THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

Parliamentary Briefing

Finance Bill 2007

Second Reading Briefing

Introduction

In its submission to the Chancellor ahead of the Budget, the ICAEW suggested a number of actions the Government could take now to improve UK competitiveness and productivity. In this context we welcome the cut in the main rate of corporation tax, introduction of a training grant for small business and the increase in funding for R&D tax credits. However we do have comments on the details of the Budget announcements, particularly the impact of the changes to the capital allowances regime needed to fund the cut in the main rate of corporation tax.

We are particularly concerned that measures announced in the Budget will impact on the ability of SMEs to raise finance for investment and will also increase the after tax cost of that investment in cash flow terms. The measures concerned are as follows:

- The intended abolition of industrial buildings allowances and agricultural buildings allowances. This has been announced in the Budget but will not be legislated until 2008. However, to pave the way for their abolition, clause 35 of the Finance Bill restricts balancing allowances for those reliefs. Our specific concern is that financing decisions have already been made on the basis of existing reliefs and there should be full grandfathering of those existing reliefs. Further, for SMEs the measure to increase the small companies rate of corporation tax and a reduction in the rate of writing down allowances for plant and machinery and in particular those items that are integral in buildings, will lead to a significant increase in after tax cash terms of future business investment.

- Changes to the tax reliefs for venture capital contained in Clause 50 and Schedule 16 of the Finance Bill; and

- Restrictions on tax relief available on losses for sleeping partners contained in Clause 26 and Schedule 4 of the Finance Bill.

Key Issues

1. Abolition of industrial buildings allowances (Clause 35)

This Bill contains part of the legislation required to make the fundamental changes to the capital allowances system outlined in the Budget Notes. The industrial buildings allowance (IBAs) gives tax relief for business expenditure on certain industrial buildings, which includes certain hotels. There is a similar relief, agricultural buildings allowances (ABAs), for expenditure on buildings used in farming activities. This clause withdraws, for disposals taking place after 20th March 2007, the final allowance or charge which was previously tax deductible or taxable on the disposal of these buildings.

Impact
What businesses want most of all is long term certainty on investment tax reliefs. Capital investment decisions require a stable and certain tax regime. The immediate withdrawal of the industrial balancing allowance and the proposed withdrawal of the annual writing down allowance have a retro active effect in that they change the impact of long-term investment decisions that were made many years ago, in some cases up to 24 years ago. Furthermore, those which have invested more recently may have loan covenants related to the purchase of the building which are secured on

minimum levels of profitability. Withdrawing anticipated tax relief will affect profitability and could result in such loans being recalled, leading to a decline in the commercial property market.

The withdrawal of IBAs and ABAs, as well as major changes to the allowances for plant and machinery, will affect the UK's capital intensive businesses, including not only the UK's remaining manufacturing base but also sectors such as the hotel trade.

In respect of the hotel trade, concerns are already being expressed that the total impact of these changes will increase room rates considerably. However, the impact will not be uniform. Hotel rates are set by market forces and refurbished hotels are unlikely to be able to raise their prices sufficiently against the market rates. The impact will vary depending on the age and composition of the hotel stock in a particular area. The position would be particularly significant for hotels that have been acquired in the last few years and which are writing off the allowances over a much shorter period than the initial 25 year writing down period. As a result, these changes will severely impact upon the profitability of those businesses with a consequential impact on future investment, not to mention the possible problems with existing loan covenants referred to earlier.

Recommendation
Urgent consideration needs to be given to providing proper 'grandfathering' relief, so as to ensure that businesses making long-term investment decisions are not now disadvantaged. There are many precedents for such a procedure. Full grandfathering was introduced with the reform of the tax rules for intangible fixed assets, loan relationships and also with previous reforms to IBAs. When the writing down period for IBAs was cut from 50 years to 25 years, the 50 year period was continued for expenditure previously incurred. More recently the relief for long life assets was only reduced in relation to newly acquired assets and not to existing assets.

2. Venture capital schemes etc (Clause 50/ Schedule 16)

This clause and schedule introduce a number of changes in response to EU rules to the following tax favoured investment schemes in small and medium sized companies:

1. Enterprise Investment Scheme (EIS)
2. Corporate Venturing Scheme (CVS)
3. Approved EIS Funds
4. Venture Capital Trusts (VCTs).

These changes have been introduced to prevent these schemes losing their tax favoured status under EU state aid rules. The Government has acknowledged that the changes will impact upon the effectiveness of the schemes in addressing the equity gap (see paragraph 3.78 of the Budget Book). The ICAEW supports the Government's efforts to lobby the EU Commission to review the state aid guidelines.

The schemes were originally introduced to help provide capital to overcome a funding GAP for larger SMEs. This was in response to the Wilson Report which led to the establishment of the Business Expansion Scheme (BES) which developed into the schemes above and to the establishment of the Unlisted Securities Market (AIM). Academic studies have shown the importance of these schemes in encouraging entrepreneurial activity.

The changes introduced effect the qualification criteria for investments to qualify for these schemes and to prevent VCTs losing their tax favoured status. The changes include a maximum full time equivalent employees limit of 50 and restrict the amount of investment that a company can raise in any one year to £2 million.

Issues
- We do not believe that the government has fully explained the thinking behind the limits that have been arrived at in the Finance Bill and would welcome further clarification
- Our members believe that the threshold of £2 million is likely to be a problem in terms of the finance gap. We would urge government to raise this limit
- This fundraising limit are likely to stop new issues on AIM qualifying for tax reliefs. The proposed changes could appear to be an attack upon the AIM market and our members are also concerned about Clause 108 regarding the meaning of a recognised stock exchange. We believe that a Ministerial statement clarifying the future status of AIM and other exchanges in terms of tax reliefs available is needed
- Of much greater concern is the 50 full time employees limit. We understand that this has been used as it is the employee numbers limit used to define a small company by EU legislation. We would like further explanation as to why the medium sized limit of 250 cannot be used

3. Clause 26, Schedule 4 Restriction on loss relief available to partners

This clause and schedule cap the loss relief available to a sleeping partner to a maximum annual limit of £25,000.

Issues
The measures are particularly likely to affect any businesses being set up with a capital investment, such as those involving the purchase of properties or substantial assets. Examples of businesses affected will include farming, but will also include, for example, a long distance lorry driver buying a lorry and running the business as a partnership with his or her spouse, or fishermen buying a boat. There are many other such examples. Whilst we understand the need to limit the loss relief available to those individuals who are actively engaged in tax avoidance schemes, we are very concerned that the measure is much more widely targeted and that its impact will limit the finance available to small businesses on start up. Whilst the Treasury may understandably be concerned about tax avoidance schemes, we are concerned as to whether or not sufficient research has been undertaken on the impact of this measure on small businesses more generally.

It is usual for new businesses starting up to source finance from family and friends which can be injected either by way of loan or by the person putting in the money becoming a sleeping partner. If the sleeping partner has other taxable income, then that is likely to be a far better route than a loan, especially if there are likely to be losses in the early years.

Losses are likely to arise where there is substantial investment in the early years and we attach as Appendix 2 some case studies showing possible scenarios. These are everyday businesses that will be affected and we do not believe that the full potential impact of this measure on such businesses has been appreciated. We are also concerned that these rules will impact on business investments being made under Sharia laws.

4. R&D Tax Relief, Clause 49

This clause increases in the level of credit available and extend SME R&D tax credits to companies with 250-500 employees.

Issues

- ICAEW research shows that the current scheme is not incentivising companies to invest in R&D as effectively as it might and needs reforming. Boosting R&D tax credits will give more firms the opportunity to invest in R&D. But companies need to have certainty about the availability of R & D tax relief before they invest. The criteria for identifying expenditure that qualifies as R&D needs to be simplified, particularly for those seeking lower levels of tax credit. An optional pre-approval process should be developed with the ability for companies to know in advance if they will receive the funds.

5. Rates of Air Passenger Duty, Clause 12

This clause increases the rate of Air Passenger Duty (APD) for flights on or after 1st February 2007 irrespective of when those flights are booked.

- The specific increase in APD is not environmentally differentiated, for example between planes with different carbon efficiencies and will not induce behavioural change and so cannot be classified as a 'green tax' increase. The increase in APD is not consistent with the changes to road tax and stamp duty within the Bill which are environmentally differentiated.

- The change has retroactive effect as it 'catches' passengers who had already booked their flights before the date of the announcement. We believe the proposal should have been debated by the House of Commons so it has the opportunity to examine these issues.. The timing of the change was also highlighted by the Treasury Committee in its report on the 2006 Pre-Budget Report:

  > 'As a general rule, we consider that, where increases in rates of duties or taxes are proposed in the pre-budget report, those increases should not come into force until after the House of Commons has had the opportunity to come to a formal decision on the proposed increase following the budget.
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  > We draw the attention of the House of Commons to the unusual timing of the implementation of the increases in air passenger duty, for which the Treasury has not cited any relevant precedents.'

- HM Treasury should conduct a full impact assessment of Air Passenger Duty and the alternative option of an Aircraft Duty, where the fee paid for take-off rises with the carbon emissions of the aircraft and the length of

the flight (potentially using road-tax like classifications). HM Treasury might offer more incentive for airlines to utilise more fuel efficient aircraft over existing aircraft and still raise the same revenue. It may also be more practical in regard to future permit trading for aircraft emissions.

6. Managed Service Companies (Clause 25/ Schedule 3)

This clause introduces legislation to define a Managed Service Company (MSC) and changes the way in which workers paid by Managed Service Companies are taxed. Income received by individuals providing their services through MSCs will in future be treated as employment income. The consequence of this will be that MSCs will have to operate Pay As You Earn (PAYE) and deduct income tax and Class 1 National Insurance contributions on all payments made to individuals in respect of services provided through such companies, irrespective of whether this is paid as a salary or as a dividend.

The clause also makes the person who provided the company to the individual (the MSC provider) liable for any taxes owed to HM Treasury.

Issues

- In principle the ICAEW understands and supports the reasons for this change, but we remain concerned that the draft legislation is too widely targeted and may catch arrangements which we believe are not the intended target of this legislation.

- The transfer of debt provisions will ensure that where an MSC incurs a PAYE / Class 1 National Insurance debt, and that debt cannot be recovered from the company, the debt may be transferred to specified persons. These will primarily be the MSC's director and the MSC Provider. There is an exclusion for certain services provided by accountants but the precise scope of the exclusion is unclear. Many of our members provide a variety of services for MSCs but are acting properly and within our ethical code and professional conduct rules. They are concerned that if the exclusion is not clarified, they could become liable for debts incurred by their clients when they have been acting entirely within the law and the professional conduct rules that govern their services. There needs to be a properly targeted exclusion clause. The new rules will also define director's liabilities in such a way that may impact on legitimate business structures. The ICAEW in anxious to ensure that members businesses are not harmed and that consultation will continue so as to ensure that these rules are workable and properly targeted.

7. HM Revenue and Customs (HMRC) Powers (Clauses 81-86)

These clauses extend the power of arrest from staff previously employed by Customs and Excise, to staff previously employed by the Inland Revenue. Fundamentally, we question whether HMRC ought to have criminal investigation powers at all. We think that serious organised tax crime ought to be dealt with by the Serious Organised Crime Office (SOCA) in the same way as any other organised crime.

Issues

- It is vital that HMRC make clear publicly the circumstances in which the powers of arrest will be used. In its response to the January consultation document HMRC say that it is developing the guidance that we and other professional bodies have asked for and that "this will be published as soon as possible and before any changes come into force".

- In order for Parliament to properly debate these clauses, the promised statement of practice should be made available to coincide with the debate. We attach great importance to this statement. In particular we think it important for HMRC to reassure people that it will always use the least intrusive of the powers that it has that is consistent with obtaining its objective. For example, we believe that HMRC ought to give a public assurance that they will not seek to obtain documents under a search warrant which they could obtain the document by applying for an order for delivery under section 20BA, TMA 1970.

8. Extension of restriction on allowable capital losses, Clause 27

This clause extends the capital gains tax targeted anti-avoidance rule (TAAR) from companies to individuals, personal representatives and trusts. It was announced in the Pre Budget Report 2006 with draft legislation, a statement of principles and guidance being issued at that time.

The clause has been introduced to prevent the contrived creation of capital losses and prevents such losses being set either against chargeable gains or, in some cases, against taxable income.

Issues

- The current legislation is goes much wider than the intended target. The wording is so wide that practically any transaction resulting in the crystallising of a capital loss could be said to be within the scope of the legislation.

- The TAAR is meant to apply to disposals on or after 6 December 2006 and it is possible that taxpayers have entered into transactions as part of their usual year end tax planning not knowing they are caught by the new rules.

- Concerns were clearly expressed during the consultation process on the draft legislation but Government has dismissed them and, rather than change the legislation, has stated that the legislation can be clarified through HMRC guidance. Enacting legislation that is wider than necessary and leaving it to HMRC's discretion to introduce guidance (which can be departed from, withdrawn or revised at any time) to determine when the legislation will be applied undermines confidence in the tax system.

- The legislation should be changed so that it is properly targeted and does not catch those who are not the intended target, such that they then need to rely on non-statutory guidance.

- The start date should be deferred

9. Filing Dates (Clauses 87-91)

Lord Carter of Coles in his report on the 'Review of HMRC Online Service' published with the Budget 2006, recommended changes to the self assessment tax return filing date, and in particular that there should be different filing dates for filing paper and online returns. After representation from the profession and further consultation, Lord Carter modified his proposals and these revised recommendations were accepted by the Government in July 2006 and are represented in these clauses.

We welcome the alignment of the enquiry window to the actual return filing date, rather than the statutory filing date.

10. Penalties for Errors, (Clause 96/ Schedule 24)

This clause introduces a new regime for charging penalties for incorrect tax returns and is a product of the ongoing HMRC Review of Powers. It will apply to returns for income tax, CGT, corporation tax, PAYE and CIS deductions, NICs and VAT, though it is expected that in future the model will be extended to other parts of the tax and tax credits system. Penalties for other aspects of tax administration, eg late filing, are the subject of separate reviews. The details of the new penalty regime are set out in Schedule 24 and will come into force by Treasury order. HMRC have said that this is expected to be for return periods commencing after 31 March 2008 where the return is filed after 31 March 2009, ie there will be no penalties under the new system until after 31 March 2009

The key features of the new penalty regime are:

- There will be no penalty where the taxpayer made a mistake but has taken reasonable care to complete the return correctly
- Stepped levels of penalty based on taxpayer behaviour
- Penalties charged as a percentage of tax lost, with increasingly large penalties for increasingly serious taxpayer default – for which there are three categories: carelessness (defined as 'failure to take reasonable care'), deliberate inaccuracy and deliberate inaccuracy with concealment
- Penalty percentages are set in statute and will be: 30%, 70% and 100% for each of the above categories of behaviour
- Substantial penalty reductions for disclosure, especially when unprompted
- Penalties for overstating losses, including group relief, and for failing to point out errors in assessments made by HMRC
- Possible suspension of penalties for carelessness (at HMRC option) and then cancellation if subsequent compliance is demonstrated
- Penalties to be charged even where the taxpayer has relied on a third party, where that third party has not taken care
- HMRC will be able to pursue a company officer for a penalty where it has arisen through that officer's dishonesty

Issues

- Taxpayer behaviour is the key to the new penalty regime, and the way in which behaviour is understood and categorised by both HMRC and taxpayers will be crucial to the effective operation of the system, particularly with regard to the important principle that innocent error should not be penalised. Detailed rules will be in HMRC published guidance and not in law, and will not therefore be subject to Parliamentary oversight.

- The penalty percentages are higher than those which are charged in many cases under the current system, which allows mitigation at HMRC discretion. We see the merit in charging severe penalties for the most serious types of default but we are concerned that those at the less serous end of the behaviour spectrum will be more heavily penalised than at present. HMRC say (in their summary of Responses to 19 December 2006 Consultation Document) that their projections show that 'there will be no overall increase in the level of penalties … for failure to take reasonable care). We recommend that both representative bodies and Parliament should be shown the relevant research and projections which support this.

Further information

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