like, real differences there. So I think it is harder to achieve and that probably explains why on the one hand 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 service companies they are still in the kind of sticking-plaster mode, and to be fair it is an understandable way of doing things because it is a much more politically fraught difference.

Q159 ***Lord Blackwell:*** As you said Mr Whiting, one of the problems with the IR35 was that it tried to define everything on a contract-by-contract basis and we have now got HMRC trying to create a definition of what the target is. Do you think that in what is obviously a very complex area the definition is one which will create certainty about what fits inside it and what does not and, in particular, is it a definition which will appropriately distinguish between legitimate businesses and those which the Treasury might think are trying to use this as a loophole?
Mr Whiting: I think we are getting there. I think it has the potential to achieve that. We still have concerns about the exact definition. CIOT set up and hosted a significant meeting with HMRC and the Treasury a couple of weeks ago at which a number of concerns were flushed out of a pretty detailed nature, for example the exclusion of provision of services by lawyers and accountants, which sounds fine except what about tax advisers as represented by these bodies or company secretaries, could they still be caught? So there are a number of detailed points that still need to be taken into account and we have communicated those obviously to HMRC and the Treasury, and we are hopeful of some amendments because, as I say, I think the definition is getting there but it still needs a bit of work to be really precisely targeted. At the moment there are some considerable uncertainties as to exactly where the boundary is and to really make sure it is focused on the provider. The elephant that everybody knows is in the room and can recognise but it is jolly difficult to define.

Q160 ***Chairman:*** If you were asked what amendment you would want, what is it?
Mr Whiting: I have drafted some amendments in another place.

Q161 ***Chairman:*** I am not asking you now but if you were able to send to us the sort of way you think it should proceed, that would be very helpful.
Mr Whiting: I would be pleased to do that, my Lord.

Q162 ***Lord Blackwell:*** Given that there are these uncertainties at the moment—and you have made representations and others have made representations—and undoubtedly it will not be right first time, how long do you think it will take before the definition, as it were, beds down and the companies have certainty about what this definition will mean?
Mr Whiting: I would hope that we get some certainty with this year's Finance Bill and some guidance around it for managed service companies. I think our concern is that that will not necessarily solve the whole problem because, as has been illustrated by our comments on previous questions, managed service companies may well be policed by these provisions and policed quite effectively, but an awful lot of companies are going out and are saying, "I am not a managed service company. I am potentially a personal service company," and whether IR35 will police them is a moot point.
Mr Kimmer: I agree. With a carefully worded contract they can get themselves out of IR35 as well, so they could be back into a genuine trading company, but you do need the right piece of paper with the right words on it and actually operate in accordance with those right words to be a genuine trading company and not an IR35 company.
Mr Whiting: Or at least create sufficient doubt so that you have a tenable position and then being realistic HMRC does not have the manpower to chase you down.
Chairman: This is just the moment to ask Lord Barnett to ask one of his usual questions!

Q163 ***Lord Barnett:*** Mr Kimmer, at the start you told the Chairman that you agreed that it would be much better if all the decisions could be taken by businesses on purely commercial grounds. Of course that is the Utopian situation that could never happen because even if you started that way you three would be in the business of offering them, perfectly properly, tax avoidance methods and there seems to be a difference between you. The Association refers to a "perceived" avoidance by MSCs whereas you in the Institute say that you "would acknowledge that some MSCs are responsible for significant underpayments of Pay As You Earn and National Insurance Contributions". When you say "some" MSCs, a lot or a small number, or what?
Mr Whiting: I could not you give you precise figures, my Lord, but we are certainly aware of situations where managed service companies have been responsible for actions that I think we would consider closer to fraud because—

Q164 ***Lord Barnett:*** Fraud?
Mr Whiting: Because of Phoenixism, in other words—

Q165 ***Lord Barnett:*** Not tax avoidance which is perfectly legal, you are talking about evasion?
Mr Whiting: Yes, evasion because of setting up a company and people just being moved on leaving a tax debt in the company but no assets or no individuals involved, and it is that managed situation that—

Q166 ***Lord Barnett:*** But they would not be your clients?
Mr Whiting: No, very definitely not, but one is aware that that is a practice that does occur, so certainly situations such as that are at the basis of comments such as you point to.

Q167 ***Lord Barnett:*** I am thinking more of the big issue which I would assume is avoidance.
Mr Whiting: Yes.

Q168 ***Lord Barnett:*** And when you say here there are some MSCs, you cannot give us any idea of—
Mr Cullinane: I do not think in all honesty we are very well equipped to give estimates. We obviously draw on the experience of our members, and comments such as those find quite wide echoes, but I do not think we are in a position to offer a scientific survey, as it were.

Q169 ***Lord Barnett:*** The big growth in MSCs; was it not done on the advice of people like yourselves perfectly properly and legally?
Mr Cullinane: I doubt it, to be honest.
Mr Whiting: There are a relatively small number of main MSC providers, between 10 and 20 organisations.

Q170 ***Lord Barnett:*** Ten and 20?
Mr Whiting: Yes.

Q171 ***Lord Barnett:*** Who are doing?
Mr Whiting: Many hundreds and many thousands of managed service companies, so we are talking about a large bulk—

Q172 ***Lord Barnett:*** These are large MSCs?
Mr Whiting: Yes, these are large managed service company providers.

Q173 ***Lord Barnett:*** Would they be mainly employees rather than self-employed?
Mr Whiting: No, I am talking about organisations who as part of their business, indeed, possibly their whole business, set up for the benefit of hundreds or thousands of individual companies that under this definition would count as managed service companies, quite possibly aimed at immigrants into the country, temporary workers, many in particular service sectors, and there is this relatively small number of organisations who do make a significant business of setting up these companies, where of course the individual just signs a piece of paper and really has no knowledge about what is going on, he or she just accepts that money will flow.
Lord Barnett: As we understand it, we are talking about hundreds of these companies being set up.

Q174 ***Chairman:*** Not hundreds of companies that are fraudulent, a few that are fraudulent but the bulk of them are operating legitimately but being tackled.
Mr Whiting: Yes, like so many things you have a bit of a continuum. There are some fraudulent or near fraudulent situations. The vast bulk are legitimate but are being used to avoid, fundamentally, employers' national insurance, which is the usual target.

Q175 ***Chairman:*** Can I pursue then that question and the concern about the transfer of the debt provisions when an MSC fails to pay the PAYE and NIC. The concept of having to pay someone else's tax is not something which should be entered upon lightly, I imagine, but do you think what is proposed is justified and realistic?
Mr Whiting: I think the basic proposal is justified and is realistic because otherwise it would be too easy for an MSC user to alienate him or herself from any wealth and possibly pass it to their spouse and say, "I have no money left to make this worth pursuing." It would be too easy to strip the value out of the company and say there is nothing to pursue yet the proprietor or the provider of the company has wealth, so as a principle I think it is unremarkable in the sense that it is a necessary part of the provisions. The concern is that it potentially goes very wide. We have concerns, for example, that could an ordinary employee of a company that provides these managed service companies—a secretary—be caught by these provisions? It could catch business partners, relatives, very remotely. It needs again to be properly targeted in terms of whoever is actively involved, which is an amendment which has been made, and proportionate to their involvement.

Q176 ***Chairman:*** How is that going to be settled? Is it going to be settled in the Finance Bill or is it going to be settled in Guidance Notes?
Mr Whiting: There is a certain amount in the Finance Bill but most of it is to be laid down in statutory instrument, and it is one of the problems, and it is very unfortunate, that although we have had initial consultation on this for the first draft of that statutory instrument, we are in a sense looking at only part of the package round this Bill because the revised proposals for this are probably not going to emerge until next month.

Q177 ***Chairman:*** 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?
Mr Whiting: Yes.

Q178 ***Chairman:*** The general principle is acceptable?
Mr Whiting: I think the general principle is acceptable but it would be much better to see the complete package rather than only part.
Chairman: Thank you very much. I wonder if we could move on to the question of the powers in the Bill and the safeguards. Lord Sheldon, I wonder if you would like to start on that one.

Q179 ***Lord Sheldon:*** How well has the consultative process in this whole area worked so far and how well is it progressing?
Mr Whiting: We had some initial concerns over the way this consultation started in that there seemed to be a steering group set up at HMRC's selection, but as things have evolved it has actually turned into a good process. There has been good consultation and a good flow of documents and dialogue, so I think this is one where we give pretty good marks for the consultation and the consultation that is continuing, so it is not all finished, there are further sections to come, but this has been a good and continues to be a good consultation.

Q180 ***Lord Sheldon:*** But the Taxes Management Act has been suspended for the time being?
Mr Whiting: The New Management Act? Indeed, that perhaps is a little unfortunate. It is one of those issues where I have to say that we support the result because we had severe reservations about the New Management Act and the way it was heading, but one would hope that the amount of work that has been put into it by bodies such as ours and of course by HMRC and the Treasury is not all going to be wasted because there was a lot of effort put in there even though we thought all along that the direction of travel was not correct.

Q181 ***Lord Vallance of Tummel:*** A figure of 2,000 HMRC officers authorised to exercise the criminal powers was mentioned in Committee of the Whole House and that appears to exclude the 4,500 working to protect the UK's borders. Are you content with this understanding of how the figures will pan out? In your written evidence you suggest that rules on the operation of powers should be contained in the legislation. Could you explain what you see as being written by way of rules in the legislation?
Mr Whiting: 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 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. We appreciate and understand that the decision has been taken that HMRC should have the criminal powers to pursue such things as MTIC (carousel fraud). Having got that far, then 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 assurance that it really is just that 2,000 or roughly 2,000 people? 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 that is not necessary, that the procedures exist, but we still feel that there is a need to give that reassurance that it is a procedure that is recognised as very significant and it really is a power only to be exercised by those in control and that there would be good report-backs on the exercise of those powers.

Q182 ***Lord Vallance of Tummel:*** Should they be exercised only by specific grades of seniority?
Mr Whiting: I do not think necessarily just grades, I think it is the training, because I could imagine that if, for example, you wanted to carry out a raid on a business premises for reasons of pursuing criminal fraud, you would not necessarily just want to take senior people, you would potentially have to take relatively junior people to do some of the work with you, so I do not think it is above a certain grade matter. I think it is down to proper training and proper supervision.
Mr Cullinane: HMRC see a difficulty in delineating grades in the law because then if they were to want to change their grading structure it is all ossified, so some sort of overall numerical limit is what we would prefer.

Q183 ***Lord Blackwell:*** You say that HMRC have argued that we do not need safeguards for the legislation because they have given various assurances. How do you think that these assurances can be monitored going forward? How can we be sure that HMRC is sticking to them?
Mr Whiting: I do think it should be a requirement 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 on the use of the powers because at one end of the spectrum if they are not used, you might say should they still be there; if they are being used it would be an important signal to Parliament of the areas that they are being used in and of course their effectiveness. So calling for how well this is being used and in what circumstances would, I think, be quite a good control information process.

Q184 ***Lord Barnett:*** The Institute tells us in your paper that you have had plenty of assurances from HMRC. How do you monitor those assurances as it goes on?
Mr Whiting: Well, that is very difficult, you are right, we have had assurances that we do not need to worry, that our concerns have been noted, for example the use of the criminal powers is subject to the same power I believe as the Chief Inspectorate of the Constabulary, who will also have a chance to look at HMRC's and it will all be looked at, but I suppose we do not see quite how we monitor those assurances on an on-going basis other than perhaps to come back here next year and say we have seen a problem.

Q185 ***Lord Barnett:*** A lot can happen in 12 months, we need to do something before that. It is the penalties that worry me, penalties that can fall on a taxpayer not because of anything he or she has done but because of the agent. Speaking for myself, my old firm do all my tax affairs and I do not look at it, I just pay the tax when I get a bill twice a year! So you are obviously worried about this issue of the agent leaving a taxpayer subject to serious penalties.
Mr Whiting: We have to be concerned about that. We would like to think that our members would never leave a taxpayer in the lurch, as it were, but it is a concern as to whether and to what extent the penalty regime—and we are moving away from the criminal penalties hopefully now into the general penalties—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.

Q186 ***Lord Barnett:*** Should a penalty fall on a taxpayer who has not deliberately set out to make an underpayment or made a mistake but it has happened inadvertently?
Mr Cullinane: The biggest area that we are concerned about in the penalties area is that there is some provision in the Bill, clause 96 and so on, for penalties to be due where HMRC thinks that the taxpayers or agents—

Q187 ***Lord Barnett:*** That word "thinks"!
Mr Cullinane: —have acted in a culpable way, and we believe that penalties should only depend on some objective test of culpability, so whereas HMRC might be reasonable in their belief that they have acted wrongly, on appeal they could demonstrate that they had not acted wrongly and then the penalty would not be due, whereas we are concerned that in the Bill a penalty could stick even in circumstances where a taxpayer has done nothing wrong because HMRC maybe quite reasonably think that they have—
Mr Whiting: Or possibly unreasonably. It seems far too subjective a measure to say that the penalties have to hang on—

Q188 ***Chairman:*** Have not the HMRC to some extent recognised that their original proposals were too subjective? Am I right?
Mr Whiting: The legislation still has "HMRC thinks" all through it.

Q189 ***Chairman:*** I think they have actually said in the Commons that they are going to remove the "think" from the legislation.
Mr Whiting: There was a suggestion in the Committee of the Whole House that that was the case.

Q190 ***Chairman:*** You would go along with that?
Mr Whiting: Very much so, because with respect.

Q191 ***Lord Barnett:*** I have not seen the word "think" in legislation before.
Mr Whiting: With respect, until we see the change, because we have been saying this for some time so forgive us, yes, we are aware of what was said in the Commons but we will continue to raise the issue and try and make it clear that it is something that bothers us quite significantly.

Q192 ***Chairman:*** Have you a view about suspended penalties?
Mr Whiting: Generally that it is a good idea because the thrust of these penalty rules is, I think, very commendable. It is a modernisation, it is to encourage partly owning up and coming clean and getting on the straight and narrow, it is to encourage good behaviour, it is to take away penalties for just a simple mistake which I think is a big step forward, and so as part of that to say, "All right, you made a mistake, you are a bit culpable because you are a bit sloppy with your records, but providing you cure your record-keeping you will not get a penalty, in other words we will suspend the penalty," I think is a very good way of doing it.

Q193 ***Lord Sheldon:*** In their submissions the CIOT offers some thoughts on introducing an informal dispute resolution process to deal with penalty appeals. Could you elaborate on that?
Mr Whiting: We particularly have in mind the unrepresented here through our Low Incomes Tax Reform Group which deals a lot with the unrepresented. The concern is that if a penalty is imposed on a taxpayer, particularly as I say for the unrepresented, it might seem too Big Brother-ish—how on earth do I challenge this? How can I challenge this at all?—and so to have with it the possibility of just asking for an informal review by another section within HMRC if only just to confirm that, "Yes, this has been properly gone through, I am sorry but this is the result," that would I think give quite a lot more confidence in the penalty regime. Of course there is still the possibility of challenge through appeal but we are trying to stop people having to go to appeal and we are trying to say that there is scope, particularly as I say for the unrepresented, to just get a sense check on penalties and get reassurance that they are not being badly treated by the regime.

Q194 ***Lord Sheldon:*** Do you think that protection is really sufficient to the taxpayer?
Mr Whiting: 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, and of course there is always the possibility that you may be represented and you may have an adviser who can explain. I think there are some good safeguards within this, however, one has to say that we are here of course talking and we have talked about criminal powers and we are talking about the general penalty regime, and just like certain blockbuster movies there is Part III just about to start, which is the safeguards, on which there is still some more work to be done.
Chairman: I wonder if we could move on now to the on-line filing.

Q195 ***Lord Vallance of Tummel:*** The policy objective of the measure on on-line services is to maximise customer take-up of on-line services offered by the HMRC so that it can provide a better and more cost-effective service for its customers. How far will those customers, whether individuals or businesses, find fulfilling their responsibilities on-line better and more cost-effective?
Mr Whiting: I think in simple terms if the business or individual can do their responsibilities on-line without incurring extra cost, then it has a lot to recommend it, so in other words if it fits with their existing systems then this is a good way forward because most things are being done electronically and therefore filing electronically has to be a good way forward. E-communication is sensible but to that end it would help enormously if not only were we able to file electronically but we were able to correspond electronically with HMRC and exchange emails with them and pursue enquiries electronically rather than filing electronically and then resorting to snail mail for pursuing a question.

Q196 ***Lord Vallance of Tummel:*** What do you think is the inhibitor there, if I could just follow that up, why can that not be done?
Mr Kimmer: At the present moment I think they are very concerned about the security aspect of it. That really is the answer we get when we raise the matter. I do correspond electronically with a number of people within HMRC on working together, but not on client tax affairs. It is the security angle as far as the clients' tax affairs that they are concerned about at the moment and I think it is still being looked at, because there is certainly from our side a wish to be able to communicate electronically.

Q197 ***Lord Vallance of Tummel:*** Does that mean that they are not concerned about the security of what is filed but are concerned about the correspondence?
Mr Cullinane: It is possible.
Mr Kimmer: Again that particular thing is going in through a specific route, through a gateway, and email basically just flows through the ether, so to speak.
Mr Cullinane: We are very positive about the use of on-line facilities but there are two areas of concern which get our hackles up from time to time. One is the element of compulsion, whenever that is hinted at, partly from the point of view of those taxpayers who may not be into that kind of thing or taxpayers whose particular circumstances mean that the provision on offer does not lend itself to being a very effective way for them. Also if it is voluntary then take-up is a good test of what HMRC are offering and whether they are putting their investment and their development in the right area. The other kind of concern is that computerisation may be seen, if you like, as a way of coping with the complexity of the system and not doing anything about it, the sentiment being "never mind, we can computerise everything and then it will be all right." However actually if you have a complex system drawing up the computer programmes and designing the gateways and ensuring the security is all the more complicated. So we are very positive about on-line facilities but we have those two areas of concern.

Q198 ***Lord Blackwell:*** Let me just ask you about the filing timescale. There have been concerns raised that 31 January is too tight a deadline but the other side of the coin is that it seems to be a longer filing period than other European countries have. How seriously do you take that concern?
Mr Whiting: We do take it seriously. We recognise that many other countries seem to file faster but, then again, their tax systems are so much simpler and the requirement is not to file precise figures based on, for example, partnership profits or trust profits or details from your employment, all of which takes a good deal of time to flow out in many cases, so we think our filing deadline is quite a realistic one as is borne out, if anything, by the number of people who still fail to make that deadline despite best efforts.

Q199 ***Chairman:*** I just wondered two things really. Firstly, do you think there are any safeguards needed before e-filing is made compulsory for businesses? Also there is a concern about PAYE documents for people who employ somebody but who could not remotely be thought to be a business and as to whether that should be electronically filed?
Mr Whiting: I suppose there are various safeguards. One has to say one wants to make sure HMRC's capacity is sufficient for everybody to file and that the systems are robust. There have been some signs that it has been a bit overloaded over the last few weeks as many employers have tried to file end-of-year data, with HMRC suggesting that some employers should instead of trying to file during normal working hours file at evenings and weekends. This does not send a good signal. The other side of it is making sure that everybody is in a position to file electronically, which echoes John's point that not everybody either is able to file electronically or would indeed want to file electronically because there will still be many, many small businesses in particular, who are going to want to file just under old-fashioned methods, I think, and so it has come back to us wanting the assurance that there will still be regard to the fact that many people

will still want old-fashioned methods and it should not be compulsory; it should be carrots rather than sticks.

Mr Kimmer: I think there is one other important point with this. If we are to file electronically there needs to be in place a system to cope with the time when the system falls down in January because inevitably it will, no matter how robust it appears to be, and at the moment there is no alternative in place. If the system breaks down and you cannot file by paper and you cannot file electronically, what are you going to do? I think that needs to be spelled out very clearly before any compulsion is put in place and there does not seem to be any flexibility in the Finance Bill provisions to give that scope.

Q200 ***Chairman:*** If I may say so, on a note of practical common sense, that is a good way to end this session. When you come before us we know that we are talking to people who actually know what they are talking about and that you have some real practical experience in dealing with it and to that extent we are particularly grateful to you for coming and helping us with our enquiries. Thank you very much indeed.

Mr Cullinane: Thank you.

MONDAY 14 MAY 2007

Present	Barnett, L	Vallance of Tummel, L
	Paul, L	Wakeham, L (Chairman)
	Sheldon, L	

Memorandum by the Association of Chartered Certified Accountants (ACCA)

1. The Business Tax Reform Package (in the Context of Simplification)

Clauses 1 and 2 rates of tax

There is some confusion as to when the various rates apply. The starting rate is to be abolished from 2007–08, the inheritance tax rate is set for 2010 in the 2007 budget, whereas technically-complex legislation comes into effect immediately and Clause 25 relating to managed service companies (see later) is retrospective.

The 22 per cent income tax rate is welcomed, as it is consistent with other years.

The starting rate is to be abolished for some sources of income, while personal allowances are increased. Would it not be better to have a substantial increase in personal allowances, to take poor people out of the tax system altogether?

Clause 3 small companies

The increase in the small companies' rate of corporation tax is regrettable. What business needs is consistency, encouragement and stability. The most vulnerable of enterprises have made long-term decisions based on the current rates.

It is unfortunate that the problems relating to the definition of associated companies have not been addressed.

Clause 35 withdrawal of ABAs and IBAs

The speed at which these allowances are being withdrawn is worrying.

Buildings are a long-term investment and businesses need certainty in order to arrange their finances.

The sudden withdrawal of the balancing adjustment and four year phased withdrawal of the annual allowances will impact extremely harshly on two vulnerable business sectors ie farming and industry.

Clause 36

The temporary increase in first year allowance for small enterprises is welcome.

2. Managed Service Companies

Clause 25 Sch 3

This legislation is retrospective and a blunt instrument, which places the onus on individuals who are not experts in the tax field. There are already sufficient safeguards in place to restrict abuse of this form of trading. The legislation has also led to potentially costly, unplanned and time consuming re-negotiation of contracts for both service providers and recipients.

The tax element is only part of the equation—the risk (financial and legal) borne by individuals who choose to adopt this company form should also be taken into account. The new legislation fails to recognise that these groups of people are taking risks being self-employed, without the relative security and "perks" that come with being an employee. This fact used to be acknowledged in the tax system. It is unfair for the Government to class these people as employees for tax purposes, but at the same time be aware that they will not be able to avail of usual employee benefits.

Para 61B is so widely drawn that a firm with a number of clients would be included. The fact that this has had to be clarified in the House of Commons is unsatisfactory and provides another element of uncertainty in an already overly complex system.

61B(1)(c) uses the expression "associates"; this expression is defined too widely and should only apply to companies which are clearly under the control of another party.

61B(1)(d)—There is a significant risk that this legislation will affect other companies e.g. special purpose companies, which it is not intended to cover. The interpretation of the Finance Bill here has caused unintended consequences.

3. Powers, Deterrents and Safeguards, Including On-line Filing

Clause 94 payment by cheque

Regulations are to be made by Statutory Instrument. While HMRC wishes to encourage payment by electronic transfer, it is important that taxpayers wishing to pay by cheque should be able to do so.

It is equally important that HMRC regulations allow sufficient time for cheques to clear.

Clause 96 Sch 24 penalties for errors

HMRC is seeking to extend its powers so that direct and indirect tax are brought within similar regimes. ACCA wants the assurances given in the Notes to be incorporated in the legislation.

The legislation mentions "where HMRC thinks" in several places. ACCA is uncomfortable with this wording and feels that this should be removed and section 95 of the Taxes Management Act 1970, which is tried and tested, should be retained.

Memorandum by the Institute of Chartered Accountants (ICAEW)

DETAILED COMMENTS ON THE FINANCE BILL

Business Tax Reform Package in the Context of Simplification

1. The business tax reform package consists of three main changes, namely:

   — changes to the corporation tax rates;

   — changes to the capital allowances rules; and

   — changes to the rules for R & D tax credits.

2. The reforms are designed (as per Budget Note BN02) to achieve three main objectives, namely enhancing the international competitiveness of the UK, encouraging growth through investment and innovation and ensuring fairness. Simplification was not mentioned as one of the objectives of the reforms, although simplification was mentioned in relation to the reforms of the capital allowances rules.

3. In terms of simplification, the package of reforms look unlikely to reduce the overall burdens placed on businesses, particularly in the short-term, for the following reasons:

   — the reduction of the headline rate will not take effect until 1 April 2008;

   — the current rates of corporation tax have been retained for oil extraction activities;

   — the small companies rate of corporation tax is being increased in 1 per cent increments for three years, starting on 1 April 2007, necessitating changes to calculations in each year; and

- the proposed abolition of industrial buildings allowances (IBAs) and agricultural buildings allowances (ABAs) should in theory simplify the current complex system of capital allowances. However, this is counterbalanced by other changes:
  - there is a lengthy transitional period as these allowances will not be phased out completely until after 2010–11;
  - a number of fundamental changes have been made to the long-established rules for plant and machinery, in particular the change to the rate of writing down allowances for plant and machinery, the change in the rate for expenditure on long-life assets and proposed new rules for integral fixtures; and
  - consultation is about to start on a proposed new annual investment allowance of £50,000 on plant and machinery.

4. Current tax policy appears to be aimed broadly at aligning the tax treatment of transactions with the commercial accounting treatment. We agree with that approach. The changes to the rules to plant and machinery were justified as aligning allowances with the economic rate of depreciation at 20 per cent. However, in respect of IBAs and ABAs, the proposals will have the opposite effect, and tax allowances and depreciation are likely to diverge.

5. We have not seen a regulatory impact assessment in relation to these measures but believe that they will have significant financial implications for businesses in the relevant sectors in terms of their investment decisions.

6. We welcome the measures to improve the attractiveness of the R & D tax credits regime, particularly in relation to SMEs. However, some recent ICAEW research appears to suggest that the scheme is not as effective as it could be in encouraging companies to invest in R & D. We suspect that part of the reasons for this is the complexity of the rules and the inherent uncertainty at the time the claim is made that the investment will qualify for R & D tax credits relief. In order to improve certainty and thus encourage take-up, we think that there is a need to develop a pre-approval process.

Managed Service Companies (Clause 25 and Schedule 3)

7. We support the underlying principle of the legislation in relation to Managed Service Companies. However, we remain concerned that some of the detailed definitions need to be more closely targeted, in particular the definition of "accountancy services". The provisions will introduce further complexity into what is already a very complex area of tax, with the result that overall compliance costs for businesses will increase.

8. Looking at the wider picture, we remain concerned that the MSC provisions are just the latest example (the changes to the small companies rate of corporation tax and the IR 35 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.

9. The major structural difficulty is the taxation of small businesses and, in particular, the difference between the tax (and NIC) treatment of employment vs self employment and incorporated vs unincorporated business structures. Many of these structural differences have existed for a long time, in particular the differences between income received by way of dividends rather than remuneration. However, changes to the tax systems in recent years have tended to widen the differences in treatment, resulting in considerable complexity in the tax system but which have also expanded the opportunities for tax planning.

10. One result is that many formerly unincorporated businesses now operate through a corporate structure, potentially lowering the tax and NIC charges. Changes taken in this Budget, in particular the increase in the small companies rate of corporation tax, will go some way to addressing these issues but the structural problems remain. We understand the continued concern of the Government (see paragraph 5.114 of the Budget Red Book) about "tax-motivated" incorporation but such comments merely increase uncertainty for business. There is a need to re-energise the small business review and seek more long-term solutions to the on-going issues that arise due to the differing tax treatment of business income and entities.

REVIEW OF POWERS, DETERRENTS AND SAFEGUARDS

11. Generally we are concerned that some of these proposals will add further burdens on taxpayers.

Criminal investigations (clauses 81 to 86)

12. In relation to criminal investigations, 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. It is vital that HMRC make clear publicly the circumstances in which the powers of arrest will be used. In its response to the January 2007 consultation document, HMRC said that it is developing guidance and that "this will be published as soon as possible and before any changes come into force". We attach great importance to this statement. 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 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.

Mandatory filing of electronic returns (clause 92)

13. Clause 92 makes further provision for the mandatory filing of tax returns by extending the existing provision in section 135 FA 2002 to include all taxes and duties for which HMRC are responsible. In other words the power to specify mandatory electronic filing of returns is extended to VAT and Duties formerly handled by HM Customs & Excise. Clause 93 extends a similar power for mandatory electronic payment from large employers to cover all taxes under the care of HMRC.

14. At this juncture we remain opposed to the principle of compulsion, and think that such an approach undermines the encouragement of e-business generally. We support measures to encourage electronic filing and payment, but our support is based on the belief that electronic business should in the long run be more efficient for taxpayers and thus result in lower costs and improve productivity rather than because it is more convenient for HMRC. Business has moved to electronic solutions for reasons of reduced costs and greater flexibility, not because they were told to on pain of financial penalties.

15. We believe HMRC should concentrate on improving its electronic services, because our experience is that HMRC's electronic systems are still not sufficiently robust for taxpayers to use them with complete confidence. It is ironic that the Finance Bill contains further measures for compulsory electronic filing, but taxpayers still cannot contact HMRC using email, the de facto industry standard for business to business communication. Improved electronic services and the ability to email HMRC would be positive developments that will encourage take-up of electronic services.

16. In relation to business, according to the regulatory impact assessment published at the time of the Budget, HMRC estimates that up to 250,000 businesses will be required to obtain access to the internet. With an internet subscription costing about £10 per month, or £120 per year, the total costs to business if they had to go electronic under these provisions would be around £30 million. In reality, many businesses are moving over to electronic solutions and using email and internet access, but the key point is that they are making the move for business reasons, not because they are being forced to use electronic services.

17. More generally, we remain concerned that certain groups of taxpayers, particularly the elderly and those who have no IT literacy, are unlikely to be able to file electronically, and we think it is unrealistic to expect them to, for example, queue up in a library to submit a tax return electronically.

Penalties for Errors, (Clause 96|Schedule 24)

18. This clause introduces a new regime for charging penalties for incorrect tax returns and is a product of the ongoing HMRC Review of Powers. It will apply to returns for income tax, CGT, corporation tax, PAYE and CIS deductions, NICs and VAT, though it is expected that in future the model will be extended to other parts of the tax and tax credits system. Penalties for other aspects of tax administration, eg late filing, are the subject of separate reviews. Taxpayer behaviour is the key to the new penalty regime, and the way in which behaviour is understood and categorised by both HMRC and taxpayers will be crucial to the effective operation of the system, particularly with regard to the important principle that innocent error should not be penalised. However, we are concerned that detailed rules will be in HMRC published guidance and not in law, and will not therefore be subject to Parliamentary oversight.

19. The penalty per centages are higher than those which are charged in many cases under the current system, which allows mitigation at HMRC discretion. 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.

20. In relation to the drafting, we are concerned at the use of the phrase "HMRC think". The Explanatory Notes to the Schedule suggest this is little more than the use of modern language, but we disagree. "HMRC think" does not suggest that HMRC are using their best judgement or taking a reasonable approach. We believe the use of this word is not helpful and will merely lead to confusion and court cases to determine its true meaning. It should instead be replaced where it occurs with a construction such as "HMRC is satisfied" or "HMRC reasonably believes".

April 2007

Examination of Witnesses

Witnesses: Mr Chas Roy-Chowdhury, Head of Taxation, Association of Chartered and Certified Accountants and, Mr Frank Haskew, Head of the Tax Faculty, the Institute of Chartered Accountants for England and Wales, examined.

Q201 ***Chairman:*** You have already been reduced by two. That is a very good start.
Mr Roy-Chowdhury: It was a full house giving evidence!

Q202 ***Chairman:*** That is likely to speed up the meeting. First of all, you are both extremely welcome. I have a suspicion you have been here before on more than one occasion.
Mr Roy-Chowdhury: Yes.

Q203 ***Chairman:*** We are very grateful to you for coming to help us. You know broadly how we proceed. We have had a fair number of evidence sessions so far, and we have got a couple more to go, but your contribution will be extremely valuable to us.
Mr Haskew: Thank you.

Q204 ***Chairman:*** Do you want to say anything before we start, otherwise we will just deal with the questions on the three topics?
Mr Haskew: No, I think we are happy to take your Lordships' questions.

Q205 ***Chairman:*** If we start with questions on the business tax package. Our starting point was the Economic and Fiscal Strategy Report which reminds us that the Budget of 2007 in the Government's view represents a simplification of the underlying tax structure, together with the £300 million reduction in administrative burdens. We start our questions on testing that. The first question is really straightforward: to what extent do you think the business tax reform package delivers the "simplification of the underlying tax structure" as claimed in the Government's report?
Mr Roy-Chowdhury: If I could just say a couple of things in preamble. Certainly I do not think there is anything in the Finance Bill taken as a whole that is about simplification. The business tax package specifically does not do anything very much for simplification. We still have a 19 per cent rate for ring-fenced corporation tax profits for oil businesses, as well as the 30 per cent rate. We are introducing a 20 per cent rate of corporation tax, to go up to 22 per cent, for small companies, and a 28 per cent rate of corporation tax in 2008. There is nothing there which seems to be simplifying anything very much. Okay, we are dispensing with Industrial Buildings Allowances by 2011 but overall the package is purely about complexity and steady as we go in terms of tax complexity. There is very little there which seems to be simplifying anything as far as I can see.
Mr Haskew: I would entirely endorse what Chas has just said. Just picking up on the IBAs and ABAs point, we have quite a lengthy transitional period there, the allowances will not be phased out until 2010–11. There are also a lot of changes to the plant and machinery rules where it is effectively a complete rewriting of all the rules. We also have this new Annual Investment Allowance of £50,000 a year. 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.
Mr Roy-Chowdhury: Can I just come back on one other point. It is all very well talking about simplification and reducing complexity but the clear message, certainly from the small companies' point of view, is that the measures seem to create a rollercoaster ride for small companies in terms of knowing where they stand. In 1997 we had a 20 per cent rate of corporation tax for small companies, that

went down to 19 per cent, the zero per cent bracket was introduced a few years later, that was then effectively withdrawn a couple of years after that and we now have a situation where the 19 per cent has gone up to 20 per cent, the 20 per cent is going up to 22 per cent and companies do not know where they stand. Added to that, we have the writing down allowance for the first year allowance for small companies fluctuating from year to year at the whim of government depending on where they feel the economics of more investment in plant and machinery is. There seems to be little acknowledgement about the long-term planning requirements of businesses. Also, those small companies, or large companies, that have invested in industrial buildings are now going to be stripped from having those allowances and it is a long-term investment in such acquisitions and, again, there seems to be no commercial understanding behind that.

Q206 ***Lord Vallance of Tummel:*** What about the reduction in the administrative burden on business? Are you equally sceptical about the progress that has been made by HMRC on that front?
Mr Haskew: There are a number of areas in which HMRC are looking to reduce the burdens. We have the Admin Burdens Board and they are working through a number of particular topics there to try and reduce the burdens. In principle we welcome those sorts of measures and we welcome HMRC's and the Government's commitment to simplification and reducing business costs, but there is a general view that a lot of the things they are talking about there 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. To an extent some of it is fairly illusory because it has only been introduced in recent years. I think particularly of things like Form 42 where that has now been taken away for 90 per cent of companies but really it was never a problem in the past for companies until three or four years ago.
Mr Roy-Chowdhury: I fully endorse what Frank says, but I do think HMRC are not in control over their destiny when it comes to reducing the admin burden in respect of tax simplification, clearly it is down to government policy and changes in the legislation. When we have such fundamental changes which happen year on year, whether they are called simplification this year or tax avoidance measures next year or something else the year after, they add to the burden and I do not see there is any real concerted effort on the part of the Government to reduce the administrative burden of the tax system on businesses.

Q207 ***Lord Paul:*** "The 2006 Review of Links with Large Business ... made proposals aimed at delivering a modern, responsive tax administration". Do you have a view on the extent to which HMRC's plan published on Budget Day will achieve this?
Mr Haskew: All the recommendations that the Varney Review have made are things that 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 for this Varney Review project. There are a lot of deliverables in there. We are right behind HMRC in trying to achieve them 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. There is good stuff in there and we are right behind it, but we are not necessarily convinced that HMRC have the resources to put into it to do it and deliver it.
Mr Roy-Chowdhury: The Varney Review and the HMRC approach to large businesses is all about reducing the grit in the system, as they call it, the unnecessary burdens that businesses have. I think the real big areas need to be addressed in terms of the ongoing onslaught of new and complex legislation and unless the fundamental reason why the administration for tax occurs is addressed then the rest of the concerted effort by HMRC, which has to be applauded, and we very much support it, is not going to be effective. The goalposts are always moving, they are not under the control of HMRC, the goalposts are being moved by government, so while HMRC may be trying to hit the ball in one direction the goalposts have already moved elsewhere in terms of legislation that HMRC are trying to simplify the administration for.

Q208 ***Lord Paul:*** Are you really saying that the intention is there but they have not got the ability to achieve that, or is it that the intention is not there?
Mr Roy-Chowdhury: The intention is there but because we have tax policy being decided within the Treasury, the administration being dealt with by HMRC, without a greater ability by HMRC to control the legislation with all the best intentions in the world they will not be able to deliver a streamlined, more efficient, less burdensome tax system.
Chairman: Can I just follow that up because it is absolutely fundamental. It seems to me that a lot of what you say, perfectly legitimately, is that if you continually change the tax system it is very hard to argue that you are actually simplifying it. On the other hand, if we want a tax system which is fit for

purpose, and here is the CBI today in a statement which indicates that they do not think it is fit for purpose, there are going to have to be some changes. I do not know whether you can indicate the way you think they should be going. If you were the Government what would you be telling the Inland Revenue to do?

Q209 ***Lord Paul:*** What would be the suggestions A, B and C that would make it work?
Mr Roy-Chowdhury: I think the CBI is right, the tax system is highly complex, there is a plethora of rates, a plethora of anti-avoidance measures, and the uncertainty of the impact of certain parts of the legislation is not welcome. 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. We need to try and take the politics out of tax as much as possible. ACCA in the past has suggested the idea of a tax policy committee, a bit like the Monetary Policy Committee of the Bank of England, which would perhaps look at the tax system from a much more impartial non-political standpoint. Yes, I think we need a steady state but there are an awful lot of things in the system which probably need to be sorted out before that steady state can come about.

Q210 ***Lord Sheldon:*** My question is to deal with the changes in the capital allowances for this year as well as next year. Could they have been tackled in a different way and, if so, how?
Mr Haskew: I am not sure when you say "tackled" differently. Ultimately, capital allowances are a policy question for government. It would be fair to say that the changes that were announced in the Budget were a complete and utter surprise to businesses in the UK. There has been a reform of corporation tax ongoing for some time and the review of capital allowances was one thing that was mentioned in there. Almost to a man, everybody who responded to that consultation said that capital allowances achieve a certain purpose and we do not particularly want to see them changed, and that was two or three years ago, but suddenly out of the blue we have a complete reversal of capital allowances rules that go back 60 years. Businesses are sitting here and thinking "We should have been consulted on these changes. They are fundamental to business investment" and, as Chas said, they are going to change the basis upon which investment decisions were made. There needs to be more open and transparent consultation on these sorts of changes. It does not sit very well with HMRC in the Varney report talking about consultation with interested parties on virtually everything. On the one hand you have HMRC wanting to consult with business and, on the other hand, it seems we have tax policy formation upon which there is no consultation whatsoever. With the best will in the world we need to have consultation on key business policy decisions. We cannot have it with HMRC on the one hand and not with HM Treasury on the other.
Mr Roy-Chowdhury: The way that the change in the capital allowance regime was announced was not at all welcomed, by which I mean the Industrial Buildings Allowance regime. They are long-term planned investments. What Government was after was trying to fund the drop in the headline rate of corporation tax and that is fine, we should have lower rates of corporation tax just to encourage inward investment, but in terms of the global corporation tax landscape the UK is certainly out of line from where it was several years ago. What we should have had was much greater consultation about the capital allowances regime being fundamentally changed. Buildings are going up with glass fronts where the businesses constructing those buildings expect to get writing down allowances on those worth millions of pounds, but suddenly those allowances are going out the window. That is an example of where the changes are impacting. 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. I think Trevor Evans in his day, we remember when he was trying to simplify the corporation tax system there was consultation on capital allowances and it came across very clearly from businesses that they did not want the capital allowances regime to change or for capital allowances to be reduced, which is basically what has happened quite drastically.

Q211 ***Lord Sheldon:*** When I asked whether it should have been tackled differently, what you are saying is there should have been more consultation, is that right?
Mr Haskew: Ultimately these decisions are a policy question for government to decide. Government has committed to greater consultation. This was clearly one of the key business changes that we had seen. We think it is absolutely essential that there is proper consultation on these sorts of measures beforehand. It is essential that it is managed properly otherwise all we see is that business is not able to plan to make investment decisions and we really do not think that is in the interests of UK plc.

Q212 ***Lord Sheldon:*** So your answer really is consultation, nothing else?
Mr Roy-Chowdhury: Certainly, from our point of view it is not just consultation but also where you raise business taxation and you are cutting the headline rate of corporation tax but overall you are raising taxes by something like £2.8 billion over three years, you need to be very careful and transparent that you are doing that rather than trying to say, "We

are dropping the rate of corporation tax" but the reality is you are increasing tax overall for businesses and also raising the rate of corporation tax for small companies. I do not think the messages going out are very good for UK plc when people external to the UK can see that businesses taxes are going up. Whether that is a government policy decision or not, there needs to be consultation but also greater commercial awareness of where its decisions are taking the UK.
Mr Haskew: I remember the days when Trevor was looking at these issues. There should be proper studies and transparency as to how the capital allowances regime works, how it benefits business, the pros and cons of having strategy depreciation versus capital allowances etc. There are a number of things one could have done. Other countries have statutory rules for set deprecation percentages for certain types of assets or we could just take the accounts and take the depreciation. There are things that one could do but it would probably need some detailed study and information sharing between both sides before one could come up with a more informed decision.

Q213 ***Lord Barnett:*** Looking at your papers there seems to be some slight difference between you about the time for the introduction of the capital allowances which clearly is a central complexity and area of the simplification. In the Institute paper you say that there is a lengthy transition which seems to worry you, whereas, on the other hand, in the Association's paper the speed at which these allowances are being withdrawn worries you. Is this a difference between you?
Mr Roy-Chowdhury: From our point of view, the reduction in the Agricultural Buildings Allowances and Industrial Buildings Allowances where basically over four years they will have been withdrawn, that is where our concern is. Going back to where we started from, where businesses have made long-term investments in such assets, to suddenly have those allowances withdrawn within four years is going totally counter to their rationale for investing in those assets. That is where we are coming from.
Mr Haskew: I do not think that is any different from what we are saying. The transitional period is over the withdrawal of the Agricultural Buildings Allowances and the Industrial Buildings Allowances. Balancing allowances and charges have been withdrawn with effect from Budget Day but the allowances are going to be reduced to effectively zero over a four year period, so, if you like, there was the sudden change, which was the change on Budget Day for balancing allowances and charges, but if you keep that building the allowances will continue for four years over a reducing basis and then stop after four years. It is probably the result of two separate things going on, if that answers your question.

Q214 ***Lord Barnett:*** You also said that you welcome the aligning of allowances with an economic rate of depreciation at 20 per cent. Is not one of the problems there that not all plant would be depreciated at 20 per cent, some would be at 10 per cent, and some even more? Companies and their auditors will vary, surely, in the economic rate of depreciation.
Mr Haskew: That is not quite what we said. We said that in principle we think that aligning the tax charge with depreciation in overall terms is a not unreasonable approach but what we said was that the changes to the rules on plant and machinery were justified as aligning the allowances with the economic rate of depreciation. We were not commenting on that. We then went on to say that in respect of IBAs and ABAs they would start diverging again. Going back to the question, it is not an unreasonable approach to have plant and machinery allowances which are based on, or very similar to, commercial depreciation. That gives you effectively the same amount of taxation. Capital allowances are set figure but tax deprecation will vary with the accounting treatment. As you say, over 10 years it could be a straight line, it could be a reducing balance, the two generally do not necessarily match.
Mr Roy-Chowdhury: I think it is a difficult one because when inflation was at a high level the capital allowance rate was not considered to be adequate and now inflation is relatively low then it is considered to be quite reasonable. The big picture behind this is the government can say it is reducing the level of capital allowances to the economic depreciation of an asset but, as Frank has already said, different assets depreciate at different levels. The reality is that these assets are a long-term investment generally speaking and for the government just to wade in and reduce the rate is not the right way to do business, to help business and to get new businesses to come into the UK.

Q215 ***Chairman:*** Just before we finish on the business package, there are just a couple of questions which are not totally related. On the question of the research and development tax credits, do you think these will stimulate further research and development?
Mr Haskew: Our view is that they probably will not. The ICAEW has been undertaking some research in relation to research and development. Certainly at the bottom end our view is it probably will not. Obviously if one gets the allowances it is all well and good but there is too much uncertainty surrounding getting them. One has to remember particularly at the smaller end it is quite difficult for small companies to fund research and development, it requires a lot of money and you generally have to write it off in accounting terms immediately.

Q216 ***Chairman:*** So the expenditure might be incurred anyway?
Mr Haskew: Yes.

Q217 ***Chairman:*** Can I just ask the second part of it. Do you want to add anything to what you said about small businesses in the tax package?
Mr Roy-Chowdhury: In terms of R&D just briefly. I think Frank just alluded to it, that one of the problems in terms of small businesses, which the R&D credit is directed at, is it that 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.
Chairman: If we move on to the managed service companies and Lord Vallance might like to start us off on some of the questions there.

Q218 ***Lord Vallance of Tummel:*** Before IR35, what was effectively employment income could be retained in a company or paid out as a dividend. If there were not any tax advantage in that there would be no problem, but various commentators, including yourselves, have made the point the point that the ways of addressing exploitation of that tax advantage are merely sticking plaster. Is there a more radical approach that might have been adopted to address that one fundamental issue?
Mr Haskew: Sticking plaster is obviously the word on the street in relation to managed service companies. It is a reflection of a problem that is deep-rooted in the UK tax system which has been around for a long, long time. If you go back 20 years, we had things like investment income surcharge and apportionment of income in close companies and, over time, with very little evidence of a strategic policy objective, we have moved to a completely different system which does encourage incorporation where you can pay out dividends, without NIC obviously. We have moved from a situation where once upon a time having companies was generally not tax efficient to a situation now where it has become very tax efficient. It is a deep-rooted problem, I do not think anybody would say there is a panacea. There was a Small Business Review back in 2003 which seems to have gone nowhere at the moment and we need to get back to that. There are things that probably could be done. We could go back, for instance, to apportionment or we could say there are different rules for one man companies or if you have employees you have different treatment, but each of those will have consequences for different sorts of taxpayers. There is no one-size-fits-all necessarily. It does require a concerted effort and consideration of it from all parties. We could go back to apportionment, say, that would be one possible way of doing it. To conclude, there are things that could be done. The problem is deep-seated and deep-rooted and requires very careful consideration.
Mr Roy-Chowdhury: One of the fundamental points about managed service companies is that the legislation is retrospective, it is a blunt instrument and does not seem to take account of the fact where individuals are operating in a self-employed capacity and the risks and rewards that they should be entitled to enjoy. It seems to be a one-size-fits-all silver bullet approach to whether people should be treated as employees or where the government considers they are employees they should be taxed in the same way, but it 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. Also, as we will probably come on to later, parts of the legislation are pretty raw in the form that we have seen it, so all round we need to consider this. Also, because this legislation does not come into effect until January next year, why not sit back and consider some of this, consult more widely and then think of implementing this in the next Finance Bill.

Q219 ***Lord Paul:*** The ACCA seems to have quite fundamental objections to the new provisions. Would you like to expand on that?
Mr Roy-Chowdhury: Some of the areas where I say that I think legislation is raw and ill-formed is, for example, in Schedule 3 61B(3) where we are talking about basically an exclusion for accountants but there is no definition of who accountants are. I think some of us in the room who are accountants would hope to be excluded if we are dealing with managed service companies but it is not clearly defined. Also, further on in the legislation there is another get-out for accountants but, again, no clear definition. What we would like to see is that legislation does not actually come in this form to the House where we have been told by HMRC that a question will be tabled in the House for which there will be a ministerial answer, therefore the answer in terms of what an accountant is will be recorded in *Hansard*. It does not seem to be the right way of proceeding in enacting primary legislation, it should be much more considered and well-formed in the first place. It is areas like that that we have great concerns about in terms of the managed service companies' legislation.

Q220 ***Lord Sheldon:*** Operating the existing IR35 legislation is by contract by contract and the MSC legislation takes a different approach. There are concerns about this. Could you deal with this matter?
Mr Haskew: It does indeed take a very different approach. We are slightly more sanguine about the MSC legislation than Chas but we share his concerns

about accountancy services. There are discussions going on now so I think we will be able to resolve it. The government has clearly had great difficulty getting to the root of attacking Managed Service Companies. In December there was some draft legislation trying to attack Managed Service Companies. We have seen that completely rewritten and now we have the latest provisions. It is a moving target, trying to catch Managed Service Companies. In principle, we support the government in trying to tackle Managed Service Companies but the fact that we are already on the second draft of the legislation and we have IR35 shows you what a difficult area we are into. It is quite difficult to see how it is going to work in practice and whether HMRC will have the necessary resources to police it properly. They have not, we feel, been very successful in policing IR35 on a contract by contract basis so they may have more success here but they are up against some very aggressive Managed Service Company providers. At the moment, it is difficult to see how this legislation is going to pan out. It is certainly frightening people and if that is getting rid of some of the more aggressive Managed Service Company providers that is probably having the desired effect. There is a whole raft of other people who could be caught here, people possibly in the accountancy definition, so there is a penumbra of uncertainty. We need to make sure we have the targets identified and that those are the people the government goes after. We certainly need to nail those people down but as to whether it is going to work the jury is probably still out on that.

Mr Roy-Chowdhury: What we would not like to see is this legislation being enacted and then being revisited next year, the year after and the year after that. As we saw when the new capital gains tax rules came in a few years ago, year after year they were modified. We would like to see this legislation going in in a way that is workable and targeted. If people who are employees are not being taxed as employees, it is unfair to everybody else. This legislation however, has a risk of catching those who are genuinely self-employed and that is where there is significant danger and also with the get outs, the accountancy exemptions. They are not formulated in the legislation and they should be there rather than relying on *Hansard*.

Q221 ***Lord Barnett:*** The Institute in its paper says that you support the underlying principle of the legislation, although you have some problem with some parts of it. The Association says that it is retrospective and a blunt instrument. I do not know whether the Association are saying that they do not support even the principle of the legislation.

Mr Roy-Chowdhury: We have no time for those who are employees being taxed as if they were self-employed. We are concerned about the retrospection where we have a commercial set-up already in place which is being attacked. Where people are genuinely self-employed, they need to be treated as self-employed. Otherwise it takes away the business incentive for those people if they are being taxed as employees. That is where we have concerns that the impact of this legislation is not focused. It has a scatter gun effect in lots of ways.

Q222 ***Lord Barnett:*** I am not clear. Do you recognise that IR35 did not stop very substantial tax and national insurance avoidance?

Mr Haskew: At the time when IR35 was introduced, the government estimates if I remember rightly that it was hoping to raise £900 million, getting on for a billion pounds, from IR35. We have never seen any statistical evidence that I am aware of supporting that figure and our view is that it probably has not been successful in raising very much money. There is a question mark over whether IR35 has succeeded.

Q223 ***Chairman:*** Is there not at the heart of this a much more fundamental question which goes back to the sticking plaster? I wonder why people are not saying to the government, "Why should the form of corporate structure or self-employed and so on alter the tax arrangements? Why should you have to fiddle about with doing it this way or that to pay the proper rate of tax?" It is because there is a very substantial difference as to which way you do it. Why are not people saying to the government, "Surely if we get these two things much nearer into line the problem would gradually lessen"? It is gong to be there for some time but is that not the problem? There are the two different rates of tax. You have to add national insurance and in practical terms most people I know consider it to be as much a tax as anything else in reality.

Mr Roy-Chowdhury: That is right. The main driver as far as the government is concerned is that they want the employee level of national insurance and the open ended employers' national insurance contributions. That is probably the main driver behind trying to put as many people as possible under PAYE effectively. In terms of aligning the system for those who are employed or self-employed, unless the government is willing to allow deduction rights for individuals for things like travel expenses for going to work, which they do in some countries, which means there is a lot of revenue at stake and a lot of Exchequer loss, that is where the problem is. National insurance is so different if you are self-employed to if you are an employee and that is the main driver behind trying to squeeze so many people into the employee camp as possible.

Q224 ***Lord Vallance of Tummel:*** If the recent sharp increase in the number of incorporations is a result of workers reverting to offering their services through personal services companies, but the underlying relationship between the end client and worker is still that of employer and employee, are HMRC going to have resource difficulties in policing the IR35 legislation which would apply in such a situation? In other words, is it a *locus* problem and, if that is the case, does it not suggest that the new legislation is simply not going to be effective?

Mr Haskew: The jury is out on this as to whether HMRC will be able effectively to police this. It is debatable as to whether they have managed to succeed in IR35. With the Managed Service Companies the potential target is obviously much less because IR35 is contract by contract and this is very much looking at the provider. It should be easier to police but there is a danger that it will not be policed effectively. As a result of that, it is debatable as to whether the legislation will be effective. If it is properly policed it will be effective but it depends on that. Our view at the moment is that we support the principle of the legislation and we support what the government is going to do, although we have a real question about the sticking plaster and the whole business/self-employed environment. Whether it will work is a debatable question.

Mr Roy-Chowdhury: I do not think HMRC has the resources to police IR35 or the Managed Service Company legislation that is proposed. Clearly under the self-assessment regime that we have in the UK and with generally pretty compliant taxpayers, it will be down to the taxpayers themselves who are going to suffer the burden of trying to work their way through the legislation to see if they are caught. While HMRC probably will not be able to do a lot in terms of tracking down people who do not comply, people out there will be pulling their hair out to see if they are within this or not or to get out of the situation where they are. As we were talking about for companies, it is just raising the burden even more in terms of compliance for businesses and individuals.

Q225 ***Lord Paul:*** Are there sufficient safeguards for companies which are carrying on genuine businesses and which should not get caught up with these provisions? Do you see any danger of their doing so?

Mr Roy-Chowdhury: I do not think there are. If we look at schedule three, section 68(a) to (c) it is very widely drawn. The legislation seems to be bringing into the net a lot of people who could be directly or indirectly involved. It is just the way the drafting is. It is there to try and capture every nook and cranny. For example, in the second line of (c) where it says "facilitated or otherwise", we have suggested that it should be "facilitated and be actively involved" so that perhaps reduces some of the impact. The legislation itself is extremely widely drawn. We would recommend to the government that they consult a little longer and defer this legislation until next year. They could put businesses on notice that this legislation is coming in and may be effective from whatever date they want before the Finance Bill next year. Let us get the legislation in place, properly drafted, rather than going through this which will need amendments or questions being asked and then reported in *Hansard.*

Mr Haskew: The government tabled an amendment on Friday, much along the lines of what Chas said. The government is clearly listening to concerns about this area but there is obviously a lot of residual concern that the target is still too wide and we still need quite a bit of further work to get this legislation working in a way that does not catch too many people.

Q226 ***Lord Sheldon:*** There are concerns about the transfer of debt provisions when the MSC fails to pay the PAYE tax and NICs. The concept of someone having to pay another person's tax liability should be followed only if it is absolutely necessary. Do you accept that it is absolutely necessary in this case?

Mr Haskew: We have to recognise that the government is trying to stop some very aggressive MSC service providers here who are operating right at the extreme edges of the law. For those sorts of people, they know what they are doing. If they are adopting very aggressive structures, where they shut them down before any tax liability is paid and effectively walk away, that is clearly something that needs to be addressed. It is probably appropriate for the debt transfer provisions to work for those sorts of people but that is entirely different to then taking it to somebody who potentially is a much more innocent third party or somebody who may not have had any knowledge of it. We have no problem with the principle for the people who are using MSCs in a very aggressive way, where they know exactly what they are doing, but again it comes back to not being properly targeted. We must not then have those provisions extended to people who did not have any prior knowledge of those provisions or who did not know that there was tax and NIC being avoided. It is essential that those people are insulated, if you like, from the debt transfer laws.

Mr Roy-Chowdhury: I agree. We need to make sure we do not have a situation where third parties who are totally innocent, who were not hand in glove operating to try and create this tax evasion, are protected. They are purely innocent third parties and they should not be in anyway caught up in having to foot the bill for other people.

Q227 ***Lord Sheldon:*** It is difficult to know whether they are hand in glove, is it not?
Mr Roy-Chowdhury: It is. I agree with Frank that people who are colluding should be held to account. I think it is very difficult and I am concerned about such a provision. We need to see how this pans out when it comes into effect. It may need further consideration and perhaps the provision needs to be withdrawn.

Q228 ***Lord Barnett:*** I see again from the papers that you have submitted that there is a worry about various ways in which this could work. I wonder if you could spell it out a little more clearly? I take it you both accept there should be penalties but would you for the moment prefer to see this stopped altogether until more consultation is able to clarify the situation?
Mr Haskew: From our viewpoint, we have some concerns with some of the proposals but, by and large, we are reasonably content with most of these provisions. There has been a long consultation process in relation to the review of powers et cetera, and a lot of concerns have come out of that process, but there is a view that we need to be a bit more public about some of that consultation. Our view is that in principle what is in the schedule is a reasonable way forward. In broad terms we welcome most of it but the devil will be in how HMRC will apply the guidance in practice, the tests of negligence, concealment et cetera. Will HMRC's judgment be quite different to that of the man on the Clapham omnibus? We will have to work through all the detail once these provisions are enacted but in principle we support them. There is also the point that so far the review has not really concentrated on safeguards for taxpayers. It seems to be very much about HMRC's powers. There is a need to counter the latest provisions with a clear commitment to, say, a taxpayers' charter or bill of rights, which we feel the government is dragging its feet on, but it is something that is essential.
Mr Roy-Chowdhury: I sit on the HMRC Powers Committee. My view in addressing the committee was that we should only have penalties where people have genuinely gone out of their way not to pay the right amount of tax. Mistakes because of the highly complex tax system that we operate under or errors should not be penalised by penalties. Whether we have that balance right or not I am not sure. We need to see how this legislation settles in but it was always very important that we had a system of appeal against any imposition of such penalties, which is here. We need to monitor and keep an open mind about how the new penalty regime operates. There might be a situation where more people might be subject to penalties. Hopefully that will not be the case. We need to be careful about that. Overall, under the new regime, people who make innocent mistakes or errors should not be given penalties which currently they may be. Hopefully we are moving away from that side of things, which I think is good. We probably just need to give it time to see how it settles in.

Q229 ***Lord Barnett:*** A number of our witnesses, including the Association, have expressed concern about the phrase "the Revenue thinking". I suppose it is understandable. You do not have an alternative word? You simply want to see it deleted and stick with section 95 of the Taxes Management Act?
Mr Roy-Chowdhury: That is right. We have said to the Revenue in the Powers Committee meeting, "Does it not mean that where the Revenue thinks that basically the taxpayer cannot appeal against the imposition of a penalty or something else they do not agree with?" The Revenue's view is no; it very much means that they can appeal but we are not happy with the use of such terms. The law should not stand still but it does seem not to be the right way of writing the legislation, HMRC thinks. We need to be much more concise in using tried and tested terms.

Q230 ***Chairman:*** Let me be quite concise in asking this next question: HMRC is going to be given criminal investigation powers similar to the Serious Organised Crime Office and you have expressed some concerns about that. I wonder if you would like to elaborate on that?
Mr Haskew: We do have an over-arching concern. First of all, we would hope that none of our members are involved in these sorts of activities. There is a concern that serious, organised, crime should be dealt with by specialists in serious, organised, crime and that is SOCA. That is the place where it should be. We have seen the *Bond House* case and in a lot of VAT cases quite frankly they have been mismanaged by what used to be Customs and Excise. There is not a good track record in handling these sorts of serious crime cases. We have an over-arching concern as to whether HMRC is an appropriate body to have these powers, given that SOCA is there for that very purpose. Subject to that though, from what we have heard from attending HMRC's open day, only a certain number of HMRC staff will have the provisions. They will receive special training and there will be some over-arching scrutiny of these provisions. If we are going to have them, HMRC are probably going about it in a reasonable way to keep checks and balances, because at the end of the day they are very serious provisions.

Q231 ***Lord Vallance of Tummel:*** How would you envisage the forward monitoring of the various assurances that have been given concerning the operation of these provisions, things like the training of officers who use the powers, how they are being exercised in practice, the delineation between civil and criminal powers and so on?
Mr Haskew: Our view is that some sort of independent scrutiny is probably the right way forward. Given things like human rights provisions and given that HMRC probably is not the appropriate body for some of these powers anyway, we do feel that there needs to be clear, independent scrutiny of these provisions and the way they are operated and that it should be operated on a regular basis, probably with a yearly report. There should be some independent element to it.

Q232 ***Lord Vallance of Tummel:*** Have you any idea what sort of independent body that should be?
Mr Haskew: One would not want to set up another quango necessarily but it should probably be a new body.
Mr Roy-Chowdhury: I do not think the National Audit Office would do the job or some existing body. It probably needs to be separate and fairly streamlined so it can report back pretty quickly on how these powers are operating. Going back one step, the reason why HMRC wanted these criminal powers was because they felt that the police did not have the technical knowledge to deal with some tax investigations. In the committee I sit on, they felt they very much needed these powers to be effective in prosecuting criminal activity. While we have quite a lot of concerns, we do accept some of the reasons given. We do need to monitor exactly how these powers then operate to ensure that they are not overstepping the mark. Given some of the examples Frank has mentioned in the past in terms of some of the prosecutions that are taking place, we need to be very sure that the taxpayer is not unfairly treated.

Q233 ***Lord Sheldon:*** In the Police and Criminal Evidence Act there is a separate schedule applying to Scotland. Should we not have common procedures throughout the United Kingdom?
Mr Roy-Chowdhury: I cannot give you a proper answer but my understanding is that the law as it operates in Scotland is slightly different from England and Wales and hence why we need slightly different provisions. You probably need to speak to somebody from Scotland or HMRC to find out.
Mr Haskew: I agree with what Chas has said. I do not think it is appropriate for us to comment.

Q234 ***Lord Barnett:*** On the question of online filing, I take it you cannot seriously disagree with the need for an element of compulsion? Otherwise, if it was purely voluntary, it would be a waste of time.
Mr Roy-Chowdhury: It is very difficult for some people to file online. There is always going to be the person on the street who is IT illiterate. Regardless of the penalty regime underlying mandatory filing requirements, they will not do it. It seems there is something fundamentally unfair, if somebody has sent in paper information which covers everything that the Revenue wants from them and is required by legislation in terms of what is required from them to comply with the tax system, but they have done it on paper rather than sending it electronically, and they are penalised. While we very much support moving towards the use of electronic means to file tax returns, payments, et cetera, we are just concerned about those who are not able to comply. If they still send in all the information that is required correctly, on time and they are fined, it seems there is something which is not quite right. I draw to your attention that, for example, today we have problems about PAYE filing over the Internet where the Revenue systems have not been operating effectively recently. While mandatory filing is fine in principle, the underlying integrity of the systems which are trying to facilitate the filing does not always work effectively in any case.
Mr Haskew: I would wholly endorse what Chas says. I am afraid we do object to compulsion in relation to e-filing. We have already made our position quite clear. We support the move to e-filing. We are right behind that drive but it has to be business led. It is absolutely essential that these decisions are taken because it makes life easier for business and for taxpayers and reduces costs. But I do not think we are in that position at the moment. We are quite a long way from it. As Chas said, 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 and 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 business and taxpayers will be to use them. You may then have 90 per cent and you will have to decide what to do with the 10 per cent but we are not at that position at the moment.

Q235 ***Chairman:*** It is the intention, as I understand it, for somebody with just one employee, maybe a domestic, to be treated as if they are a business and therefore they have to do it electronically. Is that what is proposed? If it is mandatory, that is what will happen.

Mr Haskew: That is what will happen, yes. Our view is that it is a long way down the track. We should not be concentrating on trying to compel people at this stage. We should be concentrating on designing good, robust systems that are reliable, that work and that taxpayers want them . They will then naturally gravitate to use them.

Q236 ***Lord Vallance of Tummel:*** The Association has put in a plea for cheques still being allowed. We have been told that the definition of an electronic payment does include payment by cheque at a bank using the bank giro method. How far does that allay your concerns?

Mr Roy-Chowdhury: If that is the case, we are happy to hear that but we want to make sure that does stay the situation today as well as in the future because clearly a lot of people would be uncomfortable using any other means than to pay by cheque.

Q237 ***Chairman:*** We have covered a lot of ground in a relatively short time but, as usual, you are very good at answering our questions and we are very grateful to you for coming along and helping us. I think we will draw stumps there. Thank you very much indeed.

Mr Roy-Chowdhury: Thank you for hearing us.

WEDNESDAY 16 MAY 2007

Present	Barnett, L	Sheldon, L
	Paul, L	Wakeham, L (Chairman)

Memorandum by the Federation of Small Businesses (FSB)

Introduction

The Federation of Small Businesses (FSB) is the UK's leading non-party political lobbying group for UK small businesses existing to promote and protect the interests of all who own and/or manage their own businesses. With over 200,000 members, the FSB is also the largest organisation representing small sized businesses in the UK.

This written evidence provides the FSB's views on the sections of the Finance Bill 2007 that have been identified by the House of Lords Sub-Committee to focus on for examination:

- the business tax reform package (in the context of simplification);
- managed service companies; and
- powers, deterrents and safeguards/Part 6 of the Bill (including on-line filing).

As the House of Lords Sub-Committee's remit enables it to consider technical aspects of the Finance Bill 2007 from the point of view of tax administration, clarification and simplification, rather than rate or incidence of tax, this submission lays out the FSB's views on the chosen sections and provides a more general comment on the tax system in conclusion.

The Business Tax Reform Package

Budget 2007 announced significant reforms of the business tax system. The package has three main elements:

- changes in the rate of onshore and small companies' corporation tax,
- changes to the capital allowances regime governed by Parts 2, 3 and 4 of the Capital Allowances Act 2001; and
- increases in the levels of enhanced deductions available to companies in respect of their qualifying expenditure on research and development.

We will comment on each element in turn.

Corporation Tax Rates

Repeated changes to Corporation Tax (CT) in the Finance Bill 2007 herald yet another set of tax changes for small businesses to cope with. This is the sixth such change made by the Chancellor since 1997.

In Budget 2005, the Chancellor brought in the 10 per cent rate of corporation tax and businesses were encouraged to incorporate through more advantageous tax arrangements. In Budget 2006, this was reversed and businesses were encouraged to unincorporate, which is far, far harder to do. Businesses should choose the legal entity that is most appropriate to their business needs, not be forced into choosing one for tax reasons or for political whim.

Ever more changes to the tax system reduces the resources available for the business and, inevitably in small businesses, it is the owner/manager who is diverted from productive work into unproductive time spent on administrative changes. The FSB knows from our own survey work that this takes on average seven hours per week for your typical small business to cope with. The alternative is to contract this out which adds a cost to the business—which has an equally depressing effect on enterprise and profitability.

The administrative impact of the change in CT, including the calculation of marginal relief, is going to be felt most by those doing the calculations for tax—primarily the accountants hired by the small business or the business owner themselves, if they do not contract this out.

Marginal relief calculation

Turning to changes in the fraction with which marginal relief is calculated, this is yet another change for small businesses to cope with. The FSB does not have off-the-shelf data about members' profits. This is often quite difficult data to obtain as members are reluctant to divulge what is seen as confidential information. Given the window in which to prepare for this inquiry, we were unable to carry out a survey to obtain this information. However, we do have robust data on sales turnover and have used this to test the changes to marginal relief.

Just over 10 per cent of the FSB's members have sales turnover of between £500,000 and £1 million, therefore this band are most likely to qualify for marginal relief on profits once costs are taken into account.

The proposed change in the marginal relief for this group makes a differentiation between non-ring fenced profits and ring fence profits. Ring fence profits are defined as profits from oil extraction and oil rights in the UK and the UK Continental Shelf. All other profits are non-ring fence. None of the FSB's members are involved in oil extraction and oil rights in the UK and the UK Continental Shelf, therefore ring fence profits would not apply. There are, however, members who are involved in the oil industry at a secondary level, ie small businesses in Aberdeen.

For companies with non-ring fence profits, the change in the fraction used to calculate marginal relief will result in an increase in tax liability. The Finance Bill 2007's own Explanatory Notes for Clause 3 demonstrate that a company with non-ring fence profits of £500,000 using the new marginal relief fraction of 1/40 will have tax payable of £125,000. A company with ring-fence profits of £500,000, using the old marginal relief fraction of 11/400, which used to apply to all companies in between the lower and upper profits limits, would have tax payable of £122,500. This change in the fraction used to calculate marginal relief not only complicates the tax system further, it provides a disincentive for small businesses to grow into larger ones.

In the FSB, two-thirds of our members have sales turnover of £250,000 or less. These are the businesses that have the potential to grow larger and qualify for marginal rate relief. If we extrapolate the FSB's membership data to the UK's four million small businesses as a whole, this equates to 2.68 million small businesses being discouraged from growing because of the higher tax burden due to the changes in the fraction used to calculate marginal relief. This seems at odd with the Chancellor's stated intention of not putting a brake on the UK's developing enterprise economy.

Capital Allowances

The changes made to the capital allowances regime again reflects the lack of understanding of small business needs. If small businesses are investing in buildings it is more likely to be over a 25 year period. If they are investing in plant and machinery it is more likely a minimum of three years, often five years, hence depreciation terms. Businesses do not make investment decisions based primarily on the tax regime in place at the time; they are based instead on the needs of the business.

Given the withdrawal of the existing First Year Allowances (FYAs) without firm details about the new annual investment allowance until the consultation is complete, it will be exceedingly difficult for any small business to plan ahead. Small businesses need stability and an environment where at least medium term investment decisions can be made, not constant change. This is evident in the 2006 Lifting the Barriers Survey of our members which showed that 51 per cent of members were dissatisfied with the rate of change of legislation and 53 per cent were dissatisfied with the volume of legislation.

Annual investment allowance

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. This appears to be aimed at the "gazelle" industries, with high-growth, which represent only seven per cent of the UK's four million small businesses. There is also concern that this emphasis will be a passing fashion and may well change next year or in two years time. This constant change undermines the stable investment platform that businesses committed to the market place must have if they are to survive and grow.

As stated above, the FSB does not have off-the-shelf data about members' profits, given the window in which to prepare for this inquiry. However, we have again used our data on sales turnover to test the assumptions of the annual investment allowance set at the £50,000 level and the cut off points at £300,000 and £1.5 million.

The FSB is concerned about the assumptions in the Budget that may lie behind the nature of small businesses and their expenditure.

As a proportion of their likely turnover:

- £50,000 will be at the least 16 per cent of a businesses' turnover at the £300,000 level.
- 40 per cent of members' turnover is under £100,000, therefore investing £50,000 would represent 50 per cent year on year investment.
- Two-thirds of our members' turnover is up to £250,000, therefore investing £50,000 would represent 20 per cent year on year investment.
- 90 per cent of our members have turnover that is up to £1 million, therefore investing £50,000 would represent 5 per cent year on year investment.

Investment at this level of any kind is most unlikely. Please note that this is before any costs are taken into account or any tax is paid. Therefore, the picture is even starker once this has been taken into consideration. It is also hard to imagine what a typical small business could spend £50,000 on each and every year to balance this out.

Research and Development Tax Credits

In terms of the administration of R&D tax credits, a recent FSB survey found that 65 per cent of respondents were not aware of them. Of the third who had taken R&D tax credits up, the administration was felt to be over-burdensome.

This tax credit is also limited to incorporated businesses; therefore the tax structure discriminates against some types of small business for investment purposes.

Managed Service Companies

The FSB's membership database is delineated by sector of work and does not specify whether that work is obtained through an MSC. Due to time constraints, the FSB has not been able to carry out a survey of our members which enables us to tell the Committee the exact number of MSCs that the FSB represents. However, a high number of our members work in contracted fields and it is likely that this proposed legislation will affect them.

The FSB is more than happy to collect further data on MSCs, should the Committee wish us to do so, however, we would need at least one month to produce robust enough data to be influential.

The FSB welcomes this measure because it should clarify what a MSCs is. However, 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.

New Criminal Investigation Powers and Measures

One third of small businesses are home based (either in part or whole) and therefore the administration of the criminal investigation powers in relation to rights of entry should be weighed against what is appropriate for those circumstances for entry into the home. The FSB's Lifting the Barriers 2006 report found that over a third of small businesses are operated from the home, therefore, HM Revenue and Customs (HMRC) needs to ensure that these powers are used with due care so that families and children are not affected.

The clarification that these powers will apply cross-border is to be welcomed.

HMRC Review of Powers, Deterrents and Safeguards: Penalties for Incorrect Returns

The FSB has supported the work done on penalty regimes by the Macrory review; in particular the proposed change in approach away from the undue emphasis on the use of criminal sanctions, where errors are inadvertent rather than wilful. The FSB would encourage the reflection of the Macrory principles in the penalty regime in this context.

Changes to the Income Tax and Corporation Tax Enquiry Windows, The Existing Powers to Require Online Filing and Electronic Payment, and the Effective Date of Payment by Cheque

Enquiry window

Any shortening of the enquiry window that HMRC has to respond should make things simpler and easier for businesses that are faced with this situation. Too often, the window has been open for too long and there has been no decision on the part of HMRC and there is a disproportionate effect on small businesses.

On-line filing

While the FSB is supportive of the efficiency saving resulting from greater use of on-line filing, it is important to stress that a significant minority of small businesses will continue to use paper-based systems until the requirement for on-line filing becomes mandatory and they must be catered for.

Electronic filing window

In terms of the changes proposed to the payment dates in line with the requirements for electronic filing, HMRC needs to communicate these clearly and effectively, particularly to small businesses and their professional advisors, about the deadlines and the financial implications for missing them.

Conclusion

What small businesses want, above all, is simplification and stability. The tax legislation needs to be:

— clear and specific;

— properly evaluated prior to implementation to avoid unintended consequences; and

— easy for employers to comply with and to administer.

The taxation of small businesses needs to be modernised and simplified. There are concerns about the apparent lack of progress in this area of work and the FSB would like to re-emphasise the importance of this work.

There is a concern that the Treasury and HMRC have a lack of understanding of small businesses, both in terms of their needs and how they operate, which is evident in the Finance Bill 2007. The latest change to small business corporation tax is an example of how the Treasury does not fully comprehend how constant change disproportionately affects small businesses. The alterations to the capital allowances system, the proposed annual investment allowance and R&D tax credits demonstrate how policies are designed for a handful of firms, rather than the majority. This knowledge gap needs to be tackled.

In terms of powers, deterrents and safeguards that the Finance Bill 2007 brings in, the clarification of investigatory powers is to be welcomed, however, caution must be urged whilst administering those powers through rights of entry which may disproportionately affect small businesses. As noted above, over one third of small businesses are run from home. The FSB encourages changes to the penalty regime for incorrect returns which are more in line with the Macrory principles.

In regards to electronic filing, HMRC needs to clearly and effectively communicate changes in payment deadlines to small businesses.

On a more general note, lack of proper consultation remains a problem. Over the last 12 months a number of proposals have been put forward by the Government without prior consultation with the business community. The most notable problem was caused by the acceptance of the Carter Report's proposals. The Government's U-turn on this created further uncertainty for the business community, which could easily have been avoided through proper consultation.

In administering the tax system, the move towards using call centres and closing local tax offices has been detrimental for small businesses' relationship with HMRC and more work needs to be done to improve this situation. Too often, the person at the call centre does not have sufficient information about the business to inform or advise the business correctly, and the caller needs to speak to several advisors about relatively simple queries. The loss of local knowledge is also detrimental to any compliance work, as local experience is lost and replaced by relatively blunt national risk-assessment criteria.

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The closure of local offices has also led to a worsening of relations between tax payers and the tax authorities, and the reduction in frontline staff has led to the service deteriorating. An example of this is HMRC's refusal to give receipts when tax returns are filed manually at local tax offices. The FSB strongly believes that this should form a part of HMRC's customer services and that this service should be re-introduced, in order to give businesses proof that their tax return has been received.

15 May 2007

Memorandum by the British Chambers of Commerce

Business Tax Package

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. The £50,000 annual allowance, starting next year, is unlikely to have a big impact—this allowance is said to partially offset the rise in the small companies tax rate but fails to take into account the dominance of the service sector in the UK. The economy is changing as are the types of small businesses that are starting-up and growing so we are not convinced that this new allowance for investment in plant and machinery will not be fully utilised by the majority of small businesses or indeed is the best way to target help. There needs to be a more focussed or tailored allowance which applies to all small business who have been unfairly hit with the tax rise. BCC members were polled post budget and found 69 per cent of businesses believe taxes should be streamlined so that taxes are lower overall with the current system of tax allowances and exemptions abolished.

Simplification of the tax regime must not undermine certainty for the business community. The phasing out of the Industrial Building Allowance is effectively retrospective taxation and potentially implies that all capital investment decisions taken in the last 20 years are somewhat hypothetical since the taxation treatment on which they were based is now being retrospectively changed. BCC would like to see the IBA retained, as far as possible, for existing buildings within the regime. Broadly speaking only new transactions/building should have been affected. Most building leases are long-term ie 25 years thus phasing out the allowance will have a detrimental financial impact upon those affected.

Managed Service Companies

The BCC are disappointed at the rise in small companies tax rate. Closing a loophole, which was initially created by Government incentives, penalises the small business community unnecessarily. We do not understand why the Government chose to use a blunt instrument impacting all small business rather than focussing their resources on targeting those who are using Managed-Service Companies as a front for tax avoidance. The Government should act now and not increase the small companies tax rate any further—the rise to 20 per cent is significant enough.

Review of HMRC Powers, Deterrents and Safeguards

The BCC is keeping a close eye on developments of the penalty regime and revenue powers—BCC is unhappy with the wording "HMRC thinks . . ." within their powers as this suggests HMRC can take action without confirmed evidence. Furthermore in light of the increasing powers of HMRC and to ensure a counter-balance is achieved, the BCC suggested a Taxpayer's Charter should be introduced.It is also very regrettable that HMRC will increasingly require business to file and pay tax bills online. BCC believe there should be a choice as to how to file—online or offline but most importantly payment online should not be forced through as not all employers have confidence in HMRC systems.

16 May 2007

Examination of Witnesses

Witnesses: MR MIKE CHERRY, Chairman of Financial Affairs Committee (National), Federation of Small Businesses; MR DAVID FROST, Director General, and MR PAUL BOWES, Tax Specialist, British Chambers of Commerce, examined.

Q238 ***Chairman:*** Good afternoon. Thank you very much for coming along and helping us with our inquiry. I think some of us are old hands at this and for some, I guess, it might be new. I am told to say to everybody when we start, please speak up and speak slowly so we get an accurate report of what you say. We have got a series of questions, and you know broadly the areas we want to cover. Does anybody want to make an opening statement before we start with the questions or can we get straight on with the questions?
Mr Cherry: My Lord Chairman, I would like to make a very brief opening statement, if I may, on behalf of the Federation. I would like to firstly thank the Committee for inviting the Federation here today. For too long our relationship, both with HMT and HMRC, has not been as close as we would have liked and we see this opportunity as a start to enable us to put forward concerns of the small business sector in order to promote a far better understanding of this vital sector of our economy.

Q239 ***Chairman:*** Thank you very much. We have got some questions on the business tax package, on managed service companies and review of powers, deterrents and safeguards and I wonder if we could start with the third area, the review of powers, deterrents and safeguards. If I may start the questioning by asking you, most of the legislation in Part 6 of the Bill is concerned with powers and penalties. Are there sufficient safeguards for the ordinary taxpayer?
Mr Bowes: I will start.

Q240 ***Chairman:*** Whoever likes to answer, or if all of you would like to answer, we are happy with that.
Mr Bowes: I think there is a major concern within the business community that the powers of the Revenue generally have increased as a result of the merger between Customs and Excise and the Inland Revenue and there is a fear of the increased powers of the Inland Revenue part of the HMRC. The reaction in the business community is one of dread a little bit, I think, because of the wide range of powers that Customs and Excise had. That is maybe a broad reaction in terms of the powers. The concern is that those powers are exercised in a proportionate manner. One of the things that we have put forward at British Chambers is something that has been widely discussed within the tax profession, which is a Taxpayer's 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. One would hope in most situations that things are amicably dealt with, and in general they are, but at the edges there are definite concerns where you have got a very large department that you are dealing with, a combined department, and there is a feeling that you are dealing with a very large entity and the accessibility, the ability to be able to discuss things generally with the Revenue in terms of going through to a call centre, for example, which is manned by people who are, generally speaking, unable to answer questions whereas years ago people would be able to expect to speak to somebody directly within the Revenue who may be able to at least assist with your questions. There is that element that is of concern to the business community.

Q241 ***Chairman:*** Let me press you a bit. A Taxpayer's Charter, it is a thought but has anybody had a go at drafting what should be included in that?
Mr Bowes: I think there plenty of drafts around the world. I think in the States, 43 states—

Q242 ***Chairman:*** But you have not drafted one?
Mr Bowes: —have got a Taxpayer's Charter.

Q243 ***Chairman:*** You have not drafted one?
Mr Bowes: No, we have not drafted one, but the OECD has got a model.

Q244 ***Lord Barnett:*** Could I put my question to Mike Cherry. The FSB say that they want to see the Macrory principles reflected in the penalty regime. I wonder if you could be more specific whether there are any pieces or amendments to the legislation that you would like to see.
Mr Cherry: I have to say, my Lord, that Macrory is not my field of expertise. I would be happy to field some more evidence for the Committee in that respect. We would endorse the findings of Macrory in as much as we do believe that there should be a lighter touch, particularly for those businesses that either do not understand or certainly do not mean to fall foul of the legislation in force. Again, I think it does come back to what Paul has been saying to some extent on how the Revenue behaves with the business community and this does vary far too much at the moment in our opinion. A lighter touch, particularly for those businesses which do not understand or cannot work with the current legislation rather than those who will not, is one of the main points of view that we would be seeking to have addressed.

Q245 ***Lord Barnett:*** I am not clear. You say in your paper that you support the work done by the Macrory review and you go on to say that you "would encourage the reflection of the Macrory principles in the penalty regime in this context." Can it be done through literal legislation and amendments to it or are you talking about the flexibility that should be given to the HMRC?
Mr Cherry: As I said in my opening statement to your question, my Lord, I do not have the expertise in that but my suspicion, and I will get you further evidence of this, would be that it will be in the discretion applied by HMRC rather than in legislation.

Q246 ***Lord Sheldon:*** There are three categories of behaviour where inaccuracies lead to penalties of one kind or another. They are careless, on the one hand, deliberate but not concealed and then deliberate and concealed. What are your views on the penalties for these categories?
Mr Bowes: I think it is helpful that the penalties are set out in legislation, which is a good development. Of course, it is difficult always, nevertheless, to categorise between careless, deliberate but not concealed and deliberate and concealed. My concern with this legislation generally, if I can make a broad comment, is that at the introduction and, in fact, in two other places, I believe, the words "HMRC think that . . . " and under statement of somebody's liability to tax—

Q247 ***Chairman:*** I think you have actually won the battle. I think the Government has already said they are going to change the legislation on that one, so that is a bull's-eye for you.
Mr Bowes: I was not aware. Anyway, on the rest of it the concern would be that these terms are applied in a proportionate manner. I guess that the guidelines and regulations that will follow from all of this will give some more indication as to how they will apply. One other point I would make is that appeals are to be made to the general commissioners and the reality is the general commissioners are not lawyers and they can only really judge the facts of the situation, in my view they are not people who necessarily are experts in a particular area of taxation and, therefore, I think you should be able to appeal to the special commissioners who do have the expertise because all of this area is very, very subjective.

Q248 ***Lord Paul:*** The basic question that I have is that there are rights of appeal, as you know, in the Finance Bill. Are you happy that they give sufficient protection to the taxpayer?
Mr Bowes: In the Finance Bill is there protection for the taxpayer?

Q249 ***Lord Paul:*** In the Finance Bill it mentions the various appeal rights.
Mr Bowes: Yes.

Q250 ***Lord Paul:*** In your view do they give sufficient protection to the taxpayer?
Mr Bowes: They do not to the extent that you cannot make an appeal to the special commissioners. Other than that I think they would appear to be reasonable, that there is the ability to make appeals. As I say, generally the idea of setting it out clearly, and I think this is fairly clear although these are very general terms being used, and the way they are put into practice, we will see what actually happens as to how it will work.

Q251 ***Lord Paul:*** The main question which I have to ask is you raised the concern that they are not being heard by experts.
Mr Bowes: Yes.

Q252 ***Lord Paul:*** But, on the other hand, you are saying otherwise the rights of appeals are okay. Is that your answer?
Mr Bowes: I do not know. Until one has seen in practice the degree—

Q253 ***Lord Paul:*** At the moment you have no opinion on that?
Mr Bowes: I do have an opinion; the opinion is we will have to see how it works in practice.

Q254 ***Lord Paul:*** There are some others who have pointed out that the tribunals have the power to give comfort but only to the extent that HMRC is prepared to do so. What is your opinion on that?
Mr Bowes: I am sorry?

Q255 ***Lord Paul:*** The help which a tribunal can give on appeal is only what HMRC is prepared to do and other people have concerns about that. Are you comfortable or do you have the same concern that it should not be limited to that?
Mr Bowes: Sorry, does this refer to one of the questions you have posed?

Q256 ***Lord Paul:*** It is the rights of appeal and what comfort you can get from them.
Mr Bowes: I am not sure—

Q257 ***Chairman:*** Not to worry. If you have not got an answer, let us leave that. If you would like to follow that up with a letter afterward that would be the easiest way. There is a general concern that a number of people have put to us and I wonder what your view is. Others are concerned that the detailed rules will be published in guidance rather than in the legislation. This is an aspect that certainly worries

some of the people who have given us evidence and I wonder whether that is something that concerns you.
Mr Bowes: Yes is the answer because if too much is put in guidance form the problem is in front of a court of law guidance is not law. That is one of the great problems, that if there is loads of guidance the degree to which the legislation is actually being followed is questionable, the degree to which the legislation is actually operating in practice. Whether the taxpayer is actually given the correct rights under that legislation will be more open to doubt if one is relying on pure guidance.
Chairman: Absolutely.

Q258 ***Lord Barnett:*** My question, again, will be to the FSB. You have concerns around exercising these powers against businesses which operate from home, for example where you have a lot of small businesses nowadays which operate from home to save costs. Would you like to expand on that and whether there are any specific amendments to the legislation you would like to see?
Mr Cherry: I would like to make the point that this would apply particularly where the business is in a family home and you have young children around. By just allowing a magistrate to sign off an order without having proportional discretion in some way being used, it would very much depend on how those powers were used at the time of entry to the property. I can envisage that there would be areas, particularly where the family was going to school or something like that, where you would get a disproportionate entrance to the property causing problems to the family and to the taxpayer in particular. It is almost as if those in particular working from home could be accused of disproportionate tax issues and the right proportion of entry not being taken into account.

Q259 ***Chairman:*** As we understand the legislation these searches will not be allowed without a search warrant given by a magistrate or a judge. Is that of any comfort to you?
Mr Cherry: To be honest, my Lord, it is not because it depends how execution of that is carried out in practice and that is our concern when it involves a family home.

Q260 ***Chairman:*** Yes, but you cannot do it unless a judge has said there is evidence for the warrant.
Mr Cherry: Indeed, but again it is how it is effected on the ground when it actually takes place.

Q261 ***Lord Sheldon:*** The policy about online services is to maximise customer take-up of the services offered by HMRC. That is really to provide a cost-effective service for its customers. Is not an element of compulsion essential if we are going to make progress here?
Mr Cherry: I think this is one of the areas we are still very concerned about, my Lord, and that is you have definitely got businesses that are still not filing online because they do not necessarily have the right technology to do so. Where you use an accountant or other professional to do it they are already doing that, and that is working very well indeed, but to force somebody to do something which they may not need in their business seems to be a disproportionate way forward.

Q262 ***Lord Sheldon:*** It is not really essential?
Mr Cherry: I feel that there ought to be an allowance where the business does not need to have online access to enable them to continue to run the business in the way they wish to do so. The majority of businesses certainly are IT technology enabled and would see the benefit of filing online, there is no doubt about that, but for those who do not for one reason or another compulsion would seem to me to be the wrong way forward.

Q263 ***Lord Paul:*** I have a lot of sympathy for what you say but it looks like in order to reduce costs this electronic filing is almost essential. What kinds of other safeguards do you think might help in order to achieve that?
Mr Cherry: I think "essential" is different from "compulsion", my Lord, and that is the distinct difference I am trying to make.
Mr Frost: From our point of view we can see the real driver to introduce online filing. If we are going to invest in the capital equipment to do that at some stage then clearly you would want every business to be filing online. I think we will see a rapid take-up—I know there has been a bit of a dip—as businesses become e-enabled. Therefore, at some stage in the future it may be a position of compulsion but certainly not at the moment, it is far too early.

Q264 ***Chairman:*** One of the things we have been told is that mandatory electronic payments will include payments by cheque at a bank using the bank giro method. Is that some comfort to some people?
Mr Bowes: Yes, I think that is right, it is a comfort rather than having to make a payment on the Internet. Where there have been a great deal of problems with banks generally and customer information there is a concern that by paying online it might not be secure.

Q265 ***Chairman:*** The central point which I think Mr Frost made is maybe it is possible to envisage in the future but at the moment there is not any enthusiasm for it being compulsory at the present time.
Mr Frost: No indeed, my Lord.

Q266 ***Chairman:*** Let us move on now with some questions on the business tax package. The Government has said to us and in their Budget review and so on that their intention is to simplify the underlying tax structure. I wonder how you feel that what they have proposed so far meets their objective of simplifying the tax structure.
Mr Frost: We do not think that it does. We do not believe that the introduction of capital allowance, together with the changes on the main rate and the small firms' rate of corporation tax, ultimately leads to simplification. We think the £50,000 annual allowance which starts next year is unlikely to have a big impact, particularly because of the changing nature of business that we see, increasingly a service sector based economy, a move away from manufacturing, and therefore we think there will not be a considerable number of companies who are going to be able to take advantage of the £50,000 annual allowance. The other issue relating to the changes in the main rate and the small firms' rate of corporation tax is the evidence we have from our small companies is that they feel, rightly or wrongly, the increase they will be paying is being used to fund the cut of the large firms' rate of corporation tax and that does not send out a positive message.

Q267 ***Lord Barnett:*** In your paper you say that: "Simplification of the tax regime must not undermine certainty . . . " I do not know whether that means you would rather not bother with any simplification at all.
Mr Frost: We did a survey of our members immediately post the Budget and we found that 69 per cent of our business members believe that taxes should be streamlined so that taxes are lower overall with the current system of tax allowances and exemptions being abolished. Clearly the view from the small business community is that they want much greater simplicity and streamlining.

Q268 ***Lord Barnett:*** Can I take it that you are not happy with the whole idea of what, if anything, the HMRC is doing to reduce the administrative burdens on business?
Mr Bowes: At this stage it is difficult to comment because we are at an early stage. There are objectives that have been set for HMRC to reduce the burdens of administration and they have only just started on that. They have credited to themselves helping the construction industry. Also, simplifying the pension regime has produced administrative advantages. 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.

Q269 ***Lord Barnett:*** If you are going to have any capital allowances, for example, it is bound to be more complex than if you did not have any at all, if you just had a straight tax regime.
Mr Bowes: You could have a system, for example, whereby all plant and machinery qualified for a certain writing down allowance.

Q270 ***Lord Barnett:*** You mean on a commercial depreciation basis?
Mr Bowes: Yes. What is going to happen is that we are going to have a number of rates of capital allowances. We will be facing a capital allowance write-down of 20 per cent, which is a reduction from 25 per cent writing down allowance, generally on plant and machinery. We are also having introduced a system for fixtures which will be consulted upon shortly and is going to introduce a capital allowance write-down of 10 per cent. That is actually introducing complexity in the system where there was not complexity before. Obviously there is complexity to the extent that one wishes to know what a fixture is, and that was always an issue, but the fact is you have now introduced a different rate so you have made that element of complexity greater, this is the concern. Basically business wants to see a straightforward system. The other concern, if I can go on to what was a consultation some four to five years ago on the reform of corporation tax generally, is in the autumn of 2002 the Government were looking at the possibility of getting rid of the scheduler system of taxation and airing the possibility of giving greater flexibility of utilising losses because our scheduler system does give rise to complexity. These areas, I guess, are being looked at all the time. I am just trying to illustrate that even within the basic confines of the legislation it is complex. Then you add on more and more anti-avoidance provisions which create even greater complexity. What business is asking for is a system that they can readily operate that gives them a reasonable rate of tax that more or less follows the accounts, in very simple terms. The other fact is that small businesses in particular do not like change and the reaction we had to removing capital allowances altogether, for example, which was a part of the original proposal, was to get rid of capital allowance and just follow the depreciation in the accounts. By doing so one would be making an enormous change to the tax system and that was probably a reform too far. Given that we have capital allowances, they should be easy to understand and that is what small business is asking for. Generally business is asking for ease of understanding things, which may be an impossible thing to achieve in practice but that is what should be aimed for.

Q271 ***Lord Sheldon:*** The EFSR points out that: "The 2006 Review of Links with Large Business . . . made proposals aimed at delivering a modern, responsive tax administration". This is mainly, of course, of interest to large businesses, but what are your views as to HMRC's delivery plan as to how it is going to achieve this?
Mr Bowes: If I could make some comment. My view is that in terms of large business the idea of having a client relationship or customer relationship manager within the Revenue is a good thing in that it focuses the service of the large business more readily with the Inland Revenue. That is what small business would like. Equally, 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 the manpower in the Revenue to achieve that. The truth is that is what small business is asking for. The other area is the clearance procedure which was under Code of Practice 10 previously and that was withdrawn by the Revenue. The Revenue has now introduced a procedure for obtaining clearances and rulings for large business which I think should be extended to small business as well. What one would like to see is a uniform ability to deliver these benefits which large business is receiving to be given to small business as well. One fear I have with all of this is the approachability in terms of local offices of the Inland Revenue being closed which I do not think helps small business because when you reduce the number of Revenue offices and staff on the ground what you are doing is centralising your main resources into Liverpool, Manchester and Birmingham. What is happening in the South East is there will be less and less tax offices, which I think is a great worry to the business community because they cannot approach a Revenue office directly. In my area—I live in Brighton—it may be the case that the only offices that might be left open are in Worthing which is not convenient for local business. To my mind the Large Business review has been enormously beneficial but there has not been an even-handed beneficiality to the business community at large. Possibly this reflects the problems of manpower within the Revenue, I have no idea.

Q272 ***Chairman:*** We can ask them that. Your point is a straightforward point, the benefits for large businesses are not coming through to the small businesses and your members do not approve of that.
Mr Bowes: It is not.
Mr Frost: It is going backwards.

Q273 ***Lord Paul:*** We have partially talked about the capital allowances. Mike Cherry's organisation is asking for modernisation and simplification. They are also asking for stability and certainty. What are the changes you are looking for? To the British Chambers of Commerce, can you expand on what you mean by a more focused or tailored allowance? How can changes be made that cause least disruption? How can HMRC consult on a package which creates winners and losers?
Mr Cherry: I will try and start on that one, my Lord. If we look at the corporation tax rates, the changes in the last Budget statement were the sixth change made by this Chancellor since 1997. Changes actually create complexity for small businesses. By "stability" we mean that we would like something that is simple, that is well understood and can be worked by the business through HMRC. If I can go back to Lord Sheldon's point on the big business relationship, we would certainly endorse the Chambers' view that that is not coming through and it is, in fact, a backward step because small businesses, even if they had advisers, were able to contact their local tax office, talk to somebody they actually knew or who knew of them in particular and were able to sort any issues out directly, but that no longer happens. Particularly for our accountancy members, they even have difficulty in contacting members of staff with queries who have the expert knowledge that they need to answer their questions. We do seem to be taking a retrograde step in looking at it only from the Revenue's point of view and not necessarily understanding the small business's point of view. If we look at the capital allowances, as I understand it at the moment plant and machinery allowance is no longer available to small businesses. In our submission we have tried to make it clear that we do not see how any small business, and the percentage we outline there is about 70 per cent with a turnover of only £300,000, could make themselves available at this sort of level.

Q274 ***Lord Paul:*** The Chancellor, right from the day he took over as Chancellor, has been saying at every Budget and before the Budget that he is trying to make life easier for business, especially for small businesses. Are you saying that he has not achieved that?
Mr Cherry: I would definitely say that he has not achieved that, my Lord. You cannot have a situation where the tax book, if you like, has almost doubled in size in the last ten years. How does that create simplification and less complexity?
Mr Frost: From the Chambers of Commerce perspective, my Lord, the Chancellor has been speaking on an agenda that is very pro-enterprise, which we buy into very strongly, the need to encourage more people to become entrepreneurs, a greater spread of business within the country and, therefore, we did not think the last increase in the small firms rate of corporation tax fitted into that general principle and sends out a very negative

message to small businesses and potential entrepreneurs. When it comes to stability, if we look at the sheer change that has taken place over the last ten years in the small firms' rate of corporation tax, it started off at 23, it then moved to 21, it moved to 20, it moved to 10, and a special rate for zero, back up to 19, to 20, to 21, to 22. It has been a history of consistent change. As you know, the one thing that business does require is stability.

Q275 ***Lord Barnett:*** Can I ask Mr Cherry, in your paper you said, or Cassandra Kenny says, that small businesses do not make their plans based on the tax regime but more on the needs of the business. I am not clear whether you are saying that capital allowances are almost irrelevant.
Mr Cherry: I think that we have gone from a position of having capital allowances which are not easily understood, whereas taxation is, but in a small business you need to know what is there and we have had a history of capital allowances that the businesses understood. When you bring in an element of change all the time, either upwards or downwards, that creates misunderstanding and a business inevitably will make its investment based on what the needs of the business are and not on the taxation regime at the time of any single Budget. They need to be looking at investing for their future and for no other reason.

Q276 ***Chairman:*** Can I ask you a question about the research and development tax credits. Do you think they will stimulate investment?
Mr Frost: We did some research at the end of 2005 on encouraging innovation in manufacturing. Some very quick figures: half of the firms that replied said that the R&D tax credit was a good incentive, it did encourage R&D but it needed far greater promotion, and whilst 67 per cent of firms were aware only 49 per cent took it up. 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.

Q277 ***Chairman:*** Thank you very much. We are going to move on to managed service companies and we have got some questions about that. There is a sort of halfway between the two. One of the effects of the business package is to draw closer the taxation of unincorporated businesses and small companies. Given the desire for simplification, before we look at managed service companies, I just wonder where you see the impact of the business tax package on small companies. You have given us a fair amount of answers to that and I do not know whether you want to add anything more or shall we move straight on? Is there anything that you have not said on the business package as far as small businesses are concerned? You have covered it, all right. Can I then start with the managed service companies and ask you some questions. Before IR35, what was effectively employment income could be retained in a company or paid out as a dividend. Of course, the fact of the matter is that there was a significant tax advantage in doing that; if there had not there would not have been a problem. The Government has made that way of trying to deal with it and a way before that, and now they have got this new system as well. Various commentators have made the point to us that it is really merely sticking plaster on a problem, it is not ever going to solve the problem and it is a much more fundamental problem of differentials in tax rates. Do you want to comment on that?
Mr Bowes: In a sense it links in with your last question which was not answered.

Q278 ***Chairman:*** That is right. I was trying to phase through the two, quite deliberately.
Mr Bowes: It is a difficult area because from a policy point of view you have to decide do you encourage people to set up companies and be entrepreneurs or do you make sure that the rate of corporation tax is equal to, if you like, the effects of the NIC and income tax rates. That is a fundamental issue. A corporate body is designed to encourage enterprise and the legislation set up years ago was for a company to enable people to get together, go into business and create something. This legislation is really designed to, if you like, attack the corporate veil, if I can put it that way. I have a question in that there are people who are genuinely acting on their own who would wish to expand their business who may at the start of their business be regarded by the Revenue as being, if you like, within IR35 and yet the intention would be for them to expand that business and as time goes on they obtain more clients and so it builds. If you continuously attack what I would describe as one-man companies the concern is that you are killing the enterprise environment, you are killing something which is worth preserving. It is a very, very difficult fine dividing line that you have to apply as to what is generally avoidance and what is generally enterprise.

Q279 ***Chairman:*** Can I just interrupt you because it seems to me this issue which we have all got to face is that there is a different rate of tax between doing it one way or another and most of us would prefer, I think, that businesses were run as businesses to be profitable and not deciding whether or not to be incorporated because of the different tax rates. The

structure ought not to be based upon Inland Revenue rules, it ought to be based on commercial considerations. The fact of the matter is that every small businessman knows his accountant will say, "Do it this way, do it that way", as a result of which we have had lots of companies formed. The Revenue have got a problem because there is a reality about that and businesses have got a problem as well and what we are really exploring is how you are going to try and lessen that problem, lessen the desire of businesses to do things for tax reasons instead of for business reasons. Have you any suggestions as to how the Government might help businesses in that way?

Mr Bowes: The way I would do it is to reduce the personal rate of income tax and not increase the rate of corporation tax. In other words, encourage the business community to actually go out and want to be in business. The reason why they choose a corporate veil is because it is cheaper to do so. I also think there are employment reasons for choosing incorporation because a lot of employers find employment legislation incredibly complex and they want to reduce any of the restrictions imposed by employment law. They would rather have a situation where they can easily deal with somebody in a more flexible manner. I see these kinds of arrangements as an economic valve, if you like, both from an employment and a tax point of view. It may be the fact that even if you equalise the rate of taxes such that it is neither an advantage to be within a corporation or to be on your own you would still get people setting up companies for reasons of employment law or other reasons.

Q280 ***Chairman:*** But then presumably the Inland Revenue would not mind that.

Mr Bowes: I do not think the Revenue would mind about that. Other people might mind because they would argue the employment rights.

Mr Cherry: If I can come in on this one, my Lord. There should always be the right for a person to be self-employed, that is surely a fundamental right of any person, and this is actually forcing people into PAYE, there is no other way around it. This was created by the Revenue and they are now trying to unscramble the mess that they have got us into. It is something that has got to be resolved but I think that the Revenue are going about it in totally the wrong way because they are penalising the person who wants to be entrepreneurial, wants to set up his own business but, in fact, his main customer for his first one or two years of business may be his previous employer.

Mr Frost: In terms of government policy on promoting enterprise, this issue is key to resolve. Again, coming back to the Chancellor, there is a very pro-enterprise spirit being espoused but there are huge regional variations. There are four times as many businesses per head of population in Maidenhead as there are in Middlesbrough. If we are to move away from a dependency culture to an enterprise entrepreneurial culture we are going to need to stimulate people to start their own businesses, but particularly in areas of the north.

Q281 ***Lord Paul:*** The Federation of Small Businesses is concerned that the legislation will suppress an important route from employment into entrepreneurship. Would you like to expand on that?

Mr Cherry: Let us take an example: 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. It has not enabled that person any wish to become self-employed because he sees no benefit in doing so. Entrepreneurialism has therefore decreased and it just negates what the Chancellor is espousing all the time.

Q282 ***Chairman:*** Let us move on. You have expressed pretty good disapproval of the proposals from a business point of view. I wonder if any of you would like to comment on whether you think that from a revenue gathering point of view the proposals will work or have they got problems in them? Some witnesses have told us of difficulties.

Mr Bowes: I think the proposals will make it easier for the Revenue to try and challenge promoters who go out to encourage corporate formations which were essentially IR35 formations, if you like. The reason why the Revenue have probably found this difficult is because they are having to challenge each company and this legislation is designed to challenge the promoter, if you like, the man behind the product. The fear I have with this legislation is how far you define a promoter because the definition of a promoter includes somebody who is actively involved in setting up and helping out in the running of the operations in very broad terms. The question is to what degree—there is an exception within the legislation to lawyers and accountants who are just generally giving advice—will this legislation challenge entities which really rely on a lot of external advisers to run their organisations, especially if you are a one-man company. The question is what is promotion, and I do not know. I think this area is probably going to end up in the courts at some stage.

Q283 ***Chairman:*** Witnesses have said that to us, that there will be some considerable difficulties in the Inland Revenue administering these new rules, and what you are saying tends to agree with that.

Mr Bowes: Yes, my Lord. Also, on the debt collection regulations which are due to come into force on 6 August it is yet to be defined in regulation exactly what the powers will be but essentially it challenges all those who are actively involved with managed service companies in very broad terms. Again, it is legislation which depends how far one would exercise the power to challenge structures with the wide wording of the legislation. It depends what the regulations say at the end of the day but there is a real fear that you could even have, for example, firms that are providing advice being challenged to pay the PAYE, or even employment agencies could be challenged to pay PAYE which they would not be expecting.

Q284 ***Chairman:*** We know what they are proposing, we just want to know whether you approve of it or whether you do not and clearly you do not.
Mr Bowes: Absolutely.

Q285 ***Chairman:*** Mr Cherry, do you want to add anything?
Mr Cherry: On the whole, my Lord, we support the legislation because it should remove some of the tax advantage that is there for those companies operating through MSCs. One of the important things is to have the definition of an MSC very clearly spelt out which would help both the businesses concerned and the Revenue themselves. However, just by being self-employed does not mean that you operate through an MSC.

Q286 ***Lord Barnett:*** You say in your paper that you welcome the measure because it should clarify what an MSC is.
Mr Cherry: Indeed, my Lord.

Q287 ***Lord Barnett:*** And you go on to say that your concern is about what we have already heard, but you welcome the measure.
Mr Cherry: Indeed, my Lord.

Q288 ***Lord Barnett:*** You know the figures of growth of these MSCs. In a way the figures are quite alarming from the Inland Revenue's point of view. They have grown, as far as we understand it, from around 65,000 in 2002-03 to 245,000 in 2005–06, and for all we know there will be even more this year. Clearly you would accept, I assume—correct me if I am wrong—that there has been substantial tax and National Insurance avoidance through these MSCs.
Mr Bowes: I think it is self-evident that there is avoidance but the trouble is from a policy point of view you have to encourage people to be entrepreneurial and expand their business. At the outset of a business it is sometimes quite difficult to actually demonstrate that you are self-employed.

Q289 ***Lord Barnett:*** What would you do specifically?
Mr Bowes: It is a very difficult area. If you see the situation after two years or something, in other words you had a time period, literally off the top of my head if you had a time period by which you could judge what was going on then it might give you a better indication of how that business might develop. If you say after a year, "How is this business operating?" that might not be a fair judgment because somebody is desperately trying to create other sources of income for that business and you may be relying on one source of income which from a Revenue point of view might be regarded as quasi-employment income. I think it is a matter of policy. It would be helpful to have legislation which gave some sort of timing maybe.

Q290 ***Lord Barnett:*** You have an opportunity to tell us, and we will take it up with the Revenue, what that legislation should be.
Mr Bowes: We will give it some thought, I think. I am just airing some ideas.
Chairman: Thank you very much, you have been very helpful to us. We have had a whole series of these meetings and we have heard the problems and some of the things you raised have been raised before but it is very helpful to hear your contribution to the issues. We will be having a go with the Inland Revenue and seeing what answers they are able to give us. Thank you very much indeed for coming.

16 May 2007

Supplementary memorandum by the Federation of Small Businesses

Thank you for your letter of 21 May asking for my corrections to the transcript of my oral evidence on 16 May.

Please find below supplementary memorandum to my evidence on three questions.

Question 244

In relation to question 244 from Lord Barnett, the Macrory report recommended seven characteristics that regulators should follow: publish an enforcement policy; measure outcomes not just outputs; justify their choice of enforcement actions year on year to stakeholders, Ministers and Parliament; follow-up enforcement actions where appropriate; enforce in a transparent manner; be transparent in the way in which they apply and determine administrative penalties and avoid perverse incentives that might influence the choice of sanctioning response.

Whilst the HMRC is not a regulatory body as such, the Federation of Small Businesses (FSB) welcomes the measures in Finance Bill 2007 to introduce a new, published, penalty regime for incorrect returns for income tax, corporation tax, PAYE, NIC and VAT where the penalty will be determined by the amount of tax understated, the nature of the behaviour giving rise to the understatement and the extent of disclosure by the taxpayer.

The FSB welcomes the transparency of the new penalty regime whereby the penalty payable is a percentage of potential lost revenue for each of the three categories of action. However, the FSB would encourage HMRC to take on board the other six principles Macrory laid out, in conjunction with the six penalties principles in relation to sanctions, giving particular regard to small businesses.

Question 275

In regards to question 275 from Lord Barnett on capital allowances, the FSB would point out that allowances must be applied for, as opposed to taxes which are easily understood (albeit quite blunt) instruments. As stated in our written evidence, capital investment decisions cannot be made because the Chancellor has changed the amount available that year—ie a business will not spend more on plant or machinery simply because an allowance exists that year without a business case to back up that decision. Capital investment decisions are made after an assessment of the business' needs in the short to medium term. 40 per cent of our members' turnover is under £100,000 therefore the ability to take advantage of allowances is limited.

Question 281

In relation to the FSB's answer to question 281, the FSB would like to clarify the concern is that the IR35 legislation, not Managed Services Companies per se, favours large contractors and suppresses an important route from employment into entrepreneurship. As stated in our written evidence, the FSB welcomes the measure on Managed Service Companies, which the FSB considers to be an artificial company structure where certain tax liabilities can be avoided. Having said that, it is crucial that the legislation is clearly drafted, and not open to case-by-case interpretation.

MONDAY 21 MAY 2007

Present	Barnett, L	Sheppard of Didgemere, L
	Blackwell, L	Vallance of Tummel, L
	Paul, L	Wakeham, L (Chairman)
	Sheldon, L	

Examination of Witnesses

Witnesses: Mr Peter Curwen, Director, Tax and Budget, HM Treasury, Mr Dave Hartnett, Director General, Business and Ms Theresa Middleton, Director, Small and Medium Enterprises, HM Revenue & Customs, examined.

Q291 ***Chairman:*** Good afternoon and welcome to some familiar faces and some fresh ones, we are very pleased to see you here. I think you have some idea of the questions we are going to ask and they are based mostly upon the evidence which has been put to us in our previous meetings. You have to some extent skilfully anticipated some of the questions by producing two consultative documents a few days ago, we know about them but I cannot pretend we have absorbed them as well as we ought to have done, but no doubt you will put us right in the answers if we have not got the message you are seeking to put across. We will as usual go round the table asking you questions but before we start the first thing to say to you, as I am always told to say to everybody who comes, and you know the routine as well as I do, is to speak up and speak relatively slowly so we get an accurate report. Do you want to say anything before we start?

Mr Curwen: We can go straight in, my Lord.

Q292 ***Chairman:*** I will start then with the business tax package. It is a general question. To what extent does the business tax reform package deliver "simplification of the underlying tax structure" as claimed by paragraph 3.36 of the Economic and Fiscal Strategy Report?

Mr Curwen: That question falls to me, my Lord Chairman. I would like to step back one pace, if I may, and say that the business tax package itself had three main aims within the context of maintaining sound public finances. The first was enhancing international competitiveness. The second was encouraging growth through investment and innovation. The third was ensuring fairness across the tax system. Simplification was a key element within that package but alongside it there are obviously the other aims of efficiency, competitiveness and fairness but simplification, as the Committee has focused on, is a key to encouraging investment and indeed ensuring fairness. I know the Committee wants to look at some of the issues in more detail but in summary there have been a number of reforms to the capital allowances system which are aimed at ensuring its efficiency and simplicity, and they include that most plant and machinery expenditure will be handled in one of two pools at the rate of 10 or 20 per cent. I know we will be turning to this but we have also addressed a long-standing anachronistic element of the capital allowances system with the phased withdrawal of the industrial and agricultural buildings allowances. We have also introduced a new annual investment allowance for most plant and machinery from 2008–09 which we also think will help particularly small and medium sized enterprises. Finally, I would say the changes to the small companies rate—and this builds on some evidence from one or two of the witnesses which we pondered on and thought was a rather good point—in reducing the issue of whether tax was a factor in incorporation, actually simplified the way in which agents and advisers advised individuals about whether to move into incorporation or not and therefore in and of itself became a simplification. I know you wish to go into these issues in more detail.

Chairman: There are some follow-up questions there but perhaps it would be better to come back to those later on in our discussions.

Lord Vallance of Tummel: Our inquiry into the business tax aspects includes the Review of Links with Large Businesses—

Chairman: I am sorry, we will have to go and vote.

The Committee suspended from 3.36 pm to 3.42 pm for a division in the House

Q293 ***Lord Vallance of Tummel:*** Let me start again. Our inquiry also includes the Review of Links with Larger Businesses on which HMRC published a delivery plan on Budget Day, and our private sector witnesses were generally content with the progress but some were concerned that resource constraints, whether in terms of numbers or skills, might be a brake on further progress and they were particularly interested on clearances and advance rulings. Have you any comments on that?

Mr Hartnett: Starting with the general, I think it is fair to say that we regard the Review of Links with Business as absolutely fundamental to the change we

want to bring about in how we deal 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 business with more certainty, that is why clearances are really important to us, and I think all your previous witnesses are right to challenge us as to whether we are going to pull this off. We are absolutely determined to do so and are working out right now how we can best do that by applying our resources differently, but we need some help. We need some help skilling our people up in the financial sector and some other cutting edge sectors where we need a better understanding. We need more openness from business and their advisers as well and we need help in improving the skills of our people. We are getting some of that help and I am confident we will deliver.

Q294 ***Lord Sheppard of Didgemere:*** When you comment on the Finance Bill you have also commented on the attempt to reduce the administrative task on business. Most of our witnesses have in fact, believe it or not, been positive about the progress on that but there are a couple of aspects where they expressed concern. One was they said the record on small taxpayers had been somewhat patchy and as a result we had had some hopping around, whatever the correct technical expression is, which had confused the issues with small taxpayers, and also the question is whether the targets were sufficiently ambitious on what had been said to reduce the administrative burden. Do you want to comment on those concerns?
Ms Middleton: First of all, we are really pleased with the support we have had from the private sector businesses themselves and their representative bodies of different types in taking this work forward. We are working very closely with them through an advisory board which is externally chaired and on which business representative bodies of different types sit, so it is very much a joint effort to try and take this forward, and I am pleased they have been quite positive about the progress so far. In terms of small businesses, those small businesses which have been directly affected by the changes we have made to date have welcomed the work but it is still relatively early days and as time goes by there should be more of a noticeable impact as a wider range of changes start to take effect. We are confident we are going to deliver against the targets we have set. In terms of the scale of the ambition that people have commented on, I think it is the case that the targets are stretching. The objective research which was done to baseline the administrative burden of the UK system showed we compare quite favourably with some international comparators, and in a way you could say that means there may be 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. Where we have identified changes in the past which could be made, both the predecessor departments were very focused on the burden on business, particularly the smaller ones, so we have taken some tricks already which obviously cannot be retaken, and those factors have been reflected in the size of our targets. The targets for audits and inspections are higher than for returns because we have identified with business that is an area they feel particularly strongly about. They of course would like returns to be shorter and easier to fill in, but they accept them as part of the normal process of being in business; if you are in business you have to fill in a tax return. What concerns them more are things which are more of an irritation and an audit or an inquiry can be an irritation, as can be a number of other aspects. So we have tried to combine in our approach targets which focus on where the biggest element of the burden is, which is forms and returns, but they also represent how the tax system works and how we get the money in, but also combine that with looking at the things which are particularly irritating for business. We think we have tried to get the balance right between those factors.

Q295 ***Lord Sheppard of Didgemere:*** As an observer from the outside, you have made a lot of progress in your own administration and you have done a lot of work on it in the last two or three years. Has any of that been at the expense of putting burdens on business or have you made certain that when you have reduced your own administration you do not just pass it on?
Ms Middleton: You mean in terms of the Change Programme drawing together Revenue and Customs?

Q296 ***Lord Sheppard of Didgemere:*** Yes.
Ms Middleton: When Gus O'Donnell decided that Revenue and Customs should merge he actually identified small business as the group which would have the most to gain from the merger because they would in future need to deal with only one tax authority for all of their affairs rather than two, so it is certainly the case that the merger has created the opportunity to reduce the burden. It has also enabled us to look across, not on a taxpayer by taxpayer basis because at the moment we do not have the IT support to do that (although we plan to do it in time) but to look across regimes and see the different approaches we were taking—and I know you are going to talk about powers later and that is one obvious area—and the different sorts of standards we would apply in terms of what people could expect when they contacted us. So what it has allowed us to do is to

attempt to move towards standardising experiences for business customers. It has also at the large end allowed us to bring together the relationship and the support for larger businesses within the Large Business Service which is operated as a generally joined up service for both direct and indirect taxes. It would not be truthful to say that there has been no impact because of course in a merger of the scale we have experienced, and are still experiencing, at the front line people will experience sometimes some movement and some difference from what they experienced before, but I hope that we are on top of that and are making sure we are minimising that and people may feel it is a price to pay for a greater benefit in the slightly longer term.

Q297 ***Chairman:*** There is one specific aspect which some of the witnesses have raised with us and that is—and I guess this might apply to a lot of the private sector as well—the increased use of call centres and therefore the closing of some of the offices. In practice, some people feel that actually makes it more difficult for business and adds to the cost of compliance. You ring up the call centre, as somebody said to us, who refers them to some written document which has been put out by you, and the chap said, "The only reason I rang them was because I couldn't understand what was in the written document." There is not a black and white answer but is that a concern you are aware of?
Mr Hartnett: It is a concern we hear, my Lord, but more from tax practitioners than from business. Tax practitioners want the dedicated, one-to-one service which they enjoyed for years. We are working with them today to improve the call centre experience for them so they can have a dedicated facility. My experience of listening into calls and talking to businesses is that the 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 the service as well.

Q298 ***Lord Blackwell:*** Mr Curwen, in your response to the Chairman's opening remarks you referred to the small business tax regime, and I think our evidence suggests that small businesses are concerned about both having certainty in the tax regime as well as simplicity, and there were a number of comments about the way in which the small business rate has chopped and changed in recent years. Much of the complexity in that tax system perhaps arises from the different treatment of incorporated and unincorporated business. Leaving aside for the moment the specific issue of managed service companies, which we will come back to, how far do you see it is an objective to narrow that difference and how far does the Finance Bill go in achieving that?
Mr Curwen: It might be helpful, my Lord, if I could draw a distinction at the outset because we will be on to managed service companies very shortly. The changes to the small companies rate were designed to address a structural issue, that is, as your Lordship has indicated, that some self-employed decide to become incorporated for tax reasons rather than for legal or commercial reasons. The measures on managed service companies are different in that they address a compliance issue about disguised employment, and it is quite important for us to draw that distinction from the outset. There is a structure issue around self-employed and incorporated. Why do we call it a structure issue? It is because it is the same economic activity but with a different tax outcome and in economic terms it gives rise to what we call horizontal inequity. Our view is that tax should not drive the decision on incorporation, there are other good reasons why you might want to incorporate but tax should not be a driver. So the Government decided to re-focus the manner in which it provided investment incentives to small business in the Budget and the increase in the SCR reduces the differential between the incorporated and self-employed and reduces the incentives to incorporate while the annual investment allowance targets assistance directly on businesses which re-invest profits regardless of their legal form. It does narrow the difference and there was a consultation which we undertook in the PBR 2004 looking at this area and there were a number of responses to the paper, although there was no clear consensus, except one, that there should be no quick fix and that simplicity should be the favoured option over other approaches. It is in that context that we decided to move on the small companies rate phased increase to 22 per cent. We will obviously have to see how that impacts but informed commentators have generally agreed that it reduces the distorting effect of tax-motivated incorporation.

Q299 ***Lord Blackwell:*** Do you think there is lot more to do in this area in terms of simplifying small business taxation? Is this something which will find merit or special review?
Mr Curwen: Obviously we will continue to keep everything under close scrutiny, as you might expect with the tax system. We do agree that incorporation can be and in itself is a springboard for growth, and we do not wish to discourage that, but what we are saying is that that should be because it is the most appropriate legal form and that tax should not drive the decisions. Indeed in the EFSR, the Red Book as some of you may know it, the Government is committed to continue to monitor the small business investment patterns and the level and extent to which

labour income is extracted as dividends, so we will continue to keep this under close scrutiny.

Q300 ***Chairman:*** So you are not saying to us that you have got there but there is probably more to come?
Mr Curwen: No, my Lord, we are not saying that because there were a number of responses to the consultative document in 2004 and one of the key ones was one of simplicity, and moving the small companies rate in a phased way up to 22 per cent, we believe, will narrow that difference. One important aspect to this is, and I referred to this earlier in my first answer and we did think it was a very good point from the Chartered Institute of Taxation, it will make decisions about legal form simpler for advisers, they can concentrate on commercial and legal considerations and less on the tax because there are disadvantages—there are advantages too, sure, but there are disadvantages too—from moving to incorporation; complexity and other aspects.

Q301 ***Lord Paul:*** Can I ask you to look at the changes to the capital allowances in this year's Finance Bill? Our witnesses have suggested that the simplification has been confined to the eventual abolition of industrial and agricultural buildings allowances, but there has been less certainty about the extent of simplification which will emerge when the later changes come in. Do you agree with that?
Mr Curwen: Yes. If I may, I will say a little about the phased abolition of the industrial and agricultural buildings allowances. As you say, they are 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. In the context of administrative burdens as well, the withdrawal of these allowances will remove one significant compliance burden, which was identified in the KPMG study, so we do regard that—and I know a number of your witnesses regard this—as a straightforward simplification. On capital allowances in general, our objective has been to reduce tax distortions and promote more efficient investment and generally to simplify the tax treatment of capital expenditure. There are a number of aspects to this but in terms of simplification I would note that from 2008 expenditure on most plant and machinery will be handled in one or two pools—10 per cent and 20 per cent—and we are also introducing the new annual investment allowance, and that is of itself a significant simplification particularly for small businesses. We will be consulting on the annual investment allowance and one of the key aspects of that consultation will be on the implementation of it and one of the key aspects will be simplification. So I would note those as slightly general points of simplification.

Q302 ***Lord Paul:*** Is there sufficient certainty for business with long term investment when the capital allowances keep changing?
Mr Curwen: I think the point you make is about retrospection as well, my Lord. I know that some witnesses have mentioned that in the context of withdrawal of industrial and agricultural buildings allowances in respect of past qualifying expenditure. We have a general view on this which is that annual rates of tax and company allowances are set annually and so obviously there is a legal aspect. It is not legally retrospective to reduce or remove allowances. The other thing we would point to with these two allowances is that there is going to be a phased withdrawal between 2008 and 2011 and that gives businesses time to plan, and, quite rightly in the context of simplification which this Committee has been looking at, retaining the effect of those allowances beyond the point at which they are abolished would have potentially created a significant compliance burden for up to 25 years, so it would not have fitted with the simplification agenda.

Q303 ***Lord Paul:*** The only point, it seems to me, to getting the allowances has been to recognise depreciation or to encourage growth.
Mr Curwen: What I would say is that ten per cent and 20 per cent pools are a better match for the real average rate of depreciation on those assets but, as I noted in my earlier answer, the business tax package as a whole is designed to encourage investment and growth.

Q304 ***Lord Sheldon:*** It has been put that the R&D tax credits are too complicated for many businesses to apply for them. Credits are being increased but can we simplify the rules which are supposed to be putting off business from applying? Can we be sure that tax credits actually encourage R&D rather than simply paperwork which would have been taking place in any case?
Ms Middleton: Let me pick that up. In terms of your question about complexity, we have looked at two things in terms of evidence. The first is what businesses do and the second is what businesses say about the process of claiming. In terms of what they do, we have had now around 23,000 claims for R&D tax credits since the scheme was originally introduced, 20,000 or so for SMEs and 3,000 for large businesses, and that amounts to about £1.8 billion worth of support through the two schemes. In that sense certainly the businesses are claiming the credits. We have also, in terms of evaluating the scheme, commissioned some independent research of 1,000 businesses which perform research and development, which is the largest survey of its kind conducted in the UK. In that survey we have found that three-quarters of businesses reported that they found it fairly easy or

very easy to engage with the process of claiming the R&D tax credits. However, we are not complacent and one of the things that was identified in that survey was that we could make the process of administration better, so last year in November we introduced seven specialist units to deal with R&D tax credit claims for businesses. The role of these units is to enable businesses to make the claims and help them through the process. The initial feedback we have had in response to businesses that have engaged with those units has been extremely positive so we are confident that we have got the balance right there. In terms of your question about simplicity, my Lord, and whether we should simplify the scheme, you will probably recognise that there is a trade-off between having a scheme that is targeted on a particular type of investment and having a scheme that simple and we need to constantly check whether we have the balance in the right place. You may know this, but in case you have not picked this up last year *The Tax Journal* did an article on fiscal incentives that compared the UK and its R&D tax credits against similar schemes operated in a number of other fiscs, in particular the US, Canada, Japan, Australia, so quite strong comparator countries, and found that for small and medium enterprises the UK system is widely regarded as the most generous and the simplest to administer. Again, we are not resting on our laurels here. Clearly, that is very positive feedback but we do look to continue to improve the process and make things as simple as they can be. In that respect, for example, we have published more new and accessible guidance for SMEs claiming the credit and we have also introduced an improved definition of R&D that has had very positive feedback from businesses. Your third question was about the incentive effect and here the Institute of Fiscal Studies would say that you need to monitor something for as long as ten years before you can start to see whether it has had the change that you planned for it to have. The survey I alluded to earlier has given us some quite encouraging results and again in that survey 57 per cent of companies that had claimed the credits said that they felt that they were an incentive to undertake further R&D, and obviously that is a very encouraging result early in the life of the scheme. There is also a lot of anecdotal feedback from companies that are claiming the credits that they are having an incentive effect for them. You will be aware that research and development can be a high risk investment and it can take many years for a new product or process to come to market and what the businesses that give us feedback say is that it helps to tide them over during that period of time. If I may quote from a letter that one of our new specialist units which I referred to earlier received recently, the company director said, "This particular initiative has benefited us greatly and has enabled the company to carry out its R&D, to grow and establish itself and at the same time to protect important jobs in the area of research and development within the company". We feel, therefore, that so far they are having an effect on businesses investing in research and development.

Q305 ***Lord Barnett:*** Some of our witnesses on the issue of consultation have thought it has been very helpful this year. Others have thought it a bit patchy, but, of course, consultation we recognise is very difficult given the different objectives both of the business people you are dealing with and the advisers. One suggestion whereby you might more easily get the benefits of certainty and clarification from consultation would be from the greater use of grandfathering. What do you think about that?
Mr Curwen: First of all, my Lord, I am grateful to you for your comments on consultation. We are doing our best on this and the evidence from your various witnesses indicates that. I do not want to do too many quotes from others but the Chartered Institute of Taxation in their Finance Bill representations last week noted, "We believe this Budget and Finance Bill are the best examples to date of the benefits of dialogue and consultation", and they list a number of the consultations and in fact three of them are part of your Lordship's Committee's investigations into managed service companies and penalties for incorrect tax returns and deferring Carter deadlines. I should also note that as part of the Varney review on large businesses there is a Chapter 4 within that which sets out the new consultation framework which we hope to aspire to and which complements the Cabinet Office's own guidance. On the specific issue of grandfathering, our view on this 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.
Mr Hartnett: My Lord, could I just add a word on grandfathering and it is this? As Peter said, it has its place. It can also be quite dangerous. Our experience in two of the last four Finance Bills is that the grandfathering provision which has been there has been exploited very significantly by tax planners. I can think of one in the financial services sector where the Exchequer lost about half a billion pounds almost in the blink of an eye through a grandfathering measure. You may want to say to me that that is our fault for not getting it right but it happens.

Q306 ***Chairman:*** Peter, you started by stating the three main objectives of the reforms and we have raised a number of queries about them. We have also said some encouraging things. Some of our witnesses were somewhat sceptical about the likelihood of

achieving these aims without more reforms and I just wonder whether there is anything more to add before we move on to the next section to reassure the people who are sceptical as to whether you are going to achieve your three aims of international competitiveness, encouragement of growth through investment and innovation and ensuring fairness across the system.

Mr Curwen: My Lord, I could give you quite a long answer to that but I will try to be brief. From the outset this was a very significant Budget on the business tax side. It is probably the most extensive reform of investment allowances since the 1980s. There was a cut in the main rate of corporation tax, adding to the cuts announced in 1997 and 1998. We believe that we are meeting the needs of international competitiveness with a cut in the CT rate. We are boosting growth and innovation principally through the annual investment allowance but also through the capital allowances generally. On the fairness point, we have also discussed so far the issues around the small companies rate but we will also be discussing the managed service companies point. I think we can reassure you but we always stay vigilant and we always wish to scrutinise the tax system and, as the Chancellor noted in his speech to the CBI dinner last week,—and this is in response to the CBI's task force which they have set up to look at issues about the UK's corporate tax regime, and he was talking about the business tax package in the Budget—"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".

Q307 ***Chairman:*** Maybe we had better now move on to managed service companies. You will not be the slightest bit surprised at the first question. A number of our witnesses thought that the legislation was attacking the symptoms and not the underlying cause and the phrase "sticking plaster" was used on a number of occasions. A number of our witnesses thought a better solution would have been a move to eliminating the difference between the tax treatments of employed and self-employed people. You have already commented to a degree on some of this but I wonder if you would comment on it in its relation to managed service companies.

Mr Curwen: 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 managed service company measures. 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 their 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. The objective is one of fairness because those people operating through an MSC are getting an unfair advantage over other workers and compliant businesses who are all playing by the rules. It's about individuals paying the same level of tax and NICs as other employees, I would say that almost all of those who have commented on the consultation document we put out agreed that the existing rules are not being applied by all MSCs and that action was necessary. We have had a number of very helpful comments. I feel like I am giving the Committee a large number of comments from others but the Chartered Institute of Taxation did say, and this is available on their public website, "In our view the approach set out in the MSC consultations"—this was after the PBR—"is a more proportionate and balanced one seeking to deal, as it does, with the immediate issue", so I hope that gives you some reassurance.

Q308 ***Lord Vallance of Tummel:*** Some of our witnesses thought that the enforcement of the IR35 legislation had been patchy and that rather than introduce new legislation on MSCs it should have been possible to amend the IR35 for MSCs. They were aware, of course, of the reasons that HMRC had put forward for a new approach but did not appear to be persuaded. Do you have any comments on that?

Mr Hartnett: I will pick this one up, my Lord, if I may. I have been able to read what your witnesses have said in the transcripts, and frankly we are very surprised. 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. I am sorry; I am going to quote something. It is going to feel, my Lord, that we are trying to overwhelm you with quotes but I think this is interesting. This is a letter from a recruitment agency where the proprietor says, "I want a world where the tax benefits I enjoy as a business are not being eroded by the abuse created by disguised employment". You will see there is some quite colourful language here. "Second, I want to return to the days where there is a market in which I do not lose business to less than honest competitors when we refuse to sign lengthy contracts that purport to take workers out of IR35, and third, it would be nice not to suffer the consequences of having our existing workers influenced by slick salespeople selling tax benefits that are simply not on offer from a law-abiding company." I wanted to say that in order to

try and deal with the issue where some seem to think this legislation is not necessary. Are we faultless in relation to IR35? No, we are not. Some of our compliance activity has been patchy. IR35 was designed to be rather like a self-assessment system so that the intermediary company would operate pay-as-you-earn and account for NICs where necessary. The important issue here is that we are really looking at two different things. For IR35 we have to look at contract by contract and we could not look at every contract. MSCs have set up a sort of omnibus vehicle and with MSCs we are focusing on the MSC. One we counter with investigative skills and approaches through IR35. MSCs needed a legislative solution and that is what it they have had.

Q309 ***Lord Sheppard of Didgemere:*** I want to look at a different aspect, which is the effect on labour flexibility, which as a country we have been stalling at over the years so we do not want it obviously in theory. There are some occupations where the employers do not want direct contractual relations with workers. Did you look into that aspect of labour flexibility and the labour market when you looked at the legislation?
Mr Curwen: Yes, my Lord.

Q310 ***Lord Sheppard of Didgemere:*** I would be surprised if you did not.
Mr Curwen: We did. There is a regulatory impact assessment which we published alongside the Finance Bill, which is on HMRC's website and which goes into this issue in a bit more detail. What we say is that flexibility and fairness are partners. One should go with the other. Our overall conclusion—and this is in the regulatory impact assessment—is that there would be no significant effect on the flexible labour market. There are a number of reasons for that. The first is that the proceeds, if you want to call them that, of the previous arrangements were shared between the MSC scheme provider, the workers themselves and the end user and agencies, so the impact on wages itself was likely to be limited. Secondly, by the new measure preventing MSCs from undercutting compliant workers and businesses, competition should be enhanced, and thirdly, I would say that workers can still enjoy the flexibility of temporary contracts and there are a number of alternatives available to them. If they are genuinely in business on their own account they can operate a personal service company. They can be engaged by an employment agency, and indeed they can continue to work through an MSC but would pay employed levels of tax and NICs. Dave has rightly noted the comments of a number of employment agencies and others in the compliant sector in response to our measure. The other thing I would say about the flexibility point, particularly in the temporary labour market, is 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.

Q311 ***Lord Blackwell:*** The heart of this approach is the definition of the MSC and, as you will have seen in our consultations, there was quite a lot of concern about the details of that drafting. There is an amendment being tabled, as we understand it, on clause 61B(4) but that is a fairly technical drafting amendment. A lot of other amendments were tabled at that stage, including some to deal with concerns such as exemptions for legal and accounting services or the possibility of disadvantaging genuine businesses such as recruitment businesses and some of the concerns were about the possibility of "leakage" between MSCs and personal service companies. The question we would like to put to you now is whether you think further amendments may be necessary to deal with some of these points or whether you think the responses given to those cover all the points.
Mr Hartnett: I need to step back for a moment to the consultative document that was put out by Treasury and Revenue and Customs with some draft legislation. From my personal perspective, it produced a response I am not sure I have ever seen before as we have developed the tax system in the UK. There was a concerted attempt by a number of advisers and others to thwart the legislation by providing huge numbers of personal service companies, truly huge numbers. Some firms were setting up as many as 15,000 and I suspect we will get to this issue in a few minutes and I do not want to dwell on it now, but we needed to look again at the whole approach to MSCs on the back of what we had seen. That is really in large part what section 61B is all about and I hope you will be pleased: I am not going to go into great technical detail here, but I think what section 61B succeeds in doing is making 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) are outside, and then there are other provisions which help chartered secretaries and the like to stay outside. 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.

Q312 ***Lord Blackwell:*** Are you expecting to do any further consultation with those people who have made representations to see if they are satisfied with that?
Mr Hartnett: We are engaged with just about everybody who has made representations in relation to MSCs and we are listening but I think we have got a bit of a challenge for those who want to see section 61B changed further and that is, "Show us the analysis which makes this a requirement", and I am quite sure that if they can do that we will refer it to our ministers.

Q313 ***Lord Paul:*** There was considerable concern over the transfer of debt provisions in section 688A which were felt to go far too wide. Our private sector witnesses stressed the need to protect innocent persons and business and did not think that this has been fully achieved. There were amendments made in the Public Bill Committee. These did reduce slightly the range of third parties to which a debt can be transferred. They also seek to clarify that debts cannot be transferred to employment businesses or agencies as a consequence of their normal business. Whilst we welcome these changes, again we have concerns that they may not be sufficient, given the level of concern which has been expressed. What comfort are you able to offer us?
Mr Hartnett: My Lord, I think we have given a fair bit of comfort already. What our ministers have made clear and I think the legislation is clear on, is 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. We are going to deal with debt transfer in a very particular way as well. It will be handled by a special unit we 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. If I wanted to offer you an analogy I think I would probably look back to the measures introduced really rather a long time ago, seven or eight years ago, in relation to delinquent directors whose actions in relation to a corporate led to a loss of national insurance contributions, where they actually had to be involved in the delinquency for us to be able to recover national insurance contributions from them. This will work rather like that.

Q314 ***Lord Paul:*** Can I ask you for clarification, for example, in terms of an associate and an adviser? What is the meaning in terms of these?
Mr Hartnett: In the context of the transfer of debt, an associate is someone connected to a particular company or partnership: either an MSC provider or a party closely involved in the loss of tax. It does not mean a wife or partner as association with an individual is explicitly excluded from the provision.

Q315 ***Lord Paul:*** And an adviser?
Mr Hartnett: "Adviser" is, I think, a general term and it will depend on what the sort of advice has been. If it is simple, straightforward tax advice that is one thing. If it is somebody who has been involved heavily in giving advice which has led to the loss of tax then we will want to target that person.

Q316 ***Lord Paul:*** You are also clarifying circumstances in which a client, the recipient of services, can be asked to account for the PAYE and NIC of the MSC in the current amendment.
Mr Hartnett: The circumstances in which the client could be asked to account will only be circumstances where the client has been intimately involved in whatever action has led to the loss of tax. As I said at the beginning, this is not about targeting innocent people in any way.

Q317 ***Lord Sheldon:*** There has been doubt about the legislation preventing tax and NIC losses and there were witnesses who were concerned about the growth of personal service companies and that more legislation may be required. What is your reply to this?
Mr Curwen: My Lord, I do not know if it is appropriate but I have got a very small handout which might help as we talk through this change in the number of incorporations. It is an important story to tell over the last few months which it may be helpful to your Lordships to have.

Q318 ***Chairman:*** Dave, you hinted that this might be coming off the press fairly quickly.
Mr Hartnett: We gave it a little thought in advance, my Lord.
Mr Curwen: It actually relates to the point that Dave has just made. The table that you have in front of you is of incorporations in Great Britain over the last six months and its source is Companies House, so it is information in the public domain. The first point is that November's figures are broadly similar to those through 2006–07 so we use that as the benchmark. There is normally a drop in incorporations in December, for obvious reasons, but in the PBR 2006 the Government published its draft definitions of managed service companies for consultation. In January, as you see, the weekly figures began to

increase and, as Dave has indicated, it was almost certainly the case that MSC providers were trying to avoid the draft definition by moving the workers into new company structures, probably, as Dave has indicated, being advised by accountants and others to that effect. That continued. We had the highest weekly figure of incorporations ever in the second week of February when it was nearly 21,000, with the highest average weekly incorporations as a monthly total in March. What happened then was that, of course, we had the Budget in 2007 which included a more robust definition of MSCs and, as you will notice, the level of incorporations fell back significantly in April. It is too early to be certain, particularly as Easter fell in April, but it does suggest that the final definition that we produced at the Budget is proving more effective and, as Dave has indicated, we simply do not accept that the increase in companies set up after the publication of draft legislation at PBR were *bona fide* personal service companies; rather they were MSCs slightly re-hashed. If such companies operate under an MSC provider the MSC compliance strategy will apply, which is to look first and foremost at the provider itself, and that was the advantage of the robust definition we published at the Budget. What it means is that the HMRC can police the small number of MSC providers. We think there are about 150 or so of those but about 10 of those cover the vast majority of MSC workers and some of them have tens of thousands of workers in their schemes. Hopefully that table gives you an idea of what we think was going on in the first part of this year and although it is perhaps a little early to say (we only have April's figures) they do seem to indicate, at least at first sight, that the number of incorporations and the attempt to put people into personal service companies is not now a route down which people should go because they have realised they will be caught by the robust definition within the Budget.

Q319 ***Lord Sheldon:*** Is it not too early to draw too much on these as certainties at the present time because, of course, this could be a reaction to the Budget and further consideration might be given that could lead to a further increase later on, could it not?
Mr Curwen: We do not believe so. You are absolutely right, my Lord, to say that we should not draw too much from the April figures but what we would have been concerned about would be if the April figures had continued at the same level we have seen, or indeed on a rising trend as they had done through January, February and March, but that did not happen. On the underlying point we do not believe that we will see the same impact because of the more robust definition that we published in the Budget compared with the consultation at the PBR. We made it much clearer at the time of the Budget.

Mr Hartnett: Can I just come in with two things, my Lord, which I hope you will find helpful? The first is this. We think that there were in the run-up to the Budget around 150 MSC providers in the UK, and of those maybe 15 or 16 were very big indeed. That enables us to approach the issue of securing compliance in a rather more straightforward way than we can with personal service companies. The second is that there are burgeoning indications that there will be further reduction. We have seen one of the biggest MSC providers announce publicly that it will not be continuing to operate in this area. These are only burgeoning indications but they do suggest that this has been very effective and I think our compliance regime will be effective.
Chairman: That is a very helpful way in which to end this thing. I cannot resist the comment that those of us who were Treasury ministers in the past in our different ways claimed credit for the fact that the increasing number of companies that were incorporated was a sign of the prosperity of the regime which we were members of at the time, but the world has changed considerably. Let us move on now to the third and last section of our inquiry, which is the review of powers, deterrents and safeguards and I will ask Lord Barnett to start off the questions.

Q320 ***Lord Barnett:*** As you will know, many of our witnesses did think the consultations were quite useful but many were concerned about starting with powers and deterrents rather than safeguards for taxpayers, which of course is understandable, as the Chairman says, to those of us who were dealing with it from another standpoint, but safeguards were not something you always thought of first. There is this question of the idea of a taxpayers' charter and whether it ought to be resurrected. Do you have that in mind or do you just think it is a bit like consultation, not worth doing anyway?
Mr Hartnett: Following my Lord Chairman, I think we need to make a disclosure at this point, and I think, my Lord, when Ashley Greenbank was here you made a disclosure. Peter and I ought to make a disclosure as well. I chair the steering group on the review of powers and Peter is one of the other civil servant members—there are not many civil servants on it—so you may just feel that we ought to say that we have a bit of a vested interest here. 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. I do not think, my Lord, and I stand to be corrected later because I am sure you were told, that the existing taxpayers' charters have never formally had their lives brought to an end. What they were about was how the previous departments provided service to their customers but it is very

interesting in that those who make representations for the taxpayers' charters and point to them around the world are really pointing at charters which generally have a two-way approach. They set out the obligations and the service standards that tax administrations will offer and they also set out the obligations and responsibilities of taxpayers and those who advise them. Those are issues which our steering group is discussing at the moment, so the fairest thing I can say to you is that I suspect there will be a deeper discussion about taxpayers' charters but actually it was important for us to go somewhere else first. 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.

Q321 ***Lord Barnett:*** Do I take that as meaning that you have no thoughts of introducing a taxpayers' charter?
Mr Hartnett: No, that is not what I am saying, my Lord. I am saying that I think the decision to introduce it or not will be for ministers but I think it is something that is going to form part of the discussion in the steering group and has done already.

Q322 ***Chairman:*** These are very important questions. Did you give any consideration to having a committee like the Keith Committee, which I think was in our time in government?
Mr Hartnett: In truth not a lot, my Lord, but for a very particular reason. 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 say, and I do this with enormous respect to the Keith Committee, we are moving a little faster than the Keith Committee did. It took three years to publish its recommendations and for reasons that members of the Committee may have greater insight into than some of us, it took ten years to get the measures that were enacted enacted and many were not. We are consulting very widely indeed and I think we are getting a little approbation for the extent and quality of the consultation, and that is where we have got to.

Q323 ***Chairman:*** Nobody worries that inevitably, because you are doing it fast, there is an element of the piecemeal about it? It is not all done at one time?
Mr Hartnett: 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 or in manageable pieces? We are trying to do that and we have tried to deal with really very pressing things. First, as you have seen, we have now published consultative documents on safeguards and on how we carry out investigations and the like and there is more to come. I do not think, frankly, that in the 21st century we could have managed to do everything in one go. One only has to look back to Lord Keith's time and weigh in the left hand the volume of the tax code then and weigh in the right hand the volume of the tax code today, and I know I am on thin ice in opening up a different issue but I think it is a helpful way of looking at it.

Q324 ***Chairman:*** I think if I want to keep my Committee together I will probably not pursue the discussion on that particular thing. Perhaps I could press you a bit on the view that is put to us that the detailed rules should be in legislation rather than administrative procedures or guidance. I can almost feel the answer coming straightaway but nevertheless it is right that you should try and give us the answer.
Mr Hartnett: Maybe I can surprise a little with the answer. In relation to powers and penalties 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 of the scale of 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 the 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. We are doing so at a time that will enable us to bring forward to our ministers proposals for enactment in the next Finance Bill but also to enable us to put important things in our guidance and, my Lord, the last comment I want to make on this is that we are, of course, in relation to penalties, not introducing these measures until 6 April 2008 at the earliest. They will not be switched on.

Q325 ***Chairman:*** Finally, if I may, on this one, what comments would you make to those who have said to us, "The trouble with guidance is that it could be changed and there is not a great deal of comfort when you are in a court room in some sort of trouble"?

Mr Hartnett: I would expect HMRC to come very badly unstuck in the court room if it changed guidance and sought to rely on simple change in guidance of which taxpayers and their advisers were not given decent notice. I hope we never argue like that.

Q326 ***Lord Vallance of Tummel:*** Can we home in on criminal investigations? Some of our witnesses felt that powers in this area should be exercised only by the police or the Serious Fraud Office. Others were more concerned with ensuring that powers that were going to be taken by HMRC would be exercised only by properly trained and supervised officers, and a number stressed the need for HMRC to make clear publicly the circumstances under which powers of arrest would be used. Are you aware of these various concerns and can you say what you propose to do to assuage them?
Mr Hartnett: My Lord, yes, we are aware of them and we have had extensive discussions with various representative bodies and others, if I may say so, both north and south of the border. 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. Our people are constantly the subject of appreciative remarks by judges and others in relation to their work in criminal investigations. The answer to your question about power of arrest and how we are going to conduct that is that in law, although probably not in practice in the past, something like 20,000 employees of the old Customs and Excise had a theoretical power of arrest. The review of powers suggested to our ministers that that did not feel like an appropriate number even if it was theoretical rather than actual. Around 2,000 people going forward in HMRC will have a power of arrest and there will be some 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. The final point I want to make is that we are going to be supervised. We are supervised today by HM Inspector of Constabulary and when things go wrong or if they seem to have gone wrong the Independent Police Complaints Commission look after that, so there are important safeguards there.

Q327 ***Lord Sheppard of Didgemere:*** The next question I think I am probably the least qualified to comment on because I have not got any Scottish blood or DNA or anything, and to my knowledge I am not a criminal. Having said that, there is concern expressed by various people in the evidence we have seen about the way the procedures have been introduced for Scotland and therefore they have ricocheted back onto the procedural approach to England and Wales. Do you wish to comment on that? I will not ask you to comment on my ancestry.
Mr Hartnett: My Lord, I did think about commenting on my own ancestry which has no Scots blood in it either. I think this is an important issue and one that we should try and help the Committee with by just unpacking a little what we have been doing. It was really important for us to find an approach to our criminal investigation work in Scotland which struck the right balance—and I hope that does not upset anybody; it is a turn of phrase—between the devolved powers and those powers that remained in Westminster tax and the criminal code. We 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. One of your witnesses, or maybe it was my Lord Chairman in response to one of the witnesses or one of you, commented in relation to one representative body that it distanced itself rather more slowly from this than others had. We found that. We found that many representative bodies did not have the experience to give us as much advice and guidance as we would like to have had, but we got a lot, we are grateful for it and we think we have got to the right place.

Q328 ***Lord Blackwell:*** A number of our witnesses commented on the need for ongoing monitoring of powers being exercised, and indeed that the assurances that have been given as to the way the powers will be used are being adhered to. The suggestions included that there should be a standing committee made up of HMRC officials and practitioners or that there ought to be annual reports, possibly presented to Parliament. Can you give us your view on how well these mechanisms might provide for monitoring or what kind of monitoring you think is appropriate?
Mr Hartnett: I would just like to go back to what I was saying earlier on. The independent monitoring will come from the Inspectorate of Constabulary and

indeed from the Independent 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 at 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—one of the country's leading criminal lawyers and one of the country's leading human rights QCs sit on it—are going to want to look at how we are taking forward the issues they have discussed and which have become enacted. So I think *de facto* for a while there would be a committee of that sort.

Q329 ***Lord Blackwell:*** What about annual reports to Parliament?
Mr Hartnett: 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.

Q330 ***Lord Blackwell:*** Can I pick up the particular point about small businesses operating from home and whether there is concern about how the exercise of powers might affect other family members? Are there any particular assurances or monitoring of the way those powers are exercised which might assuage those concerns?
Mr Hartnett: The first thing to say is that wherever anyone's home is involved we will exercise powers with enormous sensitivity. There has been a lot in the media this weekend about our consultative document. I am very pleased that one or two commentators recognise that we have put the issues very sensitively and we have asked openly for views. 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*. If I go back to my youth as an investigator, one of the very favourite tricks of scrap metal merchants was that if they knew you were coming they would empty their stock. There would be nothing there when you turned up at the scrap metal yard. It would either have been sold or all moved to a friend and then moved back again later. It is an extreme example but we need to be able to look at things like that. We also need to be able to look at till rolls, for example, just to see whether the goods which are sold seven days a week are truly recorded on the till seven days a week or less frequently, but 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.

Q331 ***Lord Paul:*** If I can move on to new penalties for errors, there are three categories of behaviour which have caused a lot of comments, which are that the categories are not defined clearly enough with the potential for uncertainty, concern at the level of penalties at the less serious end of the spectrum and on unused losses, and that a wider power to depart from the fixed penalties should be introduced and some guidance as to what constitutes special circumstances. Can you comment on that?
Mr Hartnett: There is a lot there, my Lord. Let me try. I think the new package of penalties does something that has not happened before and that is to make 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, if I can use that term, and deliberate understatement with concealment I think are very clear indeed and the differentiation is very clear. I am sorry; I have lost your last question.

Q332 ***Lord Paul:*** A wider power to depart from fixed penalties.
Mr Hartnett: We have had fixed penalties before and particularly in relation to VAT but also in relation to direct taxes. They create a rigidity that all the advice we received said we should move away from, that the aim was to generate through penalties first deterrence but also different behaviour. Our experience and the analysis we have undertaken is that fixed penalties do not do that. 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. I was trying to think of an extreme example for you to show the sort of thing we have in mind—maybe someone who was travelling and had not sent us their accounts or done something they had to do and got caught up in something like the tsunami and simply could not get material to us. That sort of situation where everyone would have a sense that nobody should be penalised for not having done something is what the special circumstances are aimed at but they will be special and the use of that legislation will not be common.

Q333 ***Chairman:*** That was a very comprehensive answer, if I may say so, hardly looking at the note, but there was one that I thought I missed and that was that there was some concern expressed to us about the level of penalties at what might be called

the less serious end of the spectrum and unused losses. Have you any comments on that?
Mr Hartnett: Yes, I have, my Lord. The first thing to say is that the less serious end, mistakes where reasonable care has been taken, is going to have no penalties, but unused losses give rise to a generic range of difficulties that we have had no real answer to for a number of years, much the same as with the ability to move round group relief as well in order to counter profits discovered in a company which had not been disclosed. Both involve a lack of care and a lack of reasonable care, if I use the term here, and 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 as well.

Q334 ***Lord Sheldon:*** Referring to the rights of appeal, how can we resolve disputes over penalties?
Mr Hartnett: I think there are two or three things to say. The first is this, and if I may I will go back to the second question today, which was about our review of the links with large business, where one of the measures we are introducing is that where taxpayers and their advisers feel they are simply not being listened to adequately they can approach more senior people in our department. We want that to work in relation to penalties where there is a significant dispute. People can appeal to the appeal tribunal as well which can look at the issue completely afresh, with one reservation I will come to, which is my third category, and can replace their view or the penalty with the view that we have expressed. The final thing to say is that we have this new provision about the suspension of a penalty. There 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. Apart from the last part, which is brand new, these are safeguards that have worked in the past pretty well and our belief is that they will work well again.

Q335 ***Lord Barnett:*** As you will know, there is considerable discontent with the whole idea as set out in paragraph 18 of Schedule 24 on this relationship between HMRC, the taxpayer and his agent. Witnesses told us that they thought that if you are moving to a situation of behaviour it should be your behaviour, not your agent's, that should hold you liable. What do you feel about all that?
Mr Hartnett: I agree with that, my Lord.

Q336 ***Lord Barnett:*** You agree with?
Mr Hartnett: What you have just said, but let me explain why. Let us take two different taxpayers. Let us take a taxpayer who is wholly diligent in everything they do in relation to their taxation, who provides all the material that their tax agent needs in order to complete their tax return, who constantly chases and harries their tax agent to make sure the returns are made on time. That feels to me like a taxpayer who has taken reasonable care, and that if their tax agent is in some way delinquent then I do not think we are going to be seeking a penalty in relation to that taxpayer. Let us take an entirely different taxpayer, if I may say so with a small smile, quite unlike anyone in this room, I am sure, who does not actually like dealing with tax, so when their tax return comes in they sign it blank, they leave the date blank, they hand it over to their tax agent with a box of relevant papers and say, "Harry or Jane, please deal with this for me". That does not feel like reasonable care, and if it all goes wrong that is a significant issue and it is more the second than the first of those we are focusing on. May I just add one other thing? The UK is presently leading a study for the OECD of 35 countries in the Forum on Tax Administration on the relationship between, as it happens, because we have had to constrain the scope, business tax advisers and tax administrations. The sort of issue you have asked me about, how that relationship should work, who should be responsible and accountable for what, lies right at the heart of that study and we are trying to define in a new way, not in the context of the powers review, within the context of the study the disclosure, the transparency and the collaboration that would make for an ideal relationship between those parties.
Lord Barnett: I see.
Chairman: This is the last question on this section of it. On drafting there was universal discontent with the phrase "HMRC think".
Lord Barnett: Everybody assumes you never do.

Q337 ***Chairman:*** We understand that the Financial Secretary has given a commitment to look at this but what we want to know is whether you have agreed to change it.
Mr Hartnett: Let me start in a slightly different place if I may in answering. We had a look at the record of proceedings in your House to see whether this had come up before and Lord Sainsbury and Lord McIntosh among others have doughtily defended the ability of public servants and others to think, so it is not a new issue. Having said that, I feel we have been bemused by this. We have very clear advice from parliamentary counsel that "HMRC thinks" is an appropriate turn of phrase but my understanding is that it is to be changed where it occurs in this year's Finance Bill, but I for one do not plan to stop thinking, and I think my colleagues here are in the same situation.
Chairman: That is a very good answer, as long as it is not going to be changed to be negative, that HMRC do not think. Thank you very much. I wonder if we could now move on to on-line filing.

Q338 ***Lord Vallance of Tummel:*** Our witnesses in general were happy with the measures to encourage more on-line filing but there were doubts about compulsion, particularly for small businesses. Small businesses do not necessarily have computers or are not necessarily IT literate and so can you explain why it is absolutely necessary to make it compulsory?
Ms Middleton: I will pick up this question on on-line services. We are pleased that people were generally very positive about this move and we absolutely understand that there is a proportion of taxpayers in the population that are not IT literate, although, of course, as your Lordships will be only too well aware, internet access and usage is continuing to grow year by year. Indeed, our research suggests that 57 per cent of households had internet access by 2005 and in the business population it was 89 per cent, so you can see already that there is a big difference between business taxpayers and individual taxpayers in that sense. It is also the case that many businesses, including small businesses, choose to use an agent to transact with HMRC and for those we have been concentrating our efforts on making sure that the agent community, tax practitioners and other advisers are prepared to support their clients in the requirements to file on-line. The requirements about the smallest businesses, leaving aside the requirements for filing by non-business employers, which I think you are going to come on to in a moment, will not come in before 2012, so there is a lot of time to prepare the groundwork to work with businesses to understand how we can help them to get into a position to file on-line. In terms of your question about compulsion and why it is seen to be essential here, we believe it 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 on-line and that was why he recommended a package of measures to maximise the adoption of on-line services over a period of time. It is also the case that on-line services do offer a wide range of benefits for those that use them and anecdotally we are often told about these benefits by people. Those, as it were, from HMRC, those of our friends who maybe work there, do not often come and give us good news about their experiences but this is genuinely an area where they do. They say, "I used your on-line service and, much to my surprise, it worked really well". If you have not made that step to use it you are not necessarily aware of the benefits, and there are benefits around greater certainty, the acknowledgement that your return has been received, quicker refunds where a refund is due, more speedy updating of records. There are a lot of benefits which are not necessarily obvious to people who have not engaged with the service. What we have found is that we cannot rely upon awareness of those benefits to drive people to start to use the service on-line, and indeed the experience of the OECD has been that you need to take proactive measures to drive take-up.

Q339 ***Lord Vallance of Tummel:*** What you are saying is that naturally there is an increase in the number of people who are using on-line. This is growing as we all talk and there are indeed benefits, so why compulsion? If it is happening naturally and if the benefits are as compelling as you say, why not just let it happen?
Ms Middleton: To some extent we have done that in the self-assessment on-line process where we have seen incremental and quite rapid growth in recent years. However, the investment to enable on-line filing across the range of business taxes, and of course, it is not all business taxes but it is the main business taxes here, does require it to be used. Effectively you are building a channel for use and if people do not come and use it that is not good use of public money. That is the first thing. You need to be sure that you are making a good return on your investment. The second thing is our assessment of the readiness of the population to move down this road, which the information I have given you around internet use in the population, particularly business access, supports. The third thing is the high levels of use of agents within this arrangement and the fact that increasingly they do prepare their clients' returns and accounts on-line. They then print them out and send them to us in an envelope or sometimes bring them in round about 31 January. What we would like to do is get rid of the middle part of that process and, having had the returns prepared on-line, allow people just to press a button and send the data straight to our systems to remove that part of the process. There are a number of benefits that are available to the wider public in terms of getting best use of the money that HMRC spends on supporting its customers, benefits to business which are not necessarily visible to those that do not use the service at the moment, and the business case supports moving now on this, but having all of our channels still open whilst encouraging people to move to one was not believed to be the right way to encourage take-up.
Lord Vallance of Tummel: I have to say that I think a number of our witnesses would perhaps take the view that better marketing of those benefits from HMRC might be a better approach than compulsion.

Q340 ***Lord Sheppard of Didgemere:*** To test out your views on compulsion a little bit more can we take two examples of where I would like to know what your view is? One is people who live in remote areas have not got access to broadband. I know it is getting less and less but there are still some and always will be, and also people who suffer the disability of not being able to do read figures or words on the screen.

Ms Middleton: The first thing to say is that our services work with dial-up. I know that many people are moving to broadband but broadband is not essential to the use of our services. For people with dial-up they are designed to work with dial-up. Beyond that I think this may be an area where the perception of the availability of broadband is lagging behind the reality of its availability. Apparently 99.8 per cent of the UK household population has access to broadband. I know there were concerns expressed by some of the witnesses about the position in Scotland, and it is not as good in Scotland but even in Scotland it is 99 per cent, so I think the perception of the availability is lagging behind the reality of it.

Q341 ***Lord Sheppard of Didgemere:*** But increasingly we are concerned about the human rights of 1 per cent.
Ms Middleton: That is a very fair point. They have dial-up. The other thing in this context is that you asked about taxpayers who may have a disability, particularly people who maybe have some sort of visual impairment that prevents them engaging. Here we are doing a lot of work both researching their needs and looking at how we can meet them, but also the new portal that we will have for the on-line services is going to be designed to take account of that. I could give you some detail of the technicalities of what that involves but I think, given that you probably want to move on to other questions, there is a lot that we can do to make sure that people can use those services, people who have visual impairment, and it should be a better service than the one we are able to provide now for those people.

Q342 ***Lord Blackwell:*** With regard to the reliability of computer systems and indeed, I am saying in front of a former chairman of BT, sometimes the reliability of the networks, what contingency plans do you have if the on-line filing system does not work? How would you cope with that?
Ms Middleton: If I may, my Lord, I will start with what we are planning to make sure it does work. You might recall that Lord Carter recommended that we should do capacity testing and that we should do so for up to 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 on-line performance. We have had two very successful self-assessment filing deadlines, 31 January this year and 31 January last year, where the service withstood huge volumes, particularly in the days approaching the deadline, and worked really well. I think business is starting to feel more confident there. However, as I am sure you are aware from previous witnesses, we have experienced in the last few weeks two hiccups, which is one way to describe them though I am sure it does not feel that way if you are the person trying to use the service, with our PAYE on-line service. The service this year has been better than it was last year and last year's service was better than it was the year before by some considerable degree, but we have twice experienced in the last few weeks a glitch involving agents filing returns on behalf of their clients. In both cases, as soon as we became aware that there was a problem we fixed it quickly but nonetheless for those people affected it was very unfortunate and affected their experience. To answer your question more precisely about what will happen if people need to file and cannot, should a fault occur in spite of the preparation and capacity testing we can grant extra time for people to file, so no customer should lose out as a result of something that is our fault effectively in terms of allowing them to meet their obligations on time.
Mr Hartnett: We are actually looking at what other countries are doing in relation to contingency. Generally the answer is to provide more time. The USA have just had to do it, but also a number of countries—and we will be part of this route as well—are looking at how we can build much 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.

Q343 ***Lord Paul:*** My question is a continuation of this in that there are some businesses which are very small. Do you really expect every employer to be able to do that? Some are not really businesses at all. What will it cost them? You are, I hope taking that into account and will do something about it.
Ms Middleton: Yes, my Lord, we are. The smallest employers, and I think your Lordship might particularly have had in mind what we might call non-business employers who would be looking perhaps at employing someone to look after a child or a relative or themselves, indeed, will not be required to file on-line until 2010 although, as a result of the incentive payments that were introduced a few years ago to encourage smaller employers to migrate to the on-line service, we have found that 70 per cent of small employers are filing on-line already, so quite a large part of that population has already moved towards the on-line service. As I was saying earlier in response to Lord Sheppard's inquiry, the service is good. It is quicker. The data is transmitted more accurately. Therefore, there are fewer issues with records, things can be matched more easily and it will undoubtedly reduce the burden on small employers if they can go down this road. In terms of the cost, of

course, people can use the HMRC service, which is free, so they do not need to incur a cost. Alternatively, they may choose to purchase some payroll software, depending on the size of their business, or they may decide to outsource it and get somebody else to do it on their behalf. It is possible to do that, I am told, for upwards of £200–£250. The incentive, I think, for this year's filing is that it is down to £150 but for a small business that started out at the beginning of these proposals they could, if they continued to file on-line year on year, have £825 in return which I think would certainly go some way to defraying the costs for them.

Q344 ***Lord Sheldon:*** We have been told that mandatory electronic payment will include payment by cheque using the bank giro method. Is that so, and what do we do about people who are housebound or who do not have easy access to a bank or post office?
Ms Middleton: I can confirm that it is so, that we currently treat bank giro credit as electronic because the funds and the information come to us in electronic form; therefore, as far as we are concerned, it is electronic. The proposals which I think you are interested in here around mandating electronic payment I should say apply only to corporation tax and VAT, so I think many of the smallest businesses that you might be concerned about in this aspect will not be affected here. In terms of the future of bank giro credit and our acceptance of it as an electronic payment, in the medium term it is likely that we will continue to treat it as such but we do keep things under review, and particularly we are always looking at changes in the banking system so we just need to keep that in mind in terms of its use going forward. In terms of your question about housebound people who cannot easily get to a bank, it is quite straightforward to set up an electronic payment over the telephone or indeed by internet banking. If somebody feels concerned about the security aspects of internet banking they can, of course, use via the telephone network BACS payments or CHAPS payments, the traditional electronic methods. 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.

Q345 ***Lord Sheldon:*** How long will it be before it is changed?
Ms Middleton: In terms of bank giro credit?

Q346 ***Lord Sheldon:*** Yes.
Ms Middleton: It is being kept under review, so in the medium term, which I think we can reasonably assume is two to three years, it will continue to be the case, but, as with all these things, we need to watch developments in the wider banking world, how cheques, et cetera, are used in the economy more widely and make judgments on that at the time.

Q347 ***Chairman:*** We have got past the days when I was at the Treasury and some taxpayers used to take their cheques and post them in the Shetlands and the Orkneys on the last day that they could before they ever got anywhere. Those days have gone. We have asked you all the questions and you have given us answers and we are very grateful to you for coming along again and getting through so many questions as quickly as you have. It has been helpful to us in dealing with some of the points that were raised. Thank you very much indeed.
Mr Hartnett: You are welcome, my Lord.

Memorandum by Her Majesty's Treasury

INCORPORATIONS IN GREAT BRITAIN: NOVEMBER 2006 TO APRIL 2007

Month	*Week ending*	*Week Total*	*Month Total*
November 2006	05/11/2006	7,700	
	12/11/2006	7,300	
	19/11/2006	7,200	
	26/11/2006	7,500	
	03/12/2006	7,500	37,300
December 2006	10/12/2006	7,500	
	17/12/2006	7,100	
	24/12/2006	6,600	
	31/12/2006	1,400	22,600
January 2007	07/01/2007	5,100	
	14/01/2007	8,800	
	21/01/2007	8,100	
	28/01/2007	12,100	
	04/02/2007	10,500	44,700
February 2007	11/02/2007	11,800	
	18/02/2007	20,900	
	25/02/2007	14,100	
	04/03/2007	9,200	56,100
March 2007	11/03/2007	15,200	
	18/03/2007	16,700	
	25/03/2007	16,500	
	01/04/2007	13,800	62,300
April 2007	08/04/3007	10,400	
	15/04/2007	7,600	
	22/04/2007	9,700	
	29/04/2007	9,300	37,100

Source: Companies House

Notes:
1. All figures are rounded to the nearest hundred.
2. Week totals may not sum to month totals due to rounding.

Written Evidence

Memorandum by Business In Sport and Leisure

Introduction

Business In Sport and Leisure (BISL) is an umbrella organisation for over 100 companies in the private sector sport and leisure industry. Its members include most of the major operators of commercial sport and leisure in the UK and many consultants who specialise in this field. Members of BISL represent a wide range of interests in the gambling sector, including casinos, bingo, betting, pools, online gambling, greyhound and horse racing, snooker and ten pin bowling, pubs and gaming machines. As far as we are aware BISL is the only umbrella body representing all major sectors of the gambling industry.

We would like to offer a few remarks to the Finance Bill 2007 Sub-Committee in the context of the Budget's overall Business Tax Reform Package.

Industrial Buildings Allowances

Industrial Buildings Allowances (IBA) have always provided an efficient way of encouraging new-build properties. BISL notes that such encouragement is particularly important at the current time given the pressure on hotels and restaurants to expand capacity to meet the challenges of the 2012 Olympic Games in London and increasing tourism. Although IBA is set at only 4 per cent, this has been of immense value to the hotel and hospitality industry given the magnitude of building costs. We are therefore very disappointed that IBA is to be phased out over the next four years. At present about £3 billion is invested in new hotels each year and a further £2 billion in refurbishing existing hotels. It is expected that the removal of these allowances will cost the hotel industry £400 million per annum. Depreciation at 4 per cent per annum takes place over 25 years, so existing hotels which were built with the allowances in place will be affected too. The reduction in capital allowances will have an additional effect. BISL believes that it will be an inevitable result of this measure that increased costs will be passed on to the customer and the rate of hotel development will decrease significantly, with a detrimental effect on efforts to encourage tourism growth.

Gambling Taxation

BISL notes that Budget Note BN02 states that the business tax reform package is designed to achieve the objectives of "encouraging growth, through investment and innovation" and "ensuring fairness across the tax system". It is in this context that we would like to comment on the measures in the Finance Bill that relate specifically to gambling taxation, as we feel that when taken in the round those measures do not support these two objectives.

The ongoing implementation of the Gambling Act 2005 is resulting in the gambling industry paying considerably higher fees than previously to the Gambling Commission for personal and operating licences and to local authorities for the new premises licences. A pertinent example is bingo, an industry already suffering in the UK as discussed below, whose operating and personal licence costs will rise by 75 per cent when the new Act comes into force. Alongside fee increases, gambling businesses are also coping with increased costs for preparing new plans of premises, advertising in local newspapers and applying for conversion of existing licences into premises licences. BISL feels strongly that it is important to show leniency towards such an industry in transition and that businesses will not be able to cannot bear further tax increases.

We understand that the change in gaming duty rates for casinos to 15 per cent is designed to bring them in line with rates applied for other forms of gambling. However, we are also certain that the 50 per cent top rate will affect a larger number of casinos than intended and that rather than ensuring that "this vibrant and expanding sector continues to make fair contribution to tax receipts" it will reduce the viability of operations, diminish vibrancy and growth and so actually reduce tax receipts. Moreover, whilst the increase to 15 per cent can be construed as "ensuring fairness", the 50 per cent rate cannot.

Furthermore, the problems facing bingo are not currently addressed by the Finance Bill 2007, despite bingo falling foul of a much steeper overall taxation rate than other gambling products, which is ostensibly un-fair. Bingo pays both gross profits tax (GPT) and VAT on "par fees", meaning an overall tax rate of 27.65 per cent. The bingo industry in Scotland has been decimated by the smoking ban, with profits down 44 per cent, and

BISL believes that it is imperative that the Finance Bill addresses the inequity of Bingo taxation to help relieve the financial pressure on bingo clubs across the UK and ensure their continued role in community life.

Finally, BISL was disappointed that, despite positive engagement with the online gambling sector through consultations, the Remote Gaming Duty (RGD) has been set at the prohibitively high rate of 15 per cent. Rather than "encouraging growth through investment and innovation" and ensuring that the majority of operators serving UK customers come under UK regulation as intended in the Gambling Act 2005, this will keep online gaming operations off-shore and stifle both control and investment.

Brigid Simmonds OBE

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