Centre for Policy Studies

# Pointmaker

## A NEW, SIMPLE, REVENUE NEUTRAL TAX CODE FOR BUSINESS

David Martin

### SUMMARY


- The UK tax code is a disaster. The page count for Tolley's Tax Handbooks has doubled in length to 22,000 pages since it was last measured in the CPS report *Tax Simplification*, published in 2005.
- Top tax advisers in the UK are now charging up to £1,000 per hour. This is a higher figure than almost all overseas tax advisers – with the possible exception of the US, where there is a tax code which is almost as over-complicated as that of the UK.
- The complexity of UK tax law in practice has increased uncertainty and is acting as a spur to avoidance. This complexity is mainly caused by unnecessary rule-making and by a fragmented tax base.
- The tax code must be simplified – tax should be paid simply on the aggregate profit of a business, rather than the current situation where the amount of tax depends on a large number of unnecessary and complicated rules to determine taxable amounts.
- The reformed tax code proposed here is largely obtained by eliminating unnecessary rules from the current one. what would remain would look familiar to all tax practitioners.
- The starting point for tax reform is a strategic review of current tax law, with the objective of securing a simpler and better tax code.
- First steps could then be to abolish capital allowances in favour of tax depreciation and to abolish the separate streaming of trading investment and trading income.
- Tax law would then become accessible for the ordinary citizen who conducts a small or uncomplicated business. Their understanding of their tax liabilities would be increased and their compliance burdens would be reduced. Reform would save expense for all business. It would also free up time for HMRC to have proper contact to deal with taxpayers' concerns and issues.
- Reform would pave the way for an efficient and free service for a tax tribunal to resolve outstanding disputes – which would normally be on the basis of common sense, not construing complex legislation that may appear separated from the real world.

## 1. THE PROBLEM

In some respects UK tax law operates well in comparison with that of international competitors. This is particularly so in relation to online filing, which has made reporting personal, business and VAT tax matters much easier and more efficient.

Unfortunately however the tax code itself is a disaster. The page count for Tolley's Tax Handbooks has now doubled from the figure of 11,000 pages when it was last measured in the CPS report *Tax Simplification*, published in 2005.

But does Britain's lengthy tax law serve to provide more certainty, at least for those who are prepared to wade through it all, or pay someone to do this for them? No it does not. If the law was certain would there be a need, for example, for 198 HMRC manuals to explain how it is applied?

The problem of complexity comes to the surface when something happens to interrupt taxpayers' routines – perhaps when they undertake some new transaction and need to know how it will be taxed, or perhaps if they discover that they haven't been using tax computer software correctly (not ever having understood the underlying tax law) and are faced with a large tax bill, interest and penalties.

The fact that top tax advisers are now charging up to £1,000 per hour (plus VAT) serves to demonstrate the problem – politicians in particular might usefully ponder why this is happening. Of course much of such advisory work will be connected with international tax issues, but overseas tax advisers do not charge this much – with the possible exception of the US, where there is a tax code which is almost as over-complicated as that of the UK.

## 2. INTERNATIONAL TAX ISSUES

This paper is primarily concerned with how the tax regime might be improved for all businesses, not just the few which have international connections (for example only about 5% of UK businesses export to the EU), or the few large overseas businesses that in recent years have merited well justified concern about the very low levels of UK tax they pay.

But some comment about these companies is appropriate.

A multinational group such as Starbucks conducting business in perhaps dozens of different jurisdictions may reasonably decide to have a group treasury operation, lending money to subsidiaries where needed, a base for holding intellectual property, and a focussed operation for buying in its coffee and other commodities. In choosing an appropriate location for these activities, Starbucks will take into account what human and physical resources are needed, and also how much tax will be payable. Starbucks has chosen Switzerland for its coffee purchasing operations and the Netherlands to hold intellectual property.

But the key tax issue for a group like Starbucks is whether the UK operation pays more than an arm's length price to its Swiss company for its coffee, and in royalty payments to its Dutch company for the use of its name, and in interest payments.

There are natural and serious transfer pricing concerns that the amounts paid and allowed by HMRC are excessive – how is it that independent cafés in the High Street make a profit but Starbucks UK, who seem to get plenty of customers, do not?

It needs a tough, uncompromising and confident approach from the tax authority to take on a multinational group on such transfer pricing issues, and to establish the facts about where profits are really being earned.

It is at last becoming recognised that tax law needs to change to reflect the electronic era – where offshore companies supply services over the internet to UK customers, and where advertising income is received offshore. The OECD have been conducting a major investigation – the so called "BEPS" project, (Base Erosion and Profit Shifting), and the G20 last November endorsed the measures which have been proposed. Other separate initiatives include the new Diverted Profits tax in the UK, and in recent days Nigel Lawson has proposed that the UK should take the lead on a new tax based on sales rather than profits.

But we can be confident that such issues will not be finally put to rest until the public senses that these overseas majors are paying a reasonable amount of tax on the huge amount of income they source from the UK.

## 3. TAX AVOIDANCE NOT SOLVED BY OVER COMPLEX LEGISLATION

Clients will certainly expect their adviser to know the law and apply it intelligently, but they will often want lateral or creative thinking. Why does UK tax law leave scope for that kind of tax planning? Moreover, every year for at least the last twenty the Chancellor of the day has promised a crackdown on tax avoidance in his budget. What is going on?

The complexity of tax law in practice acts as a spur to avoidance – it challenges the tax planner to find a way around it.

The situation has got so bad that the "reactive approach" – closing tax loopholes after they have been exploited with specific legislation – is now giving way to a raft of new wide-ranging initiatives. The basic idea behind these is to get taxpayers to pay the tax that HMRC wants, irrespective of shortcomings in specific tax legislation.

This is giving rise to new pressures on taxpayers, and serious concerns about whether they are being given adequate safeguards.

## 4. NEW PRESSURES ON TAXPAYERS

One of the first examples of the new approach was in 2010, requiring banks to sign up to a code of conduct to comply with the "spirit of the law", in addition to the letter. Banks who were subsequently in breach of this code would be "named and shamed".

The "spirit of the law" is a phrase that has also recurred in HMRC publications – but "the spirit" might not be at all clear to someone who has diligently studied many pages of tax law on a particular topic, and spotted where the wording of the legislation does not require tax to be charged. When tax and penalties are at stake, is it sufficiently clear what HMRC might regard as a "loophole", contrary to the "spirit of the law"?

In 2014 the approach for banks was extended to "high risk promoters of avoidance schemes" – a label that could apply to organisations that might be surprised to find themselves within the target area.

The 2014 Finance Act introduced significant new powers for HMRC to issue a "follower notice" and require an accelerated payment of tax pending an appeal on a "tax avoidance scheme". This legislation applied retrospectively, not just to new arrangements entered into after the legislation was introduced, and there is not normally any right of appeal. If the taxpayer is bold enough to pursue an appeal to the tribunal after receiving a follower notice a penalty of 50% of the tax due becomes payable if the case is decided against them.

The 2013 Finance Act introduced the General Anti-Abuse Rule (GAAR). As a result a taxpayer needs to decide whether tax planning arrangements would have been counteracted by Parliament, if Parliament had anticipated them in advance. A new feature introduced by the GAAR is that a tax tribunal has a statutory obligation to refer to guidance notes that were current at the time of the transaction to decide whether the GAAR is applicable. These guidance notes are approved by an advisory panel established for the purpose, and they are revised from time to time. They are approximately 200 pages long. Under this year's Finance Bill a penalty of 60% of the tax will become automatically payable if the taxpayer loses an appeal against an assessment made under the GAAR, which is in addition to other possible penalties.

This year's Finance Bill will also contain new rules targeted at "uncooperative" large businesses and "serial avoiders".

About 2000 large companies will be required to publish a tax strategy, in the hope that this will discourage unacceptable avoidance (in fact, the signs are that companies will treat this further burden as a formality, which will lack any real impact).

And, further, consultations are now concluding on proposals to introduce fees for those appealing to a tax tribunal, which may further discourage legitimate appeals.

So taxpayers now have the worst of both worlds – a highly complex tax code combined with a series of measures designed to enable HMRC to circumvent the application of "the letter" of that code where avoidance is deemed unacceptable. All this blurs the traditional distinction between avoidance (which is legal) and evasion (which is not) and creates new uncertainties for taxpayers. To raise objections on legitimate grounds of objectivity, and of fairness, and that tax law should be decided by Parliament, risks being deemed to be on the side of tax avoiders – and so such objections can be brushed aside.

## 5. THE WAY FORWARD

The UK tax code must re-examined. Experience suggests that there is strong support for reform and simplification. But can it be done?

Detailed analysis shows how tax law for business can and should be reformed. The fundamental problems are that the tax base is fragmented and there has been a predilection exercised over many decades for unnecessary rule-making.

The starting point for reform is therefore to create a single comprehensive tax base which simply taxes all the profits of every business. There would no longer be separate rules for income from different sources, for capital gains, for capital allowances, and for the treatment of losses from the different sources. In the light of such a comprehensive tax base other detailed rules can be reviewed to see whether they remain necessary.

Previous reports published by CPS *The Reform of Business Tax* and *The Business Tax Act* illustrate how complexity can be substantially reduced. In terms of length it is noted that the proposed 'Business Tax Act' is the equivalent of about one eighth of the total 3,200 pages in the Taxation of Chargeable Gains Act, the Capital Allowances Act, the two Income Tax Acts and the two Corporation Tax Acts which may apply to business. This simplification can be achieved without reducing the number of exemptions and reliefs in existing tax law. These contribute to complexity, and further simplification could be achieved by cutting them down.

Last year's Office of Tax Simplification report on the competitiveness of the UK tax administration recommended aligning tax and accounting profit more closely, considered replacing capital allowances with allowable depreciation, eliminating sundry tax adjustments, and taxing businesses on their profits rather than streaming trading and investment results.[1] These suggestions are reflected in the *Business Tax Act*.

1 OTS, *Review of the competitiveness of the UK Tax administration: final report*, 2014.

A tax code for small or uncomplicated businesses, which is given in Parts A to E of the proposed 'Business Tax Act', is set out overleaf. This results from the detailed analysis set out in *The Reform of Business Tax*. More sophisticated businesses would need to refer to the remaining parts of the 'Business Tax Act', but they would not be subject to a separate tax code – Parts A to E of the *Business Tax Act*.

Part A "sets the scene" by defining the scope of the charge on business profits. Parts B to D provide the computational rules that, although applicable to all businesses, are the rules which a small business needs to know. Part E identifies certain particular businesses, which would need to look up special tax rules applicable to them.

This draft legislation for small businesses is just a few pages long.

The reformed tax code would be revenue neutral. Detailed costings can be prepared, but there is sufficient flexibility within the suggested code (e.g. restricting if necessary the rate of depreciation allowed on specified assets) to enable this important objective to be achieved.

Last week the office of tax simplification published a report on small company taxation. Unfortunately the measures it proposes for consideration will not result in substantial simplification and would in some cases cause further complexity.

## 6. TRANSITION TO A SIMPLER CODE

In order to pursue the simplification project careful consideration would be required as to how to transition from the current tax code. It is unlikely that this should all be attempted in one step. It should be reassuring to note however that the proposed Code is largely obtained by eliminating unnecessary rules. What would then remain would look familiar to all tax practitioners.

Various possibilities arise for other changes. For example one could as a first step abolish capital allowances in favour of tax depreciation. (It is noted that this step has become easier in practice in recent years with (a) falling rates of capital allowances (b) falling rates of corporation tax and (c) a generous annual investment allowance – which mean that the change would be far less painful for businesses heavily invested in plant and machinery than it would have been in the past).

One could then abolish the separate streaming of trading investment and trading income.

It would also be possible to introduce proposed changes so that they applied for small businesses only before rolling the proposed changes out to all businesses.

In such ways, one would converge on the legislation which is along the lines set out in The Business Tax Act, whilst maintaining at all times a consistent strategy for tax reform.

## 7. CONCLUSION

The starting point for tax reform is a strategic review of current tax law, with the objective of securing a simpler and better tax code.

Tax law could then become accessible for the ordinary citizen who conducts a small or uncomplicated business. Their understanding of their tax liabilities would be increased and their compliance burdens would be reduced. Reform would save expense for all business. It would also free up time for HMRC to have proper contact to deal with taxpayers' concerns and issues.

This would pave the way for an efficient and free service for a tax tribunal to resolve outstanding disputes – which would normally be on the basis of common sense, not construing complex legislation that may appear separated from the real world.

Why not do it?

## PARTS A-E OF THE BUSINESS TAX ACT

### PART A: THE CHARGE TO TAX ON BUSINESS PROFITS

**Section A1 The profits of a business**

(1) The profits or losses of a business are calculated for tax purposes in accordance with generally accepted accounting practice, subject to any adjustment required or authorized by this Act.

(2) Part 1 of Schedule A provides that small businesses may prepare simplified accounts which are deemed to comply with generally accepted accounting practice for the purposes of this Act.

(3) Part 2 of Schedule A sets out the rules which apply where accounts have not been drawn up in accordance with generally accepted accounting practice.

(4) References in this Act to receipts and expenses are to any amounts brought into account as credits or debits in calculating the profits, whether or not the amount has actually been received or paid.

**Section A2 The meaning of business profits**

(1) Subject to sub-section (2) and any other express provision in this Act, all the profits of a company which are not received in a representative or trustee capacity are treated for the purposes of this Act as business profits.

(2) Any amount that falls to be taxed under Part 2, 9 or 10 of ITEPA 2003 (employment income, pension income or social security income), is dealt with under the relevant Part of ITEPA 2003 and is not dealt with under this Act.

(3) Other activities, not undertaken by a company, which are deemed to be outside the scope of tax on business profits and accordingly are not dealt with under this Act, are listed in Part 3 of Schedule A.

**Section A3 The charge to tax on business profits**

(1) The charge to corporation tax shall apply at the rate set by Parliament for a financial year in respect of the business profits of a UK resident company, or in respect of the business profits which are attributable to a UK permanent establishment of a non-UK resident company.

(2) The charge to income tax shall apply for a tax year in respect of the business profits of a UK resident or the business profits which are attributable to a UK permanent establishment of a non-UK resident, where the UK resident or the non-UK resident is not a company. The tax charge on such profits, as aggregated with any other chargeable income or gains from other non-business sources, shall apply at the rates set by Parliament in accordance with Part 2 of the Income Tax Act 2007.

(3) This section is subject to any provision in this Act which applies to determine the taxable amount of business profits, including the rules for the utilisation of losses set out in Part H.

**Section A4 Accounting periods**

(1) For income tax purposes the profits or losses to be included in a tax year are calculated by reference to the accounting period which is the basis period for that tax year.

The general rule is that the basis period for a tax year is the 12 month accounting period that ends in the tax year. Part 4 of Schedule A sets out the detailed rules, including commencement rules for a new business, termination rules where a business ceases, and rules where accounts are drawn up for periods other than 12 months.

(2) For corporation tax purposes the profits or losses to be included in a financial year are calculated by reference to those accounting periods which fall wholly within the financial year, and to an apportioned part of those accounting periods which fall partly within the financial year. Part 5 of Schedule A sets out the detailed rules.

## PART B: RULES RESTRICTING DEDUCTIONS

### Section B1 Expenses for which tax relief is not available or is restricted

In calculating the profits of a business, no deduction is allowed for:

(1) expenses not incurred for the purposes of the business, or for losses not connected with or arising out of the business. If an expense is incurred for more than one purpose, this sub-section does not prohibit a deduction for any identifiable part or identifiable proportion of the expense which is incurred for the purposes of the business;

(2) a dividend or other distribution paid by a company, (subject to any provision of this Act expressly authorising a deduction);

(3) an amount charged in the accounts for a period in respect of disallowed accrued expenses which are not paid before the end of 9 months immediately following the end of that period. If the amount is paid after the end of that 9 month period, a deduction for it is allowed for the period of account in which it is paid;

(4) expenses incurred in providing entertainment or gifts in connection with the business;

(5) any social security contribution, save for employer's contribution which is a secondary Class 1 contribution, or a Class 1A contribution, or a Class 1B contribution;

(6) any tax penalty, interest or surcharge;

(7) a criminal payment; and

(8) a debt owed to the person carrying on the business, save in so far as the debt is an allowable bad debt.

## PART C: RULES ALLOWING DEDUCTIONS, EXEMPTIONS AND RELIEFS

### Section C1 – Rules which override section B1

Notwithstanding Section B1(1), a deduction is available in calculating the profits of a business for:

(1) qualifying pre-start expenses incurred within 7 years before the date on which the business commences;

(2) any reasonable expenses ("subsistence expenses") incurred on food or drink for consumption by the proprietor of the business at (or en route to) a place to which he travels in the course of the business (save that this rule applies only for income tax and not for corporation tax purposes);

(3) a payment by an employer to an approved agent who is operating an approved PAYE scheme on behalf of the employer;

(4) qualifying gifts to charity;

(5) qualifying remuneration to seconded employees who are seconded to charities and educational establishments, or for qualifying contributions made to local enterprise organisations or urban regeneration companies;

(6) payments are made for counselling services or retraining courses for employees;

(7) redundancy payments;

(8) costs of research and development;

(9) expenses incurred where a special threat arises to a person's personal security by reason of the particular business being undertaken (save that this rule applies only for income tax and not for corporation tax purposes); and

(10) qualifying expenses incurred connected with a foreign business.

**Section C2 – Enhanced tax depreciation**

(1) A deduction is available for expenditure of up to £200,000 on plant and machinery in a 12 month period under the rules for the Annual Investment Allowance.

(2) A business may elect to write down the cost of [a fixed asset of a description specified by Parliament for this purpose] for tax purposes at a fixed rate by means of a fixed asset election. [suggested new law – see The Reform of Business Tax].

**Section C3 – Exempted receipts**

(1) tax exemption is available for qualifying industrial development grants received.

(2) If a liability to pay a debt is released, the debtor is not required to bring into account a credit in respect of the release if the insolvency conditions are satisfied.

**Section C4 Further exemptions and reliefs**

[These reliefs would only normally be relevant for the more sophisticated type of business. It is therefore suggested that in due course they are set out in a later Part of this Act, with only a cross reference here, so that the provisions of Parts A-E would be kept relevant for less sophisticated businesses.]

(1) Expenditure on research and development.

(2) Remediation of Contaminated Land.

(3) Film Production.

(4) Television Production.

(5) Video Games development.

(6) Theatrical Productions.

(7) Disposal by companies of substantial shareholding.

(8) Patent Box.

(9) R&D expenditure credits.

## PART D: COMPUTATIONAL RULES FOR ALL BUSINESSES

**Section D1 Only historic cost basis of accounting to apply to certain assets**

It shall be assumed for tax purposes that the following assets shall be measured using the cost model and not their fair value:

(1) investment properties falling within IAS 40 or within FRS 102;

(2) property, plant and equipment falling within IAS 16 or FRS 102;

(3) investments in subsidiaries, jointly controlled entities and associates falling within IAS 31 or FRS 102;

(4) equity financial instruments which are available for sale falling within IAS 39 or FRS 102.

**Section D2 Rules for determining taxable profits from accounts**

(1) Part 1 of Schedule D sets out further rules for the determination of taxable profits from the accounts of the business: the use of amortised cost and of fair value accounting, rules where there is a revaluation of an asset, or a part realisation of an asset, or an asset is acquired with a nil accounting cost, or where assets are fungible, or where assets are not fully recognised for accounting purposes.

(2) Part 2 of Schedule D sets out rules for the valuation of trading stock and work in progress either on the cessation of a business, or on appropriation not in the course of trade.

(3) Part 3 of Schedule D sets out rules for the charge to tax on post-cessation receipts.

(4) Part 4 of Schedule D sets out rules giving relief for unremittable amounts.

(5) Part 5 of Schedule D sets out rules for deductions at a fixed rate for income tax purposes for the use of a car or for the use of a home.

(6) Part 6 of Schedule D set out rules for a wear and tear allowance for the furnished letting of a dwelling house.

(7) Any part of a gain accruing to a company or other non natural person on the disposal of a dwelling which has been subject to the annual tax on enveloped dwellings, ("ATED"), and which is subject to capital gains tax, is excluded from the calculation of profits liable to tax under this Act.

## PART E: SPECIAL RULES FOR PARTICULAR BUSINESSES

### Section E1 Particular businesses

There are special rules for the following particular businesses:

(1) an entertainer, sportsman or sportswoman of a prescribed description (a "performer") who is non-UK resident in a tax year, and performs a relevant activity in the UK in the tax year (see Part 1 Schedule E);

(2) divers and diving supervisers (see Part 2 Schedule E);

(3) farmers and creative artists which relate to the averaging of fluctuating profits (see Part 3 Schedule E),

[Farmers and the herd basis to be included here if appropriate following review];

(4) to cemeteries and crematoria (see Part 4 Schedule E);

(5) the purchase and sale of woodlands (see Part 5 Schedule E);

(6) ministers of religion (see Part 6 Schedule E);

(7) barristers and advocates providing for an alternative basis of calculation in early years of practice (see Part 7 Schedule E);

(8) a business or to a managed service company which makes a deemed employment payment in respect of services performed by an individual for a client through an intermediary (see Part 8 Schedule E);

(9) the deposit of waste materials by a person holding a waste disposal license (see Part 9 Schedule E); and

(10) unit trusts, Investment trusts and venture capital trusts which exempt from tax profits (and deny relief for losses) of a capital (see Part 10 Schedule.

## APPENDIX 1

### Notes on the draft legislation

The proposed legislation is shown as it appeared in the version published in October last year, save that an attempt has been made to improve the presentation of the law by leaving definitions for a separate definitions schedule. (For online users of the revised tax code a definition or cross-reference that needs to be checked would be immediately obtained by clicking on the words or phrases which appear in italics in the draft above). The proposed legislation has not been further amended to take into account the 2015 Finance Acts.

## APPENDIX 2

### IFRS

It is proposed that accounts are used as the basis for the tax computation, with simplified accounts available for small businesses. The question is often then raised whether accounts prepared under International Financial Reporting Standards are a suitable basis for a tax computation, because specified assets are entered at fair value instead of historic cost in such accounts.

If a taxpayer were to be assessed to tax on profits attributable to such valuations he may not have the cash to pay it. Further the valuation, and hence any tax payable, may be uncertain, whereas a profit realised on an actual transaction is not uncertain.

For these reasons there is general agreement that most fair valuations reflected in accounts prepared under IFRS need to be eliminated for tax purposes.

But the exercise of obtaining taxable profit from IFRS accounts is not as difficult as is sometime asserted. Assets where fair value accounting should be ignored for tax purposes can be identified in the tax code. Most of the adjustments would be straightforward, and generally entail the substitution of a complex subjective number by a simpler objective one.

The Business Tax Act already reflect most of the adjustments that are likely to be required. Further adjustments, such as whether to further restrict impairment for tax purposes, or whether the tax code needs to place further limits on depreciation rates which are allowed for tax, would also clearly be subject to further debate.

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