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Pre-Budget Report 2007 – Detailed Measures



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Air Passenger Duty

The existing basis of Air Passenger Duty will be changed from 1 November 2009. Instead of a rate per passenger, the duty will be levied on a “per flight” basis. It will be interesting to see the details of the proposal, which is expected to generate an additional £520 million of tax. In the meantime, a change is to be made to the current rules on APD, from 1 November 2008, so that the standard rate of tax will apply to “business class only” flights.

Our view

In its current form, the relatively low rate of APD is unlikely to lead to wholesale behavioural change amongst passengers and simply raises additional tax. It is likely to be hard to set the tax at a level that would have a genuine impact without making flying prohibitively expensive for the less well off. The weakness with the proposal is that with the tax levied on the airline and not the individual, it is less transparent and even less likely to affect behaviour patterns.

Biofuel Duty

The Chancellor proposes to reduce the excise duty on Biobutanol (an alcohol produced from the fermentation of biomass) from 50.35 to 30.35 pence per litre. The reduction will apply to Biobutanol used as a road fuel in specific pilot projects to be individually approved by HM Revenue & Customs. The measure will take effect 21 days after the associated statutory instrument is laid before Parliament.

Our view

Biobutanol is a lower carbon emitting substitute for petrol. The reduction in duty will help to encourage its use and is to be welcomed.

Capital allowances implications

Following the far reaching alterations to capital allowances announced earlier in the year, the Chancellor today announced a smaller number of further changes to the UK capital allowances system in the Pre-Budget report.

Fire safety expenditure

Legislation specifically extending capital allowances to building alterations made in response to a Fire Authority notice will be withdrawn from April 2008. This follows the fire safety legislation moving to operate on a self assessment basis and CAA2001 s. 29 no longer serving its purpose.

Biofuel plants

The Chancellor today announced that the Government has decided not to pursue State Aid clearance for its proposed 100% first year allowance for biofuel plants that meet certain qualifying criteria and which make good carbon balance inherent in their design, stating it would offer little value to a limited number of businesses while introducing considerable administrative complexity. This proposal was only announced in Budget 2007.

Disposal of plant & machinery to a non resident

Measures announced today result in capital allowances being fully recaptured when plant & machinery is disposed of to a non resident. This is achieved by the repeal of s222 CAA 2001, which limited the disposal value to the Tax Written Down Value in the case of certain sale and finance leasebacks. Following the repeal of s222 CAA 2001, the ability of lessor to access capital allowances is restricted by deeming leasebacks to be Long Funding Leases except in the case of plant & machinery less than 4 months old.

Compound interest claims

Before the PBR, it was rumoured that an attempt might be made to limit the cost of claims for compound interest resulting from HMRC breaches of taxpayers’ European law rights. Fortunately, these rumours have proved to be unfounded, at least as far as the PBR is concerned. However, in the consultation document “Tax Appeals Against Decisions Made by HMRC” it is suggested that the circumstances in which interest should be paid and the rate at which it should be paid should be laid down by Parliament rather than determined at the discretion of the VAT Tribunal.

Corporation tax: disguised interest

The corporation tax regime for loan relationships includes provision to charge to corporation tax profits on certain types of shares where these are intended to generate returns that are economically equivalent to deposit interest. These rules are known as the “shares-as-debt” rules. Ordinarily dividends and other distributions of a UK company are not chargeable to corporation tax in the hands of a UK resident company. However, the shares-as-debt rules over-ride this in respect of dividends and certain other distributions. For distributions paid on or after 9 October 2007, the shares-as-debt rules are extended to over-ride the corporation tax exemption for all types of distribution. HMRC indicates that this responds to the disclosure of schemes structuring the returns on such shares as distributions which would not otherwise be taxable under the shares-as-debt rules.

Our view

The familiar story of change being prompted by tax planning innovation.

Our view

The Disregard Regulations were introduced from 2005 to allow the continuation of most forms of hedge accounting for tax purposes, in particular where these are not permitted in individual company accounts prepared under IFRS or modified UKGAAP. The forex matching provisions in the Regulations have been seen as a short-term solution; the first change above is a further “sticking plaster” solution for one of the significant practical problems identified.

The long term solution aims to consolidate the provisions currently contained in primary and secondary legislation in one place.

Informal consultation is in progress on both changes via the HMRC IAS39 Working Group, which includes participants from the professions, commerce and industry.

Corporation tax: foreign exchange matching rules

The rules on the tax treatment of hedges of net investment in a foreign operation (“forex matching”) are being changed, in two stages. The first change will be relevant to companies that apply IFRS or modified UK GAAP, and are seeking to secure tax-effective forex matching under the Disregard Regulations (SI 2004/3256). The second change is more wide-ranging.

The first change is that the Disregard Regulations will be amended later this year to allow companies to elect to match the underlying net asset value of shares in foreign operations, rather than the book value as at present. The change will apply to periods of account beginning on or after 1 January 2008, and the deadline for making an election will be the later of 31 March 2008 and 30 days from the start of the first affected accounting period. Informal consultation on the change is taking place.

The second change is that a new set of regulations dealing exclusively with forex matching will be laid next year, to have effect from 1 January 2009. The new regulations will bring together those provisions applicable to companies who still account for foreign currency transactions under SSAP 20 (enabling the primary legislation in section 84A FA 1996 and paragraph 16 Schedule 26 FA 2002 to be repealed) and those applicable to companies accounting under IFRS or modified UKGAAP. HMRC will be issuing a Technical Note, together with draft regulations, for consultation in the first quarter of 2008.

Fire safety capital allowances

The Government has today announced that legislation extending relief for building alterations that are incurred in response to a notice from a Fire Authority is to be repealed. Capital allowances will no longer be available for expenditure incurred on or after 1 April 2008 for businesses within the charge to corporation tax and on or after 6 April 2008 for businesses within the charge to income tax.

Relief for expenditure on fire safety equipment such as fire alarms and sprinkler systems will continue to be available for all businesses.

Our view

This is a technical change that has been introduced to prevent businesses delaying vital safety improvement work in order to benefit from relief in the form of capital allowances.

Holiday pay – NIC exemption to be withdrawn

The special exemption from NIC on certain holiday pay (mainly in the construction industry, but also used elsewhere) is to be abolished. It will be removed on 30 October 2007 for employers outside of the construction industry and there will be a five year transitional period for the construction industry, ending on 30 October 2012, when the exemption will be withdrawn completely.

The Chancellor has chosen not to limit the exemption indefinitely to the construction industry as the construction industry is no longer the only industry to employ people on a short-term basis and the Working Time Regulations ensure that holiday entitlement is preserved even for short time periods.

The exemption will be fully available until 30 October 2012 where the employer is carrying on a business which includes construction operations and the employee is personally engaged in construction operations at the time the entitlement to the holiday pay is earned. This therefore excludes employees of construction companies who are not directly involved in construction work from benefiting from the exemption during the five year transitional period.

Our view

The exemption for NIC on holiday pay is an anomaly arising from historical industry-specific factors. The transitional period seems designed to allow construction industry employers to take advantage of the NIC exemption until the end of construction for the 2012 Olympic Games.

Income shifting for individuals

As already announced, new rules are to be introduced to counter higher rate taxpayers shifting their income to a lower rate taxpayer through the use of company dividends or partnership distributions. Those most likely to be affected are smaller family businesses.

Our view

HMRC made it clear at the time of the historic Arctic Systems case that they would be looking to effectively reverse that case. Consultation will take place on the detail of the new provisions.

Introduction of a new NIC limit for state pension accruals

Currently the Upper Earnings Limit (UEL) is the end point for earnings related state second pension (S2P) accruals. A new lower end point, the Upper Accrual Point (UAP) is to be introduced on 6 April 2009. The actual level will be announced in January 2008. Only earnings up to the UAP will be used to calculate S2P rights.

From 6 April 2009 employers and employees who have contracted out of the S2P will receive contracted out rebates on earnings between the Lower Earnings Limit (LEL) and the UAP. In other words, the rebates will be less than they would have been. Employers and employees will pay NIC at the contracted in rates of 12.8% and 11% respectively on earnings between the UAP and the UEL.

The UAP will be an additional complication for employers in annual reporting.

Our view

The introduction of the UAP is just one change provided for by the Pensions Act 2007. It has been introduced to achieve a simple flat rate S2P by around 2030.

Investment manager exemption

There are two policy objectives underlying the tax treatment of UK resident investment managers and their overseas clients. These objectives are:

- That overseas investors should not be charged to UK tax in relation to most investment transactions conducted on their behalf through an independent UK investment manager but.
- Any fees earned by a UK resident investment manager for services performed for the non-resident should be fully chargeable to UK tax.

The UK tax system seeks to achieve these objectives through the Investment Manager Exemption (IME), which applies where certain conditions are met. The exemption enables non-residents (funds and individuals) to appoint UK investment managers without the risk of exposing themselves to UK taxation. Consequently, the IME is one of the key components of the UK's attraction for the investment management industry, including the offshore hedge fund industry.

In July 2007 HMRC revised its guidance on implementation of the IME (Statement of Practice 1/01), to reflect developments in the investment management industry. However, there were some issues where the industry wanted to see changes which went beyond the scope of the revised guidance and require legislative amendment.

Following dialogue with the industry HMRC propose legislative changes in Finance Bill 2008 to deal with the following two issues:

- Alignment of the IME definition of ‘investment transactions’ with the FSA definition of ‘regulated activities’ (subject to additions or specific exclusions), the advantages of which should include tax simplification through alignment of regulation and accommodation of innovative financial instruments as they come to the market. In practice this means that UK managers of offshore funds should have the legal certainty they seek when they engage in a wider range of transactions. HMRC is continuing to consult with the industry on the precise scope of the new rules.
- Removal of an unpopular ‘cliff edge’ where the whole of an offshore fund’s UK profits might be brought into UK tax if certain transactions cause one of the qualifying conditions for the IME to be failed. The intention is to provide a more proportionate tax effect for non-qualifying transactions or arrangements.

Our view

This announcement is welcome and follows a period on ongoing consultation with the investment management industry.

Landfill Tax

A welcome technical change is to be made to update the Landfill Tax exemption for depositing waste produced from dredging operations. Broadly speaking, the change will maintain the original effect of the exemption in the light of developments in environmental law.

Our view

This is a welcome technical change that will maintain the effect of the original exemption and avoid an additional tax cost on dredging operations.

Leasing plant and machinery

Anti-avoidance to tackle certain sale and finance leaseback transactions which fell within section 222 CAA 2001.

Anti-avoidance aimed at transactions which create tax losses where there is a commercial profit.

Changes to the Sale of Lessors rules.

Anti-avoidance to tackle certain sale and finance leaseback transactions which fell within section 222 CAA 2001

HMRC has introduced new draft legislation intended to counter two schemes which exploited section 222 CAA 2001 to restrict the disposal value required to be brought in for tax purposes of plant and machinery sold to the tax written down value.

The schemes avoided triggering a full claw back of capital allowances on the disposal of valuable plant or machinery to a non-UK resident.

Section 222 was originally introduced to prevent a company which could not obtain a benefit from capital allowances (for example because it was loss making) transferring the capital allowance entitlement by selling the plant & machinery to a taxpayer who could utilise the benefit of capital allowances. The assets would then be leased back for reduced rentals which reflected the benefit of capital allowances to the lessor.

The new legislation will apply to sale and finance leaseback transactions entered into on or after 9 October. The legislation repeals section 222 CAA 2001 completely so that a full disposal value will be brought into account in accordance with the usual rules where a company sells and finance leases back plant or machinery.

The transfer of capital allowances is now prevented by a different technique following the repeal of s222. In future, with the exception of “new” plant & machinery (see below) finance leasebacks under a sale and finance leaseback will be treated as long funding leases. Accordingly the lessor will not be entitled to capital allowances except where the plant and machinery is “new” (less than 4 months old).

Our view

Lessors acquiring used plant or machinery to lease back to the original owner will need to consider how these anti-avoidance rules may affect their entitlement to capital allowances, even where the lease is a short term lease that would otherwise be excluded from the long funding lease rules.

Anti-avoidance aimed at transactions which create tax losses where there is a commercial profit

HMRC also introduced anti-avoidance to tackle schemes whereby a sub lessor in a lease chain realises a tax loss where there is a commercial profit (or a smaller commercial loss) either by:

- Obtaining a trading deduction for the cost of an asset but only being taxed upon the finance element of rentals received under a long funding lease; or
- where over the lease term there is a substantial difference between the GAAP profits and the tax result; that difference was to some extent a result of the “ceiling” in the long funding lease rules applying and that difference was a main purpose of the arrangements.

In each case the new rules remove the “ceiling” in the long funding lease rules which would otherwise apply to restrict the lessor’s taxable income.

The changes take effect in the case of 1. if deductions arise after 9 October (with just and reasonable adjustment) and in the case of 2. if arrangements are entered into on or after that date.

Our view

The ceiling in the long funding lease rules which restricts the income taxable upon a lessor to the finance element of rentals received was intended by HMRC only to apply where the lessor receives no deduction for the capital cost of the asset via capital allowances. The new legislation deals with the situation where a deduction is available for the capital cost of the asset otherwise than by the capital allowances system which brings it in line with the policy objective of the long funding lease rules.

Changes to the Sale of Lessors rules

FA 2006 brought in rules aimed at so called “leasetail” transactions. Leasetail transactions were used by lessors to permanently defer the tax in respect of rentals under leases. A lease will often not create taxable profits in its early years since capital allowances are in excess of rentals received under the lease. In the latter years of a lease capital allowances are usually less than rentals received so the lessor becomes taxable on the excess of lease rentals above capital allowances. By selling a portfolio of leased assets (or even the rental stream) to a loss making business, the loss maker could use its losses to shelter the tax which would become payable in the latter years of a lease and hence avoid ever paying tax on the commercial profit on such lease rentals.

The sale of lessor rules provide that a charge equal to the difference between the accounting value of the plant or machinery and the tax written down value (effectively the deferred tax balance) crystallises as a cash tax liability where the ownership of a leasing company changes.

Although there is no commercial purpose test for the sale of lessor rules to apply there is an equal and opposite tax deduction available to the leasing business which in theory brings neutrality where the transaction is commercially driven.

New draft legislation published by HMRC seeks to amend the sale of lessor rules to deal with certain situations involving the change in ownership of a leasing business from a partnership to a company. In such a scenario the legislation previously brought a charge upon the partnership disposing of the leasing business but did not provide for an equal and opposite deduction for the purchaser. The new legislation ensures that an equal and opposite deduction is received by a company acquiring a leasing business from a partnership.

Our view

This legislation is intended to correct an inequality in the legislation as previously published.

Life tax measures

It is probably fair to say that the PBR contained more specific measures than most commentators expected. In particular, HMRC has attempted to keep up the momentum of the ongoing work to reform the tax regime for transfers of insurance business by today publishing revised ‘near final’ regulations. When finalised, these are to be issued under Regulation-making powers contained in Finance Act 2007, and would extensively re-write the Finance Act provisions. Although perhaps a minority sport, for companies planning such transactions these changes will potentially be very significant, and the draft regulations will need to be worked through in detail over coming weeks. HMRC has acknowledged the importance of understanding the commercial impacts of the changes under discussion, but it is to be hoped that the continued reference in the PBR Notes to a 1 April 2008 deadline does not mean that HMRC will not heed the industry’s representations that the commencement date should be deferred to allow appropriate assessment of the proposals.

Draft anti-avoidance legislation has also been published to counter what HMRC sees as abusive structuring of certain reinsurance arrangements to maximise tax relief for expenses incurred in selling life business which is subsequently reinsured. The legislation, which is to be introduced in Finance Bill 2008, may affect policies or contracts made from today. It may also impact the quantum of brought forward expenses deductible in periods beginning after today. Revenue yield of £35m for 2008-9 (£45m for each of 2009-10 and 2010-11) is estimated from measures against “life insurance companies’ avoidance”.

Other changes directly aimed at life insurance are:

Legislation is to be introduced, with effect for accounting periods beginning on or after 1 April 2008, to tax life policies and annuity contracts owned by companies – with the exception of protection-type policies – as debt instruments. HMRC’s assessment is that very few companies own such policies, but those that do should ensure they have taken account of the transitional rules in particular (which deem the policy to be surrendered in full at transition, holding over the chargeable event gain until disposal of the policy or contract). We understand that the position of investment trusts holding life policies should not be altered by this change.

The rules affecting the apportionment of income and gains where there has been a “relevant reattribution” (of an inherited estate) are to be repealed. These rules were first introduced following an announcement in the 2004 PBR, and it is uncertain whether those who have been through the process of making representations to get the regime into its current state will be relieved at its demise, or concerned at the prospect of reopening the debate in the context of the ongoing consultation workstream on apportionments. In addition, consultations are continuing with the industry on a range of other issues.

General Insurance

No specific measures were announced affecting general insurance. Consultations are continuing with the industry on a number of issues including general insurance reserves, general insurance losses and certain Lloyd’s issues.

Measuring the tax gap

HMRC has issued a document which discusses methodology issues in estimating direct tax losses and sets out HMRC’s approach to improving their ability to measure such losses. The “losses” referred to are those arising from non-payment and submission of incorrect returns. This clearly includes error and deliberate understatements; but it is not clear whether avoidance is included as it is not mentioned in the document.

The measurement of these direct tax losses is extremely difficult; HMRC note that no tax authority routinely publishes comprehensive direct tax loss estimates.

One technique currently adopted by HMRC is to carry out “random enquiries” whereby samples of taxpayers are selected at random and their returns subjected to full enquiries by HMRC officers. This programme gives information about taxpayers under-reporting their tax liabilities, and the corresponding amount of the additional tax due. The results can be used to produce a figure for tax losses for the whole population because the enquiries are randomly selected and form a representative sample. This method is used in the USA but the sample sizes are much larger and therefore the estimates are more accurate.

HMRC report that progress is being made but there are a number of key areas where HMRC does not yet possess robust methodologies. Therefore HMRC is attempting to develop a range of measurement techniques that cover all types of direct tax loss across all taxes and taxpayers. For example, HMRC plan to use their risk assessments on large businesses, which are recorded on a new management information system, to help understand the size of direct tax losses. HMRC also want to use the effective tax rate shown in company accounts as a technique to estimate direct tax losses.

Our view

It is helpful for HMRC to publish their methodology. However it merely confirms what had been thought, namely that considerable further work is needed to help HMRC determine the size of the potential tax losses due to incorrect returns.

Procedures for resolution of tax disputes

The merger of Revenue and Customs has left the merged department with separate procedures for the resolution of tax disputes: those which apply to taxes dealt with by the VAT and duties tribunal and those dealt with by the Special and General Commissioners in the case of direct tax. The purpose of this consultation is to look streamlining procedures. In addition, there is a separate Government initiative to rationalise all tribunals. This initiative will also affect tax appeals. Legislation has been enacted (Tribunals, Courts and Enforcement Act 2007) and it is expected that the changes proposed in this legislation will be operational from 2009. The details of this legislation and the changes that it makes are not part of the consultation.

Views are sought on the following issues by 31 December 2007.

- Internal review of decisions: It is the case in VAT that before a formal appeal to the tribunal is begun, the taxpayer can choose to request a departmental review of the disputed decision. This right is not available in the case of direct tax. It is proposed that this right might be extended to direct tax. The document outlines various ways in which this may work.
- Administration of appeals: The document seeks views on administration of appeals made, alignment of time limits for appeals and procedures for dealing with late appeals.
- Deferral of payment of tax: Where there is a dispute, the procedures for dealing with payment of the disputed tax differ in the case of direct tax and VAT. VAT has to be paid before an appeal can proceed (subject to a taxpayer succeeding in making a hardship application); payment of direct tax can be postponed (in practice, at the discretion of HMRC). The document seeks views on these matters.
- Interest: The statutory rules on interest due on tax and VAT differ. In particular, the VAT and duties tribunal has a discretion to award interest at any rate that it considers to be appropriate. It is proposed that rules should be aligned and in particular, the VAT tribunal’s discretion should be removed.

- Administrative decisions: It is currently the case that some administrative decisions in relation to VAT (such as exercises of discretion) can be subject to appeal to the VAT and duties tribunal. In the case of direct tax such exercises of discretion by HMRC can only be challenged by way of Judicial Review. It is proposed the rules here could be aligned.
- Transitional arrangements: Views are sought on the process for the change-over between the old and the new tribunals.

Our view

Alignment is plainly sensible and to be welcomed. The possibility of internal review of direct tax matters is potentially helpful but it will be important, if it to be effective, that this is an independent review. Interest rules are a particularly contentious area at the moment following the decision of the House of Lords in *Sempra Metals* (that compound interest was payable by HMRC) so the stated intention to remove a discretion from the VAT tribunal has to be reviewed in the light of this decision.

It is currently the case that the VAT tribunal does, in principle, have a power to award interest including on a compound basis. There are some issues that are conspicuous by their absence: for example, the VAT tribunal has a general discretion to award costs to a successful taxpayer; in direct tax, costs can only be awarded if the one party has behaved 'wholly unreasonably' in relation to the appeal. This distinction would seem very hard to justify in a unified tribunal.

Taxpayers should use the opportunity provided by the consultation to make their views known.

Programme for tax simplification

Three principles of tax simplification.

Anti-avoidance legislation.

Corporation tax rules for related companies.

Our view.

Three principles of tax simplification

The Government has today announced the start of a programme of tax simplification. It sets out three principles of tax simplification:

- simplification will be a priority when designing and reviewing tax policy, alongside sound public finances and fairness;
- the Government will work with business to identify further opportunities to simplify the tax system; and

- the Government will share its findings on the viability of tax simplifications with business.

In particular the document announces that Government will launch three reviews this Autumn. HM Treasury and HMRC will work with business to evaluate how a range of tax policies could be simplified.

These initial reviews will cover:

- VAT rules and administration in the UK and the EU;
- how anti-avoidance legislation can best meet the aims of simplicity and revenue protection; and
- how to simplify the corporation tax rules for related companies.

These reviews will be wide-ranging but areas where Ministers have already made political or manifesto commitments or policy decisions to protect the public finances from criminal attack and serious non-compliance will be out of their scope.

Each review will first evaluate whether it reflects business concerns and priorities and are consistent with the Government's principles of tax simplification outlined above. Businesses and tax professionals will be invited to comment and to suggest other areas for discussion. Once priorities have been identified a work programme, setting out the remit and estimated timetable for the reviews, will be agreed with business. The Government will provide an update on the progress of each review at Budget 2008.

Unusually participation in the reviews, including commenting on the priorities outlined below, is invited either by completing the online questionnaires available or responding by email.

HM Treasury and HMRC will also be discussing simplification priorities with business through existing forums and specially arranged events.

Suggested priorities for each review, how they apply to business, and issues that might be discussed are outlined below. Views are invited by the end of November.

Anti-avoidance legislation

The document says HM Treasury and HMRC believe the priority areas in relation to anti-avoidance legislation are:

- ensuring new anti-avoidance legislation is clear, effective and well targeted; and
- simplifying areas of existing anti-avoidance legislation.

The document states modern anti-avoidance approaches can be consistent with moves to simplify the tax system, and cites some examples in this year's Pre-Budget Report and recent Finance Acts. HMRC and HM Treasury want to agree with business which legislative methods minimise business burdens. The review could also look at whether all anti-avoidance provisions should be in primary legislation or use a more flexible combination of primary and secondary legislation, and whether anti-avoidance legislation should be in separate parts of the tax code or integrated.

HMRC and HM Treasury would welcome views from business on any areas of existing anti-avoidance legislation it thinks could be updated and simplified, whilst ensuring revenue protection. Business is asked to highlight those areas of anti-avoidance legislation that impose the most significant burden. Government will then work with business to see how these areas could be simplified or even removed altogether, without harming revenue protection.

Corporation tax rules for related companies

There are over one million active companies in the UK, many of which have related companies, either as part of a group, or because of common ownership. These relationships often complicate tax affairs, and simplifying the corporation tax treatment of related companies could help reduce administrative and compliance burdens. The document states HM Treasury and HMRC believe the areas where simplification will be of most significance to UK companies are:

- group aspects of corporation tax on chargeable gains;
- associated company rules for small companies corporation tax rate;
- CTSA filing and payment for groups; and
- the burden of the transfer pricing rules.

The Government believes there may be scope for: (i) simplifying some of the provisions aimed at ensuring tax is only levied on gains realised when an asset is disposed of outside a group; (ii) aligning the tax outcome more closely to the economic effect for the group.

Each of these are discussed below.

As regards group aspects of chargeable gains, HMRC and HM Treasury seek views on:

- what should comprise a group for the purposes of corporation tax on chargeable gains;
- the treatment of assets transferred between group companies;
- the offsetting of gains and losses within a group;
- the treatment of companies on joining and leaving a group; and

- whether the taxation of the chargeable gains of a group of companies is fair and accords as far as possible with economic outcome.

As regards the associated companies rules for the small companies rate of corporation tax, they have existed for many years and, by and large, still deter income fragmentation. However the document notes that when the rules were introduced, partnerships were limited in size and the administrative burden of establishing the number of associated companies controlled by business partners was not great. Limits on the size of partnerships were lifted some years ago, and partnerships can now be very large. This increase in partnership size can in some cases cause problems in establishing the number of associated companies. The Government believes there may be scope for simplification of the associated company rules as they apply to the small companies rate.

As regards CTSA filing and payments for groups, arrangements already exist in certain, currently limited, circumstances for payments and tax information to be provided to HMRC on a group basis, for example group Quarterly Instalment Payments and claims to group relief. There may be scope to review the efficacy of these existing arrangements with business and identify the potential for improving and extending such arrangements to reduce administrative costs for business.

Transfer pricing is a key area of concern for businesses. Most of all, business wants greater certainty and speedier resolution of enquiries leading to reduced compliance costs. This is being addressed through the Review of Links with Large Business. The review will discuss whether the burdens caused by transfer pricing in cross-border or domestic situations can be further reduced.

Our view

This announcement is perhaps one of the Pre-Budget Report's more interesting documents. It will have little or no immediate effect but which could turn out to be significant. At least one of the new Chancellor's speeches had indicated an interest in tax law simplification, but of course this is not unknown for new Ministers. The practicalities of balancing simplification with the needs for fairness and revenue-raising often quickly crowd out thoughts of simplification before anything gets done.

At this stage the proposals are necessarily in their early stages. It has yet to be seen whether HMRC and the Treasury can engage meaningfully in a debate with business and advisors to simplify the areas of law initially put forward, and perhaps identify other areas for simplification.

Review of links with large business

Today sees the publication of “Making a difference: clarity and certainty” which sets out HMRC’s current progress on implementing the November 2006 Review of Links with Large Business. The review looked at proposals in four areas that business had told HMRC would make a difference: certainty, risk management, speedy resolution of issues and clarity through effective consultation.

HMRC reports progress as follows:

Greater certainty.

Clarity and consultation.

Speedy resolution of issues.

Resourcing to risk.

Greater certainty

Today the Advance Agreements Unit is announced. This aims to provide greater certainty and support for inward investments and significant corporate reconstructions, across all duties and taxes. The new service follows consultation; a new Statement of Practice SP 2/07 is published today. (This relates to Proposal 1 of the Review).

HMRC have today published the business response to its public consultation paper “Giving certainty to business through clearances and advance agreements”, which set out the detail of its proposals for clearances. Overall, business welcomed the proposals outlined in the paper and the move towards ‘real time’ dialogue. HMRC plan to continue to work with business on these proposals and the accompanying guidance on making applications. HMRC are consulting with a small group of business representatives to provide direction on implementation. HMRC plan to run a clearances pilot from January 2008 to help evaluate the proposed new clearance process. (Proposal 2).

Clarity and consultation

Following publication of HMRC’s Consultation Framework at Budget 2007 there have been 16 formal consultations. 15 ran for a full 12 weeks, compared to 12 out of 20 for the previous year. HMRC expect a total of 27 consultations for the year to March 2008, with the vast majority running for 12 weeks. Business is increasingly involved in early informal consultation, to help HMRC’s understanding of the potential effect of proposals, to guide formal consultations, and to deliver new and updated guidance. (Proposal 9)

HMRC have today updated its programme of planned updates and improvements to its guidance to Summer 2008. (Proposals 10 & 11).

HMRC have commissioned research to understand taxpayers’ experience of dealing with HMRC and assess the practical effect of the Review proposals to engage with business and research bodies. HMRC will publish the results by 31 December 2007 and will plan to ensure the views of business inform implementation of each proposal. HMRC propose to convene a panel of international expertise on tax administrations to bring a fresh, global perspective to Government. The panel will include members from academia, business and Government and will complement the existing Business Tax Forum and the Large Business Advisory Board. (Proposals 12 & 14).

Speedy resolution of issues

Large Business Service taxpayers each have a Client Relationship Manager, which normally improves working relationship between taxpayers and HMRC. As expected HMRC are now extending this service to some of the large business taxpayers within HMRC’s Local Compliance - Large & Complex Businesses. These Customer Managers will be able to help businesses resolve issues in a more efficient, less confrontational way. (Proposal 7).

Resourcing to risk

Implementation of the Risk Framework. Early indications are that 40% of the largest businesses could be classified as ‘low risk’, reducing their compliance burden, and 75% of ‘low risk’ open issues could be settled in the short term (Proposal 4).

Since publishing “HMRC approach to compliance risk management for large business” at Budget 2007, HMRC has been working with business to develop the new risk framework and the characteristics of a ‘low risk’ taxpayer, including how it should best address high risk taxpayers to reduce the overall amount of tax at risk. HMRC will shortly be publishing guidance. For the 1,300 or so very large businesses dealt with by Large Business Service:

- HMRC expect to apply the new framework in 2008. Current indications are that 40% of taxpayers could be ‘low risk’ by 31 March 2008.
- HMRC has been working with businesses to ensure that only significant risks are taken forward and expect to reduce by 75% the number of smaller risks that were unsettled at the beginning of 2007.
- HMRC are addressing those taxpayers with the greatest risk and have significantly increased the resources allocated to a number of the highest risk cases, creating specialist teams to quickly resolve significant existing and new issues. HMRC are seeking dialogue with high risk taxpayers at senior level to promote the benefits of reducing their risk profile.

HMRC expect to implement the new risk framework for the rest of large businesses dealt with by Local Compliance during 2008. (Proposal 4).

With effect from 1 April 2007 HMRC has ceased cyclical employer reviews, and all new “interventions” are now risk-based. HMRC have withdrawn the extensive opening questionnaire and replaced it with a Risk Assessment Aide Memoire for staff. Reviews will start by discussing risks and governance. Large scale systems and records reviews, if necessary, will provide assurance to employers. HMRC have appointed a team of senior managers to oversee this, and employer tax specialists to manage the resolution of the more complex issues that arise in very large businesses. (Proposal 6).

A summary of responses to the consultation document “HMRC approach to transfer pricing” is published today. Overall, HMRC say business supported focussing on higher risk issues and greater commercial understanding, agreed action plans for the speedy resolution and active management of enquiries, greater specialisation and team work on international issues, and early engagement with companies that request pre-return risk assessment. HMRC will continue discussions with business on its plans leading to implementation and publication of new guidance at the end of 2007. (Proposal 5).

HMRC have started a five year Tax Professionalism Programme to raise the level of expertise amongst its tax staff (Proposal 13).

This includes:

- a new modular framework of tax qualifications;
- development of a clear career path for tax staff;
- mandatory Continuous Professional Development;
- improving commercial awareness.

Our view

Rapid progress has been made by HMRC since publication of the November 2006 Review of Links with Large Business. However much of the progress is, understandably at this stage, on how to do what the Review promises, rather than actually delivering it. The challenge will come as and when the Proposals are implemented and taxpayers actually start, for example, using the Advance Agreements Unit and asking for the clearances required. The challenges will come at the same time as HMRC is delivering its staff reductions. HMRC know they have a big challenge; business will certainly welcome most or all of the proposals. Can HMRC deliver?

As regards resolution of Transfer Pricing enquiries, we think HMRC are working along the right lines, and we think the Varney 5 principles will help significantly in many cases. However we think that HMRC also need to tackle the lack of engagement with the documentation and analysis provided to them which sometimes happens.

Spreading of tax relief for pension contributions

With effect from 10 October 2007, HMRC are reinforcing the current rule that abnormally large employer pension contributions should be spread for tax deduction purposes up to four years. Under the new, post 2006 rules this is required where, for instance, a multi-million pound contribution exceeds 210% of the previous year's amount. However, if the previous year's amount is nil spreading is not required.

Our view

It appears that some groups have exploited this anomaly to avoid spreading by routing contributions through a newly-established participating employer with no previous record of paying contributions. This will no longer be effective.

Tax simplification review: VAT

HMRC and HMT have announced a review, working in partnership with business, on how to simplify VAT rules and administration in the UK and the EU. They are seeking views (including through an on-line questionnaire) **by the end of November** from businesses and other stakeholders.

Five areas prioritised for simplification include the 'option to tax'; partial exemption (including the capital goods scheme); frequency of return submission; VAT retail schemes; and complexities requiring simplification at an EU level.

An update on progress will be reported at Budget 2008.

Our view

Any simplification to the VAT system must be welcomed. Businesses should feel encouraged to submit their views on the priorities. The on-line questionnaire should facilitate this.

Our view

The guidance is aimed primarily at UK and offshore funds, the tax treatment of which depends on trading or investment status. It is consistent with the recent redraft of Statement of Practice 1/01 regarding the Investment Manager Exemption.

Whilst clarification of HMRC's views in this area is helpful, the guidance is not a panacea and developments in the financial markets are likely to continue to create uncertainty for fund promoters.

Tax treatment of financial derivatives

HMRC will incorporate within its Business Income Manual guidance on the tax treatment of financial derivative transactions. Although the guidance derives from discussions with the IMA and the asset management industry, it is intended to constitute generic guidance applying to financial derivatives in whatever context they are used. Nevertheless, it is stressed that the guidance will not colour the HMRC view of the distinction between trading and investment in the wider context of a commercial activity, or activities, as a whole.

The guidance sets out the following principles. Financial transactions include the acquisition, holding, disposal and dealings in respect of financial assets such as shares and bonds, together with "synthetic" positions in relation to such instruments. HMRC consider that there is no conceptual difference between a real and a synthetic position, and accept that:

- shorting is conceptually the same as long positions;
- derivatives that give exposure to part of an asset are conceptually the same as derivatives that give exposure to the whole; and, finally,
- multi-derivative or hybrid strategies should not be unbundled.

In HMRC's view, none of these intrinsically entail trading. The three approaches may constitute investments per se, or may form part of an investment strategy.

Individuals

Anti-avoidance through interest loss relief

From 9 October 2007 where an individual pays interest on a loan to invest in a partnership or certain kinds of small company, the loan interest will be restricted in certain cases.

Certain loans are structured such that all the interest on the loan is payable at the beginning. This leads to a large tax deduction because the existing rules allow for a tax deduction in the year that the interest is paid and not the year to which it relates. The resulting loss can be set against other income and capital gains and lead to potentially large repayments.

The borrower may then repay the loan at a large discount to reflect its non interest bearing nature.

The new rules deny tax relief on the interest which is due for later years.

Our view

This is a further example of HM Revenue & Customs using the tax scheme disclosure rules to close down perceived tax avoidance loopholes.

Capital gains tax reform

Major changes to the taxation of capital gains on individuals, trustees and personal representatives will take effect from 6 April 2008. Capital gains realised by companies are not affected by the changes announced.

For disposals on or after 6 April 2008 there will be a flat rate of tax on the capital gain of 18%. The annual exemption, currently £9,200 for individuals, will remain but indexation allowance and its successor, taper relief, will be scrapped. The 18% rate will apply irrespective of whether the asset was a pure investment, such as quoted stocks and shares, or a business asset, such as shares in an unquoted trading company.

Other changes relate to assets held at 31 March 1982. From 6 April 2008 the market value at 31 March 1982 has to be used. Previously the actual cost could be used if it led to a lower capital gain. Also, a disposal of an asset held at 31 March 1982 which had a capital gain held over will not have half the held over gain relieved as is currently the case.

The complicated rules relating to the matching of shares when they are sold are to be modified from 6 April 2008. From that date, with one exception, all shares of the same class held by a taxpayer will be treated as one asset and the costs aggregated, irrespective of when they were acquired. The exception relates to shares which were acquired on the same day as a disposal or within the next 30 days. These rules remain to avoid bed and breakfasting which increases the base cost of shares for capital gains tax purpose.

It was announced that most other reliefs, such as the relief when selling the main home, and rollover relief on business assets, will remain from 6 April 2008. The use of capital losses against future capital gains will continue as before.

For disposals up to 6 April 2008 the existing rules will apply. Draft legislation is to be published later this year.

Our view

Taper relief was introduced from 6 April 1998 to remove from charge a percentage of the capital gain depending on length of ownership and the type of asset being sold. It replaced indexation allowance which effectively increased the base cost of the asset to reflect inflation.

Since taper relief was introduced there have been numerous changes to the legislation covering it to prevent perceived abuses and to correct anomalies with the legislation. The removing of the relief and replacing it with a flat rate of tax greatly simplifies the capital gains tax legislation. A simplification of tax legislation is always welcomed if it is done appropriately and replaces unwieldy and unnecessarily complicated existing legislation.

One of the drivers for the change was the benefit obtained by wealthy shareholders who were paying an effective rate of tax of 10% on some of their investments. A move to 18%, whilst an increase, is still an attractive rate of tax to pay compared to the top rate of income tax of 40%.

Consultation Paper on offshore funds

A consultation paper was issued today on offshore funds. The consultation period ends on 9 January 2008. The Chancellor's objectives are to simplify the tax regime for offshore funds, provide certainty to UK investors and strengthen anti-avoidance.

The main features are to propose a new method of defining offshore funds for UK tax. The result should be of little material impact for most investors in retail type funds.

The status of funds in umbrella structures, including protected cell companies, will be tested at the fund or cell level, in line with current rules in order to ascertain whether they are "reporting funds" – broadly equivalent to "distributor" funds.

There is a loophole intended to be closed on the taxation of offshore income gains. This is the basis of taxation for non-distributor funds at present, and will apply to non-reporting funds in future. At the moment, income gains arise on 'rolled up' gains. An investor can be non UK-resident for as little as one complete tax year to avoid tax on these gains. In future it is intended that investors will need to be non-resident for five complete tax years, bringing the tax position into line with the taxation of capital gains.

Fuel Benefit Charge – multiplier to be increased to £16,900

From 6 April 2008 the fuel benefit charge multiplier (FBC) will be increased from £14,400 to £16,900. This will impact employees who drive company cars and received free fuel for private use and also employers who bear Class 1A National Insurance Contributions on the corresponding taxable benefit.

Since April 2003 the fuel benefit charge has been calculated by applying the appropriate company car tax percentage (based on the CO2 emissions of the company car) to a set figure known as the 'multiplier'.

Our view

The above inflation rise in the multiplier figure will increase the income tax and employer national insurance otherwise due. This change is designed to discourage the continued provision of 'free fuel benefit' and is part of wider government initiative to use the tax system to encourage more environmentally friendly behaviour by employees & employers.

Inheritance tax anti-avoidance: transfer of pension savings on death

From 10 October the Government has further tightened the anti-avoidance rules aimed at preventing pension scheme members from avoiding inheritance tax by arranging their pension entitlement so as to benefit their relatives after their death. The legislation imposes an unauthorised payments charge at an aggregate 70% for the member and the scheme. It does not apply to schemes with 20 or more members where the pension increase caused by the arrangements is at the same rate for all. There is a secondary inheritance tax charge, with offset for the unauthorised payments charge, where the member dies after reaching age 75, raising the aggregate rate of charge to 82%.

Inheritance tax nil rate band

From today individuals will be able to set any unused nil rate band on their spouse's death against their own estate in addition to their personal nil rate band.

An estate is not subject to inheritance tax if it is within the nil rate band (currently £300,000). Transfers between spouses are generally free of inheritance tax. If an individual simply leaves all their estate to their surviving spouse then the nil rate band is effectively wasted. Many married couples have in the past drawn up relatively complex wills to ensure that the nil rate is used on the first death.

The new rules allow a surviving spouse or civil partner to use any nil rate band that their spouse, or civil partner, did not use against their inheritance tax estate, in addition to their own nil rate band.

The new rules apply to deaths after today, so they are in part retrospective as unused nil rate bands arising on deaths before today can be added to the nil rate bands of surviving spouses, or civil partners, dying after today.

For example:

Mr Jones died in May 2007 having made no chargeable transfers. He left his entire estate to Mrs Jones. Mrs Jones dies in March 2008 and can set £600,000 of nil rate bands against her inheritance tax estate.

Our view

This is a very welcome change which will give a significant relief to married couples and those in civil partnerships allowing them to simplify the way they distribute their estates on the first death.

Inheritance tax provisions for alternatively secured pensions

The IHT provisions for alternatively secured pensions (ASP) will change in line with the new proposals for transferring the balance of the unused nil rate band on the death of a surviving spouse or civil partner. Under current provisions, a charge arises on left-over ASP funds once a relevant dependant's pension benefits cease. The rates of tax that apply are those in force at that time rather than those that apply at the date of death of the scheme member. This rule is to be modified to take into account the proposed changes so that relief will be given where the IHT nil-rate band was not fully used when the original 'owner' of the ASP died. This proposal is to be welcomed.

Introduction of a new NIC limit for state pension accruals

Currently the Upper Earnings Limit (UEL) is the end point for earnings related state second pension (S2P) accruals. A new lower end point, the Upper Accrual Point (UAP) is to be introduced on 6 April 2009. The actual level will be announced in January 2008. Only earnings up to the UAP will be used to calculate S2P rights.

From 6 April 2009 employers and employees who have contracted out of the S2P will receive contracted out rebates on earnings between the Lower Earnings Limit (LEL) and the UAP. In other words, the rebates will be less than they would have been. Employers and employees will pay NIC at the contracted in rates of 12.8% and 11% respectively on earnings between the UAP and the UEL.

The UAP will be an additional complication for employers in annual reporting.

Our view

The introduction of the UAP is just one change provided for by the Pensions Act 2007. It has been introduced to achieve a simple flat rate S2P by around 2030.

Measuring the tax gap

HMRC has issued a document which discusses methodology issues in estimating direct tax losses and sets out HMRC's approach to improving their ability to measure such losses. The "losses" referred to are those arising from non-payment and submission of incorrect returns. This clearly includes error and deliberate understatements; but it is not clear whether avoidance is included as it is not mentioned in the document.

The measurement of these direct tax losses is extremely difficult; HMRC note that no tax authority routinely publishes comprehensive direct tax loss estimates.

One technique currently adopted by HMRC is to carry out "random enquiries" whereby samples of taxpayers are selected at random and their returns subjected to full enquiries by HMRC officers. This programme gives information about taxpayers under-reporting their tax liabilities, and the corresponding amount of the additional tax due. The results can be used to produce a figure for tax losses for the whole population because the enquiries are randomly selected and form a representative sample. This method is used in the USA but the sample sizes are much larger and therefore the estimates are more accurate.

HMRC report that progress is being made but there are a number of key areas where HMRC does not yet possess robust methodologies. Therefore HMRC is attempting to develop a range of measurement techniques that cover all types of direct tax loss across all taxes and taxpayers. For example, HMRC plan to use their risk assessments on large businesses, which are recorded on a new management information system, to help understand the size of direct tax losses. HMRC also want to use the effective tax rate shown in company accounts as a technique to estimate direct tax losses.

Our view

It is helpful for HMRC to publish their methodology. However it merely confirms what had been thought, namely that considerable further work is needed to help HMRC determine the size of the potential tax losses due to incorrect returns.

Payments on account – threshold increased to £1,000

For tax years beginning on 6 April 2009 the threshold below which individual taxpayers do not need to make in year payments on account (PoA) is to be doubled from £500 to £1,000.

Currently a taxpayer having a balance owing on their tax return of £500 or more (and where less than 80% of their total tax liability was covered by withholding taxes) will be expected to make in year payments on account for the following tax year. For example a taxpayer owing £600 for 2006/07 may be expected to make payments on account for 2007/08 of £300 each. These payments would be due on 31 January 2008 and 31 July 2008 respectively. The doubling of the threshold is expected to remove approximately 367,000 taxpayers from the PoA regime. This will alleviate the tax compliance burden for a large number of taxpayers and effectively provide them with a further nine months to pay any tax expected to be owing.

Our view

The current threshold of £500 was set in April 1996 and has remained unchanged. The increase to £1,000 is therefore to be welcomed as an overdue change to ensure that self assessment thresholds maintain their link with increasing incomes.

Planning-gain supplement: a summary of responses

The Government has today published a summary of responses to the consultation on the proposals by Kate Barker to implement Planning-gain Supplement (PGS) as a means of releasing the land value uplift created by the planning process to help finance the infrastructure needed to support new housing and growth.

There was a broad acceptance amongst stakeholders of the need to fund additional infrastructure and that capturing a portion of the land value uplift created by the planning process was an appropriate source for this additional funding. However, there were a variety of opinions as to the right mechanism for achieving this.

Stakeholders wanted clarification on the use and distribution of PGS revenues and a number of stakeholders objected to the PGS proposals and favoured alternative means. Some were concerned at the complexity of the proposed rules, together with the administrative burden and operating costs whereas others felt that the model was too simple. Other concerns included the potential reduction in land available for development given reduced the reduced price for landowners, the impact on commercial viability of brown field development.

Our view

In light of the fact that no clear proposals to take this suggested tax forward have been made, it would appear that the Government is having second thoughts about its implementation in this form and will need to give further consideration as to how best achieve its policy objectives.

Procedures for resolution of tax disputes

The merger of Revenue and Customs has left the merged department with separate procedures for the resolution of tax disputes: those which apply to taxes dealt with by the VAT and duties tribunal and those dealt with by the Special and General Commissioners in the case of direct tax. The purpose of this consultation is to look streamlining procedures. In addition, there is a separate Government initiative to rationalise all tribunals.

This initiative will also affect tax appeals. Legislation has been enacted (Tribunals, Courts and Enforcement Act 2007) and it is expected that the changes proposed in this legislation will be operational from 2009. The details of this legislation and the changes that it makes are not part of the consultation.

Views are sought on the following issues by 31 December 2007.

- Internal review of decisions: It is the case in VAT that before a formal appeal to the tribunal is begun, the taxpayer can choose to request a departmental review of the disputed decision. This right is not available in the case of direct tax. It is proposed that this right might be extended to direct tax. The document outlines various ways in which this may work.
- Administration of appeals: The document seeks views on administration of appeals made, alignment of time limits for appeals and procedures for dealing with late appeals.
- Deferral of payment of tax: Where there is a dispute, the procedures for dealing with payment of the disputed tax differ in the case of direct tax and VAT. VAT has to be paid before an appeal can proceed (subject to a taxpayer succeeding in making a hardship application); payment of direct tax can be postponed (in practice, at the discretion of HMRC). The document seeks views on these matters.
- Interest: The statutory rules on interest due on tax and VAT differ. In particular, the VAT and duties tribunal has a discretion to award interest at any rate that it considers to be appropriate. It is proposed that rules should be aligned and in particular, the VAT tribunal's discretion should be removed.
- Administrative decisions: It is currently the case that some administrative decisions in relation to VAT (such as exercises of discretion) can be subject to appeal to the VAT and duties tribunal. In the case of direct tax such exercises of discretion by HMRC can only be challenged by way of Judicial Review. It is proposed the rules here could be aligned.
- Transitional arrangements: Views are sought on the process for the change-over between the old and the new tribunals.

Our view

Alignment is plainly sensible and to be welcomed. The possibility of internal review of direct tax matters is potentially helpful but it will be important, if it to be effective, that this is an independent review. Interest rules are a particularly contentious area at the moment following the decision of the House of Lords in *Sempra Metals* (that compound interest was payable by HMRC) so the stated intention to remove a discretion from the VAT tribunal has to be reviewed in the light of this decision.

It is currently the case that the VAT tribunal does, in principle, have a power to award interest including on a compound basis. There are some issues that are conspicuous by their absence: for example, the VAT tribunal has a general discretion to award costs to a successful taxpayer; in direct tax, costs can only be awarded if the one party has behaved 'wholly unreasonably' in relation to the appeal. This distinction would seem very hard to justify in a unified tribunal.

Taxpayers should use the opportunity provided by the consultation to make their views known.

These initial reviews will cover:

- VAT rules and administration in the UK and the EU;
- how anti-avoidance legislation can best meet the aims of simplicity and revenue protection; and
- how to simplify the corporation tax rules for related companies.

These reviews will be wide-ranging but areas where Ministers have already made political or manifesto commitments or policy decisions to protect the public finances from criminal attack and serious non-compliance will be out of their scope.

Each review will first evaluate whether it reflects business concerns and priorities and are consistent with the Government's principles of tax simplification outlined above. Businesses and tax professionals will be invited to comment and to suggest other areas for discussion. Once priorities have been identified a work programme, setting out the remit and estimated timetable for the reviews, will be agreed with business. The Government will provide an update on the progress of each review at Budget 2008.

Unusually participation in the reviews, including commenting on the priorities outlined below, is invited either by completing the online questionnaires available or responding by email.

HM Treasury and HMRC will also be discussing simplification priorities with business through existing forums and specially arranged events.

Suggested priorities for each review, how they apply to business, and issues that might be discussed are outlined below. Views are invited by the end of November.

Anti-avoidance legislation

The document says HM Treasury and HMRC believe the priority areas in relation to anti-avoidance legislation are:

- ensuring new anti-avoidance legislation is clear, effective and well targeted; and
- simplifying areas of existing anti-avoidance legislation.

The document states modern anti-avoidance approaches can be consistent with moves to simplify the tax system, and cites some examples in this year's Pre-Budget Report and recent Finance Acts. HMRC and HM Treasury want to agree with business which legislative methods minimise business burdens. The review could also look at whether all anti-avoidance provisions should be in primary legislation or use a more flexible combination of primary and secondary legislation, and whether anti-avoidance legislation should be in separate parts of the tax code or integrated.

Programme for tax simplification

Three principles of tax simplification.

Anti-avoidance legislation.

Corporation tax rules for related companies.

Our view.

Three principles of tax simplification

The Government has today announced the start of a programme of tax simplification. It sets out three principles of tax simplification:

- simplification will be a priority when designing and reviewing tax policy, alongside sound public finances and fairness;
- the Government will work with business to identify further opportunities to simplify the tax system; and
- the Government will share its findings on the viability of tax simplifications with business.

In particular the document announces that Government will launch three reviews this Autumn. HM Treasury and HMRC will work with business to evaluate how a range of tax policies could be simplified.

HMRC and HM Treasury would welcome views from business on any areas of existing anti-avoidance legislation it thinks could be updated and simplified, whilst ensuring revenue protection. Business is asked to highlight those areas of anti-avoidance legislation that impose the most significant burden. Government will then work with business to see how these areas could be simplified or even removed altogether, without harming revenue protection.

Corporation tax rules for related companies

There are over one million active companies in the UK, many of which have related companies, either as part of a group, or because of common ownership. These relationships often complicate tax affairs, and simplifying the corporation tax treatment of related companies could help reduce administrative and compliance burdens. The document states HM Treasury and HMRC believe the areas where simplification will be of most significance to UK companies are:

- group aspects of corporation tax on chargeable gains;
- associated company rules for small companies corporation tax rate;
- CTSA filing and payment for groups; and
- the burden of the transfer pricing rules

The Government believes there may be scope for: (i) simplifying some of the provisions aimed at ensuring tax is only levied on gains realised when an asset is disposed of outside a group; (ii) aligning the tax outcome more closely to the economic effect for the group.

Each of these are discussed below.

As regards group aspects of chargeable gains, HMRC and HM Treasury seek views on:

- what should comprise a group for the purposes of corporation tax on chargeable gains;
- the treatment of assets transferred between group companies;
- the offsetting of gains and losses within a group;
- the treatment of companies on joining and leaving a group; and
- whether the taxation of the chargeable gains of a group of companies is fair and accords as far as possible with economic outcome.

As regards the associated companies rules for the small companies rate of corporation tax, they have existed for many years and, by and large, still deter income fragmentation. However the document notes that when the rules were introduced, partnerships were limited in size and the administrative burden of establishing the number of associated companies controlled by business partners was not great. Limits on the size of partnerships were lifted some years ago, and partnerships can now be very large. This increase in partnership size can in some cases cause problems in establishing the number of associated companies. The Government believes there may be scope for simplification of the associated company rules as they apply to the small companies rate.

As regards CTSA filing and payments for groups, arrangements already exist in certain, currently limited, circumstances for payments and tax information to be provided to HMRC on a group basis, for example group Quarterly Instalment Payments and claims to group relief. There may be scope to review the efficacy of these existing arrangements with business and identify the potential for improving and extending such arrangements to reduce administrative costs for business.

Transfer pricing is a key area of concern for businesses. Most of all, business wants greater certainty and speedier resolution of enquiries leading to reduced compliance costs. This is being addressed through the Review of Links with Large Business. The review will discuss whether the burdens caused by transfer pricing in cross-border or domestic situations can be further reduced.

Our view

This announcement is perhaps one of the Pre-Budget Report's more interesting documents. It will have little or no immediate effect but which could turn out to be significant. At least one of the new Chancellor's speeches had indicated an interest in tax law simplification, but of course this is not unknown for new Ministers. The practicalities of balancing simplification with the needs for fairness and revenue-raising often quickly crowd out thoughts of simplification before anything gets done.

At this stage the proposals are necessarily in their early stages. It has yet to be seen whether HMRC and the Treasury can engage meaningfully in a debate with business and advisors to simplify the areas of law initially put forward, and perhaps identify other areas for simplification.

Remittance basis – Irish investment and employment income

From 6 April 2008 certain restrictions in the way the remittance basis of taxation applies to investment income and employment income from the Republic of Ireland are to be removed.

Under current rules individuals who qualify for the remittance basis of taxation are normally only liable to tax on foreign source income if it is remitted to the UK. The remittance basis does not, however, apply to investment income from the Republic of Ireland. In certain circumstances employment income from Ireland is also taxed on an arising basis when if it were derived from a country other than UK or Republic of Ireland it would be taxed on a remittance basis.

The proposed change will therefore benefit UK resident but not domiciled or not ordinarily resident taxpayers with Irish source investment or employment income and will ensure that Irish source income is treated in the same manner as other non UK income.

Our view

This change is to be welcomed as it removes an historical anomaly which could be deemed to be discriminatory to those with Irish source income (generally Irish Nationals).

Residence and domicile

The test for UK residence

The Government has made some major changes to the test for UK residence.

When deciding an individual's residence status, days of arrival in and departure from the UK will be counted as days of presence in the UK with effect from 6 April 2008. This will impact those who are not currently UK resident purely on the basis that they are excluding days of arrival and departure in their test for residence.

Taxation of UK resident but non-UK domiciliaries

Following the announcement of a review of the taxation of non-UK domiciliaries in 2003, the Government has made some major, although not entirely unexpected changes to the taxation of UK resident non-UK domiciliaries. The new rules – outlined below – will take effect from 6 April 2008.

The changes include an 'additional tax charge' of £30,000 for individuals who have been in the UK for seven years or more and want to continue using the remittance basis of taxation. The seven year time limit runs from the first year of residence in the UK, i.e. if the individual has already been UK resident for five years, the new rules will apply after a further two years.

Where an individual decides not to use the remittance basis (and not to pay the additional tax charge) he or she will be taxed on their worldwide income and gains whether or not they are remitted to the UK.

Entitlement to personal allowances will be removed for individuals resident in the UK who are using the remittance basis, subject to a de minimis level of unremitted foreign income of less than £1,000.

In addition, a number of alterations will be made to the remittance basis of taxation:

- The 'source ceasing' rule is to be removed with effect from 6 April 2008. This means it will no longer be possible to cease a source of income in one tax year and remit funds tax-free in the following tax year.
- It will no longer be possible to remit income arising in one year tax-free the following year by claiming the remittance basis in the first year but not the second.
- Further changes will mean an extension to the definition of remittance of relevant foreign income.
- There will also be a tightening of the rules relating to the use of offshore trusts and companies to convert taxable income and gains to non-taxable payments in the hands of non-domiciliaries.
- A general extension of anti-avoidance legislation, which currently does not catch individuals taxed on the remittance basis.

There will be consultation on the detail of the changes based on draft legislation due to be published later this year. The Government also intends to consult on whether individuals who have been resident in the UK for more than ten years should be charged an even higher amount by way of the 'additional tax charge.'

Our view

The new rules represent a major change in the position of non-domiciled taxpayers. Going forward, such taxpayers will need to calculate whether they are better off paying the £30k annual charge or giving up the benefits of their status in relation to their foreign income and gains. For the so-called "super-rich" that will be an easy decision as they will prefer to pay the annual charge. For the less wealthy it will sometimes be a marginal decision. For many the most crucial aspect will be the additional legislation promised to clear up "anomalies arising from the remittance basis".

VAT and housing

From 1 January 2008 the reduced VAT rate of 5% will apply to renovation work on residential properties where those properties have been empty for two years (the current qualifying period being three years).

Our view

This is a helpful measure in extending the scope of the reduced rate.

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