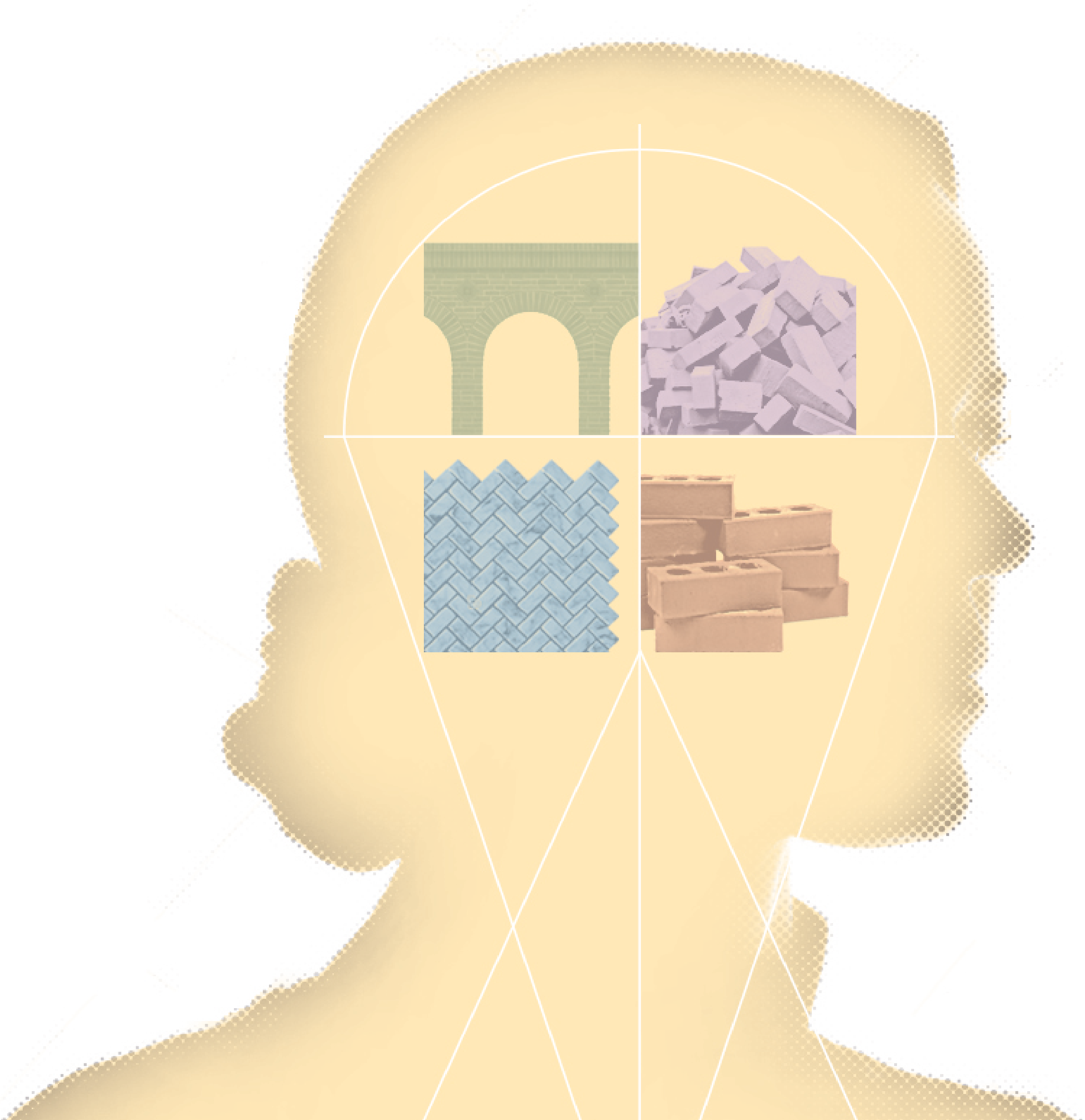
ICAEW THOUGHT LEADERSHIP

TAX FACULTY

Business rates: maintain, demolish, rebuild or refurbish?



ICAEW Tax thought leadership

Technology is profoundly affecting the administration of tax systems, as well as bringing unprecedented challenges to the tax base. Solutions are now being rapidly developed that would have been unthinkable only a short time ago (for example, recent proposals to tax revenues on the value created through digital platforms).

The 2011 Mirrlees Review identified the characteristics of a good tax system. It also recognised that, at least in the UK, extensive reform is necessary to meet this ideal. Mirrlees concluded that the current UK tax system was 'inefficient, overly complex and frequently unfair'. Not only are these criticisms unfortunately still valid, they are increasingly being compounded by rapidly evolving technology that affects who pays tax and how much they pay. At the same time, anti-avoidance and other measures aimed at countering the effects of these developments continue to make the tax code more complicated.

It is now time for action. Without fundamentally reviewing the basis for tax and the implications of changing technology, governments may face the dual problem of shrinking tax revenues and mounting criticism of a tax system regarded as overly complex and unfair. The implications could be critical, especially as public finances face mounting pressure from an ageing population and increasing expectations of government assistance.

ICAEW is an independent professional body acting in the public interest. Our Ten Tenets for a Better Tax System comprise 10 key characteristics against which to evaluate tax systems and tax policies. This paper is part of a new thought leadership programme that aims to address difficult issues about how tax can evolve to meet the needs of the future. We want our work to be relevant to anyone with an interest in tax and we welcome your comments.

Join the debate by using #BizRates on Twitter or by posting on our discussion platform: ion.icaew.com/taxfaculty

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Executive summary

Property makes a good target for taxation. Its location is fixed, its ownership recorded and, valuation complexity aside, the tax liability can be calculated with relative certainty and consistency over time. Given these advantages, it is unsurprising that business property forms an important part of the tax base in many countries.

Yet business property taxes are becoming increasingly unpopular. The advent of online business models that can operate with a smaller physical presence has led to criticism that some businesses are being taxed unfairly. At the same time, the system for assessing the tax liability can be extremely complex, difficult to understand and correspondingly costly to navigate.

The situation is particularly acute in the UK, which in aggregate has the highest property taxes in the Organisation for Economic Co-operation and Development, and where the system of business rates can be traced back to at least 1601. UK businesses have made it clear that a reform of business rates is overdue. Some are suffering real hardship from rates bills that do not scale with ability to pay.

All of the main UK political parties have committed to reform, and the government has already made or proposed a series of changes to the system to address some of the pressures. However, for many businesses, the 2017 revaluation in England and Wales made the situation more acute. While the smallest businesses benefited from generous relief in the 2016 budget, others, including many high-growth entrepreneurial enterprises that are the backbone of future economic prosperity, have received limited or no respite.

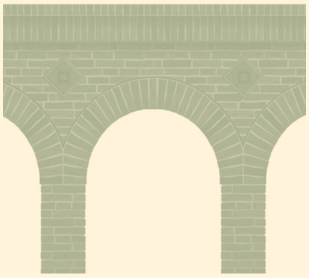
Business rates have been a reliable and consistent contributor to UK government revenues. Over the past 10 years receipts have risen rapidly, from £21bn to £29bn, outstripping the growth of both the Retail Price Index and gross domestic product. However, this may no longer be sustainable.

Common criticisms of business property tax include the following.

- The digital economy is putting increasing strain on the retail sector, one of the biggest contributors.
- The system entails additional, unrecognised, costs for businesses. In the UK rate-payers must themselves take responsibility for initiating the review of valuations. Although the new 'check, challenge, appeal' system might reduce incidences of appeals, if it induces businesses to accept a level of inaccuracy in valuations, they might not consider it a cost saving.
- Elements of the system discourage economically productive investment, such as where plant and equipment or other movable property is included.
- Property taxes fail to scale with profitability, which differentiates them from other taxes that track the business cycle. When the next downturn arrives this will place additional strain on the economy and could lead to the failure of otherwise viable businesses.

Maintain, demolish, rebuild or refurbish?

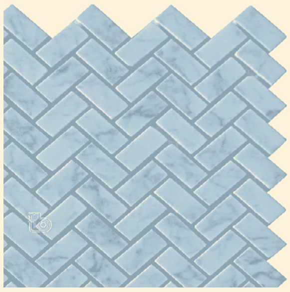
To secure revenues for the future, and to make the system as simple as possible for businesses and for the government to administer, hard choices must now be made. We believe there are four options.



1. Maintain: Make piecemeal changes to the system to address particular stresses, perhaps by providing more targeted reliefs, or allowing local government greater flexibility to address particular local issues or capture growth opportunities (this is the option taken so far).

2. Demolish: Remove tax on business property and raise revenues elsewhere instead, perhaps by increasing corporate or sales tax. Although such a move could dramatically simplify business tax, there may be a scale problem: UK business rates raise nearly half as much as corporation tax, and abolition would significantly increase taxes elsewhere.

3. Rebuild: Replace the tax on business property with an entirely new tax (such as a land value tax), with the aim of simplifying assessment and administration while spreading the tax burden equitably.



4. Refurbish: Retain business property tax but fundamentally reform elements of the system that are particularly inefficient or problematic.

We believe that (1) maintain and (2) demolish are not sustainable in the UK. Given the issues outlined above, 'making do' no longer appears to be a viable option. Equally, business rates raise too much revenue for the burden to be transferred elsewhere. The scale of the increases to other taxes that would be required to absorb business rates receipts are likely not politically feasible.

Choices (3) rebuild and (4) refurbish merit further investigation. The replacement of business rates with a new tax, perhaps based on land values, might be more efficient to administer and, if designed appropriately, might provide more effective incentives to business, boosting the economy and the tax take. However, any such move would create both winners and losers, and would require strong political will to achieve. Alternatively, elements of the business rates system might be reformed to operate more effectively.

The case for action

This paper demonstrates that hard choices will undoubtedly have to be made to ensure that property tax is match fit for the 21st century. The reward would be a tax system that worked to generate more prosperity for everyone, and more tax for government as a result.

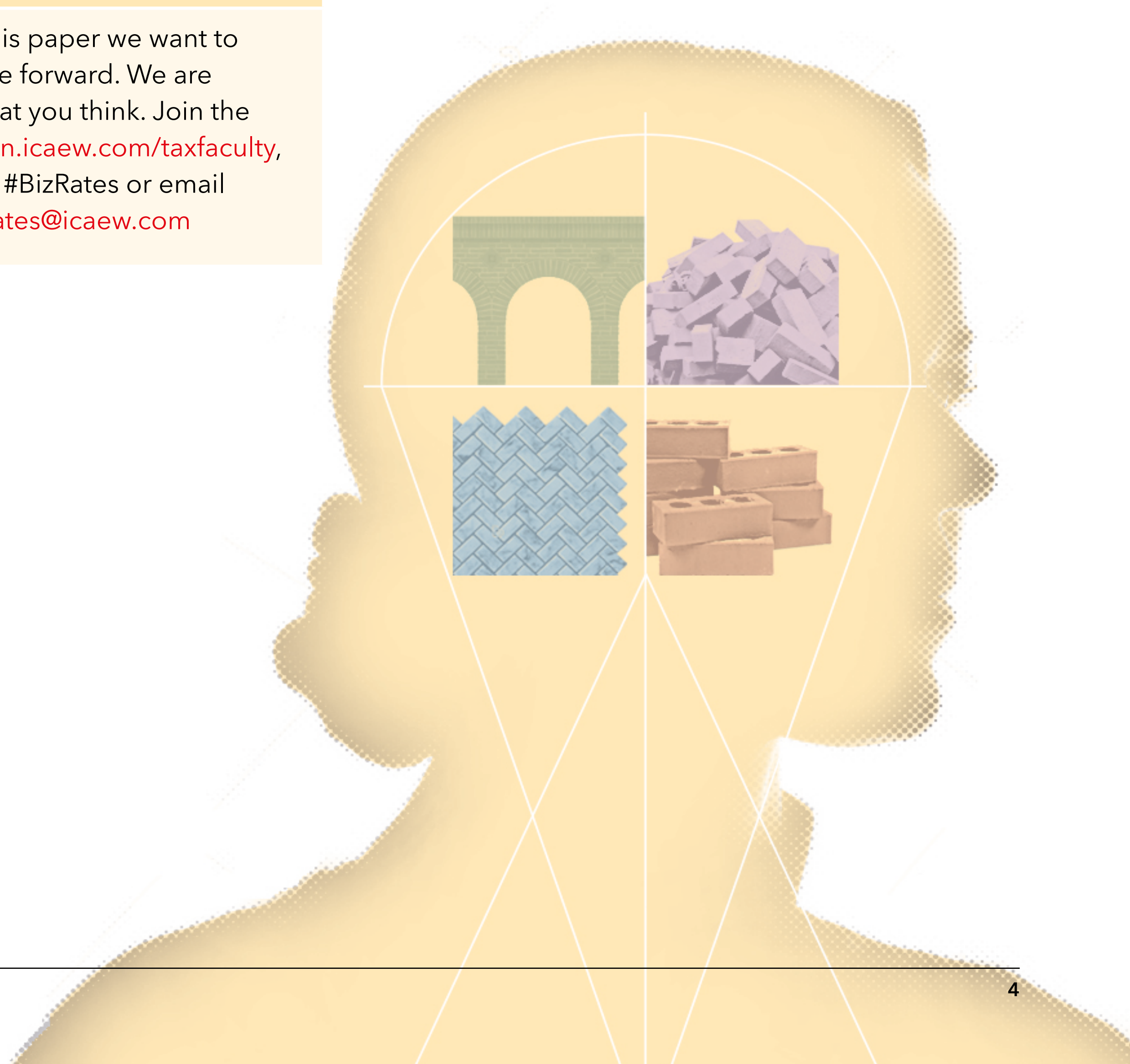
ICAEW is exploring the various issues that the digital economy is raising for tax systems around the world. Business property tax is an important, and often overlooked aspect of this debate. As ICAEW Chartered Accountants have typically not been closely involved with the assessment or appeal of property tax (unlike other taxes), we have not previously developed detailed views in this area.

We believe that this provides us with a good basis to consider these issues with a fresh eye. Property tax is also a good starting point for a wider examination of the issues facing tax in a digital economy.

It is now time for a public debate on the tax implications of the digitalising economy. In the UK an increasing share of business taxes are based on property, but they affect some sectors far more than others. The business rates system is under increasing strain, and in the public interest we need to consider how it might be reformed.

SHARE YOUR VIEWS

By publishing this paper we want to move the debate forward. We are interested in what you think. Join the discussion on ion.icaew.com/taxfaculty, on Twitter using #BizRates or email us at: businessrates@icaew.com



The survey: where we are now

Business property taxes are an issue of concern around the world, and revenues in many countries are affected by similar challenges. They are a particularly acute issue for the UK, which has the highest property taxes in the Organisation for Economic Co-operation and Development (OECD). Although this report focuses on UK business rates as a case study, the questions it raises will also be relevant for other countries.

Rates have a long history, both in the UK and in other countries such as the USA, where property taxes share a common ancestry with those in the UK. The obligation for property occupiers to pay rates to their local authority can be traced back until at least the English Poor Relief Act of 1601. The remarkable longevity of these taxes reflects their effectiveness at raising revenues for government.

In the UK, business and domestic property taxes have taken different tracks. While both have long been subject to rates, domestic rates were reformed in the 1980s, while business rates remained largely unchanged. The echoes of this divergence still resonate today. The replacement of domestic rates in 1989/90 was traumatic for the UK, and resulted in an unprecedented level of public disorder in recent times. Although the decision was based on a political desire to bring greater central control and accountability to local government finance, it had its roots in a familiar problem.

In theory (and in statute since 1925) property in England and Wales should have been revalued every five years, but in fact this only occurred in 1929, 1934, 1956 (based on 1939 values), 1963 and 1973 – before the rapid inflation of the 1970s. By the time the poll tax was introduced in 1989/90 (at the peak of a property price boom), properties had not been revalued for 16 years, and values were significantly out of line with reality. The poll tax presented a radical solution to an intractable problem by side-stepping revaluations, a highly contentious political issue. Ultimately, however, it proved too radical, leading the end of the Thatcher government.

The council tax system, which replaced the poll tax, reintroduced tax on domestic property, leaving the problem of revaluations unresolved. Welsh domestic properties were revalued in 2003; but council tax in England is still based on the original 1991 values, despite a planned revaluation in 2007. Similarly, Scottish properties are still assessed on 1991 values, although a redistribution between bands occurred in 2017. Revaluations for business rates have occurred at regular five-year intervals since 1990, although the 2015 revaluation was delayed by two years to 2017.

Business rates were also introduced in 1989/90. They marked a major change to the basis for local authority financing, with a uniform national multiplier being introduced to replace the discretion of local authorities. However, for rate-payers much of the administrative basis of the system remained unchanged.

On the 2010 rating list there were in total

2.3m

requests for assessment reviews, resulting in

1.0m

challenges to rateable values.

29%

of these challenges were successful in causing a change to the rating list.

CALCULATING BUSINESS RATES

The basic calculation of business rates is relatively simple. In England and Wales:

1. Find the 'rateable value' for the business premises. This is an estimate of its rental value on the open market on 1 April 2015.
2. In England, identify which of the two national 'multipliers' apply to the premises. The standard multiplier is used if the rateable value is £51,000 or more and the small business multiplier is used for rateable values below £51,000. For the 2018/19 tax year the standard multiplier is 0.493 and the small business multiplier 0.48. In Wales the multiplier for 2018/19 is 0.514.
3. Multiply the rateable value by the multiplier. This shows how much is due in business rates (before any reliefs).
4. Deduct any reliefs that the business is entitled to. For example, transitional relief may apply or the business might be eligible for small business relief (in addition to applying the small business multiplier).

But although the calculation itself is simple, working out the exact level of liability for each business can be very complicated. This is because:

- the 'rateable value' for each individual premises is bespoke, and a degree of subjectivity is involved in the valuation. For example the rateable value of a retail premises entails a complex calculation predicated on factors such as the width of the frontage and the depth of the shop. Many valuations are appealed as a result;
- rateable values are updated periodically and complex transitional reliefs are applied to smooth the effects of the change;
- reliefs are not applied as a matter of course and must be claimed individually under a variety of different schemes. Complex rules apply where the business has more than one premises; and
- the multipliers change every year, either to reflect RPI or the effects of revaluation.

As a result many businesses turn to professional advisors for assurance that the rate they are paying is appropriate and for advice and support with the appeals process. Indeed, most businesses have historically opted to have their assessment reappraised, with a significant number then proceeding to challenge the assessment.

KEY TERM: HEREDITAMENT

A key concept in business rates is the legal term 'hereditament'. Its statutory meaning is 'property which is or may become liable to a rate'. Although in many cases it will be obvious what the rateable property is, a complex body of law guides identification of the hereditament. As the staircase tax illustrates (see page 10), the answer is not always clear-cut.

DO BUSINESS RATES FUND LOCAL PUBLIC SERVICES?

Business rates are collected by local authorities. They retain part of what they collect directly and receive more back in their grant from central government. Conceptually therefore there is a strong link between business rates, levied locally, and the provision of local services. However, the settlement formula for what each local authority receives is complex and as a result, funding does not wholly reflect local changes in business rates receipts. This protects local authorities where economic conditions are challenging but also mutes the local benefits from economic success. This situation is changing as government moves to allow local authorities to retain more of what they raise.

Since 2013/14 local authorities have retained part of what they collect under the 'Business Rates Retention Scheme' (BRRS). Currently most authorities retain 50%, although some pilot authorities nominally retain 100% of what they collect. There is a plan for all authorities to retain 100% and to have some powers to vary the multiplier locally, although this is currently on hold.

In any case, the system is much more complex than these headline figures suggest: BRRS is supplemented by a series of 'tariffs and top ups' designed to alleviate hardship in authorities that fall behind over time. In summary, this system enables authorities to retain some of the growth in business rates receipts in their area (or suffer some of the decline), but not all of it. Exactly how much they can retain is subject to a complex formula. So complex in fact that many authorities are unable to say whether they have gained or lost since the introduction of BRRS. Further details can be found in IFS Briefing Note BN193.

CASE STUDY: GREENWICH

The local authority in Greenwich, London was facing a difficult problem. With the economy rapidly changing, companies using a disruptive new technology were increasingly able to escape tax. Local services were funded by rates raised from the occupiers of local property. But this new technology was mobile. Its operators had limited physical presence in the borough and moved through it using public infrastructure that anyone could use freely.

The growth of the internet and e-commerce has made this a familiar story. But the case in point dates back to 1873 when the Greenwich local authority took legal action against the Pimlico, Peckham and Greenwich Street Tramway Company to bring their tram network into the local tax net.

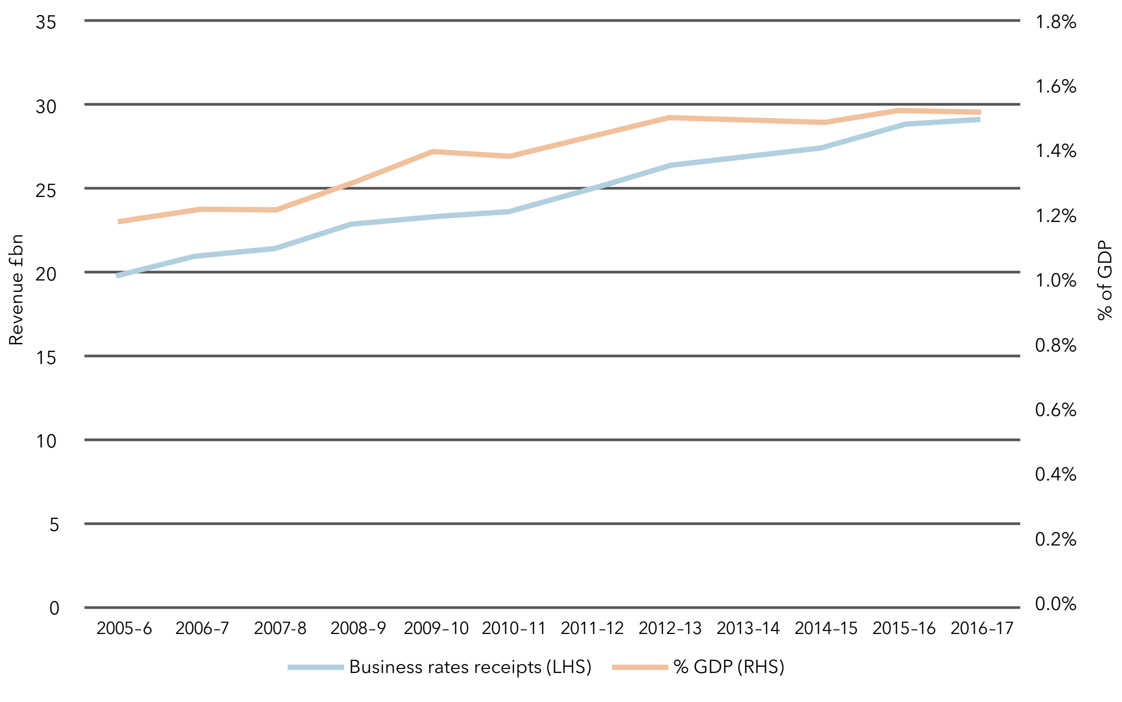
The problem was that the tramway's state-of-the-art horse-trams ran along the public highway. Anyone could drive along the street and doing so was not taxable. While the tax inspectors did not dispute this fact, they pointed out that the rails the tramway had installed required special flanged wheels, giving the company exclusive use of them. Thus, as the sole occupier it became liable for rates. It was a landmark case still referenced in rating law today, but it is only one of a long series of incremental developments that have shaped the UK's business rates system.

GROWING REVENUES

Despite the financial crisis, business rates receipts have continued to grow strongly: in the 10 years from 2006/7 to 2016/17 business rates receipts grew by 39%, from £21bn to £29bn. Business rates amounted to 1.5% of gross domestic product (GDP) in 2016/17 (up from 1.2% of GDP in 2006/7), providing an important and consistent source of revenue for the UK government. This effectiveness explains why the tax remains a central element of UK fiscal policy, despite its 17th-century roots. Nonetheless, tensions are beginning to show in an increasingly cumbersome system that demands far more from some businesses than others.

The 2017 revaluation brought these issues into sharp relief. Due to the seven-year gap since the previous revaluation in 2010, the media cited examples of small businesses suffering rate hikes of more than 300%, alongside increasingly vocal calls from business groups for urgent action. These are not the first demands for reform: the Institute for Fiscal Studies launched a rates review in 2011, and all of the political parties have since committed to reform. Yet the debate continues to intensify as pressure mounts on property-intensive businesses, particularly those competing with online alternatives.

FIGURE 1: BUSINESS RATES RECEIPTS ARE OUTPACING GDP



Source: HM Treasury, Budget reports 2007-2017; Office for National Statistics

CALLS FOR REFORM

Meanwhile, many industry groups have been campaigning vociferously for reform. The Federation of Small Businesses describes rates as: 'Outdated, unfair and not related to the ability to pay, or changing economic circumstances.' The British Retail Consortium believes that: 'There is no doubt business rates are discouraging local growth' and the Campaign for Real Ale claims: 'The current business rates model is crippling thousands of pubs every year.'

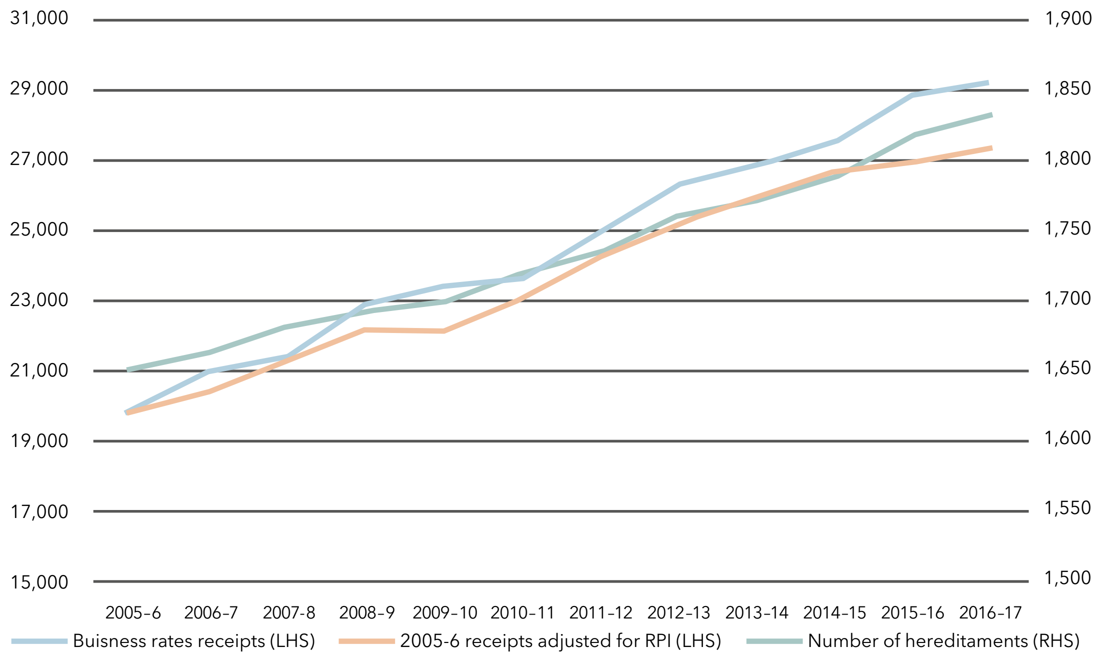
Political debate has tended to focus on relatively limited measures to reduce pressures in the existing system. While a Labour motion in December 2013 sought to 'ease the burden of business rates', the ensuing debate focussed on slowing the rate of increase, rather than on deeper reforms. The government subsequently delivered that objective in the 2016 Budget, although not to the extent or as rapidly as advocated by Labour.

Part of the problem has been the relatively high level of the RPI over the past 10 years. By this measure, prices have risen by 3% annually on average, swelling business rates receipts. Although the RPI might appear to be a sensible and neutral basis for tracking inflation, it has been increasingly discredited.

Mark Carney, as reported by the Financial Times on 30 January 2018, commented that the RPI should be abandoned for use in government contracts and scrapping the link to the RPI for business rates is only the latest in a series of moves away from the index. For the many businesses unable to increase their own prices at this rate, this rapid escalation in what is often one of their biggest expenses has inevitably caused pain.

Business rates have now been adjusted to track the CPI, but the legacy of annual RPI inflation remains in the increased tax base.

FIGURE 2: GROWTH IN BUSINESS RATES RECEIPTS HAS OUTPACED THE RPI



Note: Figures are for UK business rates receipts (number of hereditaments: England). Business rates have now been adjusted to track the CPI, but the legacy of annual RPI inflation remains in the increased tax base.
Source: HM Treasury, Budget reports 2007-2017; Department of Communities and Local Government - National non-domestic rates collected by local authorities.

A COMPLEX SYSTEM

Adding to the complexities of rating law, properties are valued using a range of different approaches that are often highly location-specific and extremely detailed (for example, a retail shop can be divided into different zones, each valued differently on the basis that the space closest to the front is worth more). These are also somewhat subjective, and different valuers can reach different conclusions. As a result, the valuations process is costly and cumbersome for the government to administer, and costly and time-consuming for taxpayers to review (and, if necessary, appeal).

Moreover, different authorities administer different parts of the system. For example, valuations in England and Wales are conducted by the Valuations Office Agency, and businesses must apply to them for valuation appeals; however, billings are handled by local authorities, and billing queries, as well as applications for reliefs, must be directed to them.

This is all compounded by the distinctive nature of business rates, which are often considered not to be a tax at all. Tax advisors are used to dealing with taxes based on transactions, where the basis for the tax is either profits or consumption. Business rates are different, as the tax liability cannot be deduced from either a company's accounting records or its trading patterns. As a result, these rates could be overlooked in considering a company's tax affairs. Yet, business rates are a major tax on businesses; indeed for some they are much more significant than income or corporation tax, even though in accounting terms rates are typically classified with rent rather than tax expenses.

The tendency not to consider or report rates as a business tax may obscure the scale of their impact on businesses. Studies such as PwC's Total Tax Contribution of the 100 Group, which does include business rates, are helpful in clarifying the full scale of taxes that businesses pay.

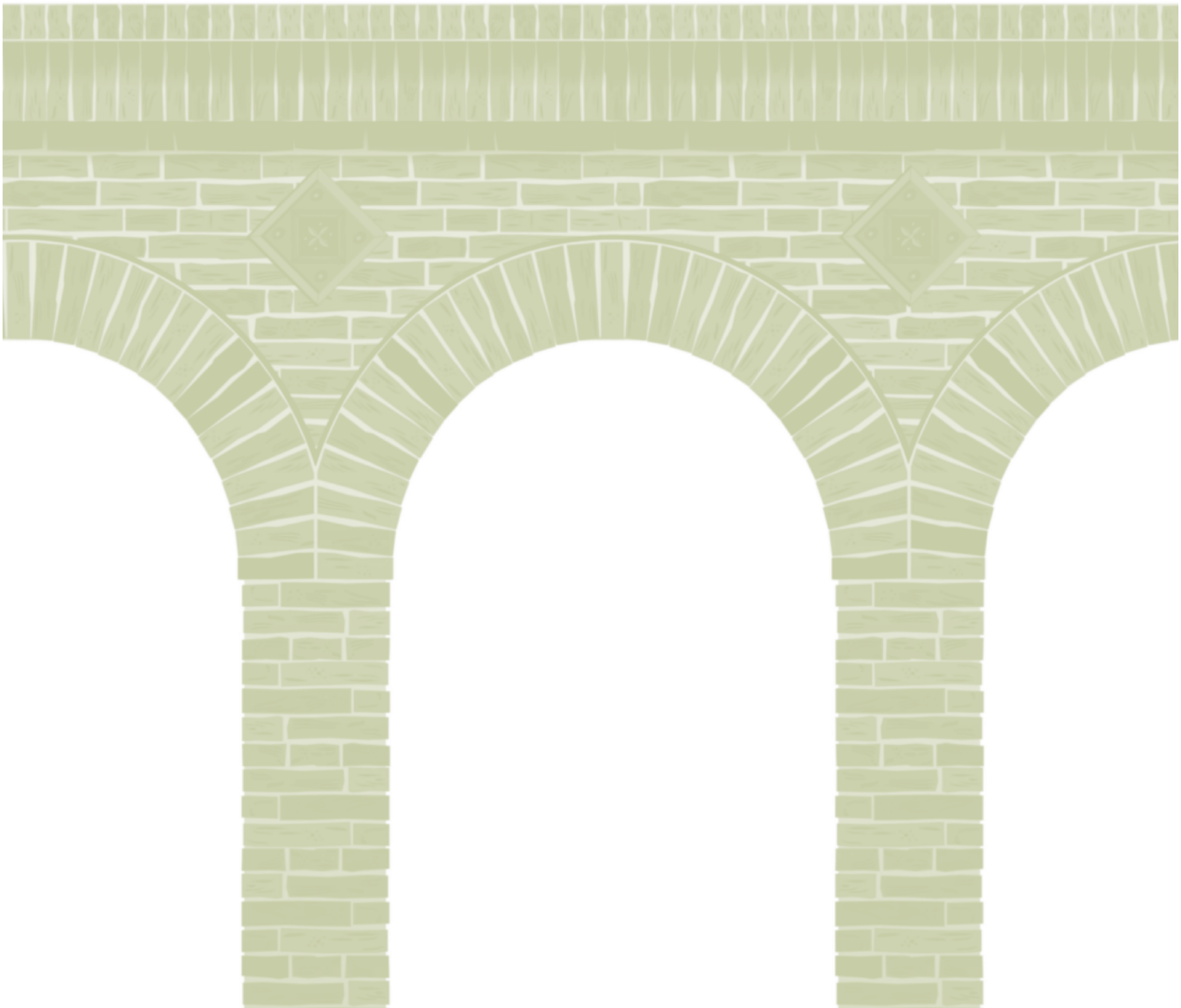
Overall, the system is extremely complex for businesses, which must also navigate the system for each of the properties they occupy. Many businesses and business-representative groups have been calling, increasingly strongly, for reform. In the remainder of this paper we consider the decision facing the government: namely, whether to maintain, demolish, rebuild or refurbish the existing system.

CASE STUDY: THE STAIRCASE TAX

In 2017 the UK media announced the discovery of a new tax. Wittily dubbed the 'staircase tax' (recalling the 18th-century 'window tax' that was infamously avoided by bricking up windows), this was no new tax at all, but rather a legal case that changed the basis of rating valuations. Generally, larger premises qualify for lower rates per square meter, in what is known as 'quantum relief'. However, a 2015 Supreme Court decision ruled that occupiers of multiple floors of a building could only combine them into one 'hereditament' if they were linked by private areas. A shared staircase meant separate hereditaments and, consequently, less quantum relief. The government acted swiftly to legislate away the staircase tax in the 2017 Budget, but its emergence shone a rare spotlight on the labyrinthine body of rating law. In particular, part of the problem with the 'staircase tax' was that, despite the medieval roots of the 'hereditament' as the basis for assessment, what comprises a hereditament is rather unclear.

1. Maintain

The first option is simply to make do. To retain the current system, but take specific action to address issues that arise, perhaps by simplifying certain areas.



There is no doubt that the UK government has been listening to the concerns of business. In their manifestos for the 2017 election all three main parties committed to reform. The Conservatives, for example, promised: 'A full review of the business rates system to make sure it is up to date for a world in which people increasingly shop online.'

Changes have already been made to address some of the pressures. The 2016 Budget introduced a reforms package costing £6.7bn over five years, including an extension of small business rate relief. In England and Wales the rate of this relief has increased from 50% to 100%, while the qualifying threshold in England doubled from £6k to £12k (Wales: £6k). Tapered relief is now available up to £15k (Wales: £12k). From 2018, increases in annual bills will link to the lower rate of Consumer Price Index (CPI) inflation, rather than RPI inflation. The government has also committed to delivering more frequent revaluations of business premises (at least every three years), and in its Spring Statement 2018 promised to bring forward (by one year, to 2021) the date when these triennial reviews would start. The seven-year gap between valuations in 2010 and 2017 exacerbated the scale of adjustments up to market rent levels.

The scale of these reforms should not be underestimated; the £6.7bn concession is equal to the total inflationary increase of the past decade. However, the reductions are against future rates income, and rates receipts will continue grow, although more slowly. Moreover, the reforms do nothing to address the complexity of the system.

We can expect further action in the future to address specific issues as and when they arise, just as we have seen over the past few years. But is making do enough, or is more fundamental reform now necessary?

The qualification thresholds were increased significantly in the 2016 Budget, lifting thousands of businesses out of the tax altogether.

Business premises in England with rateable value under

£12k

now qualify for relief of

100%

Tapered relief is now available for properties with a rateable value of up to

£15k

Small businesses with rateable values below

£52k

also benefit from a reduction applied to the 'multiplier' used to calculate the rates bill.

2. *Demolish*

If we choose not to maintain the current system, it might be asked why we have business property tax at all. Given the criticisms outlined in this paper, might it be better to abolish the tax altogether? But how much scope does the government really have for reform?

At the heart of the issue in the UK is the scale of the revenues involved. UK property taxes – comprising mainly business rates (£29bn), council tax (£30bn) and stamp duty land tax (£12bn) – make up more than 12% of total UK tax revenues, the highest percentage in the OECD. As a percentage of GDP, UK property taxes exceeded 4.2% in 2016, more than double the OECD average of 1.9%. Reducing dependence on any of the three property taxes would be fiscally very difficult to achieve. Despite the government's apparent appetite for reform, this revenue gap limits its capacity for wholesale change.

That is a problem; any alternative approach would need to compensate for foregone revenues by raising them elsewhere, and the tax burden would need to be redistributed. Politically, this would be extremely difficult. With business rates revenues in excess of £29bn, even a relatively small redistribution could make it necessary to raise billions of pounds elsewhere. For example, shifting 10% of business rates revenues to corporation tax could increase the headline rate by 1p in the pound. In an internationally competitive environment for corporate tax, even that small increase might be difficult to sustain.

Taxing property has a number of advantages for government that are difficult to ignore. The tax base is fixed and largely immovable, it can be readily identified and its ownership and occupancy is already documented. Despite the complexities involved and the huge resources employed in conducting individual property valuations, values can be ascertained with relative objectivity and transparency. Consequently, it is difficult to imagine removing a property-based business tax entirely.

12.3%

UK property taxes as percentage of overall taxation

7.3%

OECD average property taxes as percentage of overall taxation

Source: OECD data – Tax on property, January 2018

3. Rebuild

Might business rates be replaced, either wholly or partly, by a new tax? In this section we consider some possible steps that might be taken in this direction.

CHALLENGES OF THE DIGITAL ECONOMY

The issues caused by business rates have been given fresh impetus by the growth of the digital economy which is challenging long-established business models, particularly on the high street. Online competition adds a sharp new dimension to the business rates debate: it enables the tax to be portrayed as unfair. High street retailers' presence in the community brings a range of social benefits including employment, but that presence means that they have to pay more tax in the form of business rates.

Tax authorities around the world are making well-documented efforts to capture the profits from online activities more effectively. Exactly where online businesses are established, and where they facilitate their activities from, can be subjective and fluid – characteristics that the international corporate tax system has not yet properly evolved to deal with. Taxing profits is one thing, but with property representing a significant portion of the UK business tax base, business rates pose an additional challenge. Online businesses might not have a physical presence in a country at all, or they might conduct operations from low-rent premises, paying much less in rates than competitors as a result.

Unsurprisingly, government and international bodies like the OECD are consulting on what can be done to protect the tax base. It might be inevitable that governments will find effective ways to tax digital activities. In the UK and the EU, for example, proposals for an online sales tax are being rapidly advanced.

We have been here before, as the case of the Pimlico, Peckham and Greenwich Tramway illustrates (see page 7). But will it be possible, or desirable, to capture online businesses in business rates to the same extent as traditional businesses? A tax based on location will clearly struggle to capture virtual activities. One approach might be to vary multipliers depending on the business usage, but this would add another significant level of complexity and might itself be unfair. Equally, perhaps business rates should be replaced or supplemented by a new tax that attempts to level the playing field. This is already happening, with the UK and EU both announcing plans for a turnover tax on tech companies; however, these new taxes are typically conceived in view of the challenges posed by the digital economy to corporate tax. If the aim of the exercise is to ensure that overall the tax base is equitable and sustainable, a broader view might be necessary as the distribution of tax changes.

A LAND VALUE TAX AS AN ALTERNATIVE

Could we scrap business rates altogether and switch to a land value tax levied on landowners?

As the supply of land is largely fixed, economists say that taxing it would detract little from the economic incentive landlords have to make productive use of it. Such a tax is typically envisaged as applying solely to the intrinsic value of the land, that is, its current value less the value of any improvements made to it. Such 'improvements' would include the construction of any buildings on the land. In sought-after areas the intrinsic value of land can be many times the value of the buildings themselves, while in deprived areas by contrast the intrinsic land value might be negligible. Focusing on intrinsic value, which is unaffected by the actions of the owner or occupier, ensures that there is no disincentive to investing in business inputs (other than the physical location where business is conducted).

A land value tax would preserve many of the advantages that government derives from business rates. Public land registers would help identify who and what to tax, and it may be more straightforward to assess values for land than for buildings. Such a move could also extend the tax base. Although most economic value is concentrated in land zoned for domestic or business use (most of which is already subject to council tax or business rates), undeveloped or derelict land is not currently taxed. Advocates of a land value tax suggest that such a tax might also be simpler and cheaper to administer.

Some politicians are taking the idea seriously. In 2016 the Greater London Assembly investigated the potential for introducing such a tax in London, potentially replacing business rates and council tax. The report issued by the GLA's planning committee was clear about the rationale for such a tax, pointing to sites that they felt could be brought forward more quickly to provide much needed housing in London 'if they were taxed appropriately'.

The mayor was positive about the idea, but lacked the power to implement it without primary legislation granting further devolution. Proponents of such a scheme point out that councils have already been promised powers to vary the level of business rates from 2020 and to retain the income generated, with London also able to add a premium to rates bills to pay for new infrastructure. They suggest that introducing a limited form of land value tax may be a relatively small incremental step; however, with London making such a major contribution to UK government revenues, the appetite for further devolution might be limited.

Further research might help establish the benefits of the change relative to the existing system. For example, in areas where market demand for new development is weak or non-existent, could a land value tax be expected to incentivise development effectively? Where levied on land that does not generate cash flows, collection might be a problem. Moreover, across the UK 56% of land is occupied by agriculture, while a further third is covered by moors and forests. Proponents of a land tax often suggest that farmland should be included too, as it is in Denmark which has had a land tax since 1922. However, as UK farms are currently exempt from business rates, making an economic or political case to bring them into the scope of a new tax will be challenging. Furthermore, the government will soon be debating how to replace the £3bn of farm subsidies that UK farms currently receive from the EU. In this landscape it appears unlikely that a new tax on agriculture could gain much traction. Although Danish farms are subject to land tax, the combination of much lower market values of agricultural land and a reduced tax rate means that agriculture contributes only a small proportion of land tax revenues in Denmark.

In comparison, industrial and commercial units occupy only 0.8% of land in the UK. A further 5.5% is urban areas, much of which is housing. As this property is largely already captured by business rates or council tax, most land is already in the tax base.

Reliefs pose another set of questions. Currently, reliefs are carefully targeted at the smallest businesses to encourage entrepreneurialism where the tax burden might otherwise make it unviable. If a universal land tax were levied on all properties, would these businesses still receive relief? A land value tax would also not address the issue of the tax liability scaling with the profitability of the business or the challenges of the digital economy. Although the total amount of land is fixed, its value remains variable; therefore, in an economy that derives less value from land, the significance of land in the tax base will similarly decline.

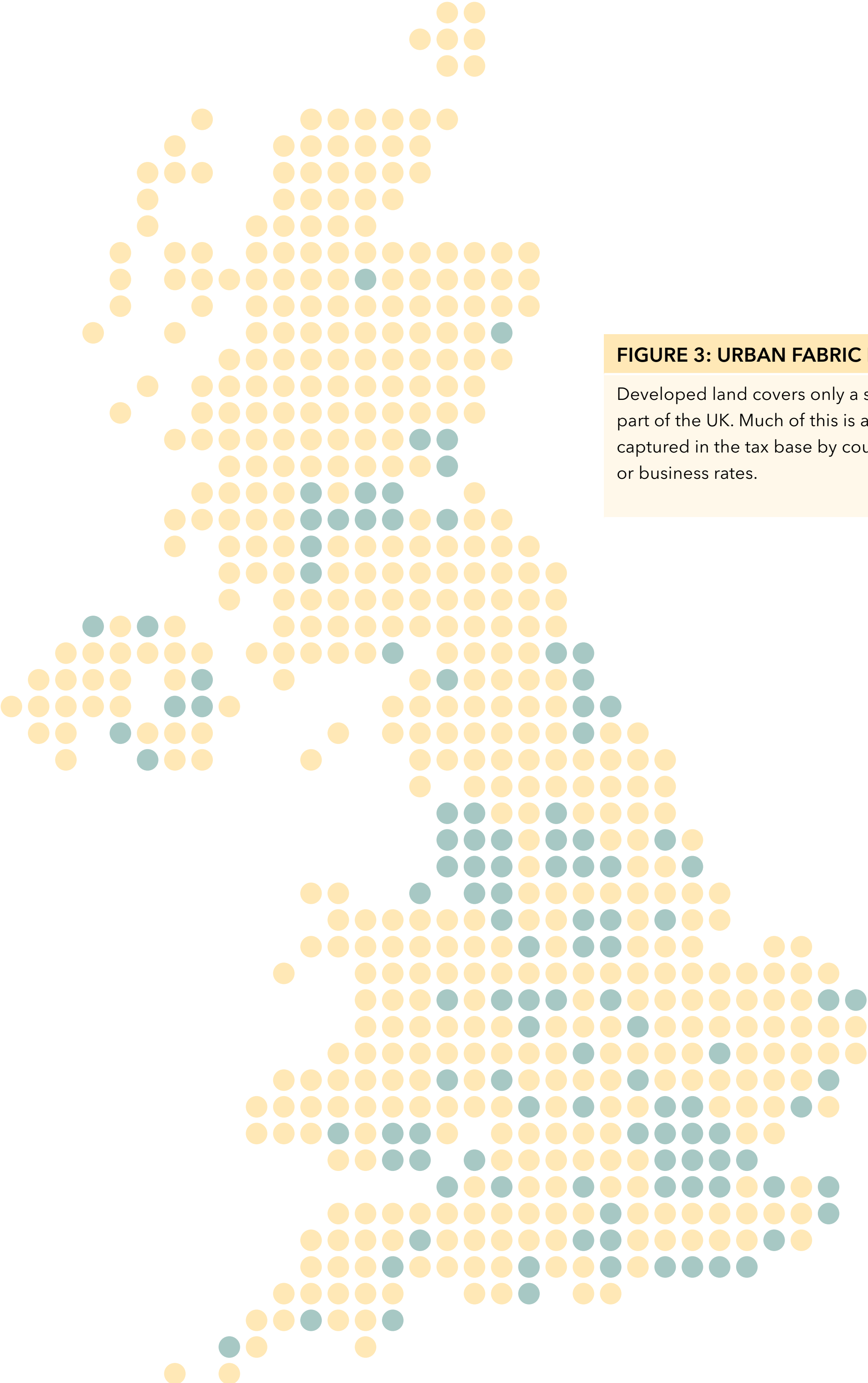


FIGURE 3: URBAN FABRIC IN THE UK

Developed land covers only a small part of the UK. Much of this is already captured in the tax base by council tax or business rates.

Ultimately, replacing business rates with a new tax may be politically unpopular. As the 2011 report by Professor Sir James Mirrlees recognises, and the poll tax riots demonstrated, replacement would create large groups of winners and losers. That is the case even if the overall tax take remained the same. While this might be equitable in some cases, it would provoke political opposition.

Nevertheless, due to the simplicity and efficiency of a land tax, it will likely continue to be advocated. The Greater London Assembly is taking the idea seriously. In high-value urban areas like London, major policy goals might be achieved by incentivising the release of land more quickly for development. The 2017 revaluation has placed major stress on many businesses in London, and a broad constituency is calling for business rate reform. If a land value tax does emerge as a political possibility, it might be at a local level where government has the devolved ability to be more creative and a particular incentive to act.

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4. Refurbish

In the previous two sections, we considered either abolishing or replacing business property tax altogether. In this final section, we consider instead how the existing system might be improved.

EXEMPT CERTAIN PLANT AND EQUIPMENT INVESTMENTS?

When Tata steel announced plans to close its steelworks at Port Talbot (the UK's biggest) in 2016, it highlighted the pressure that business rates place on capital-intensive industries. It was reported that Tata had faced an annual increase in rates of £400k after rebuilding a blast furnace on the site. Business rates are assessed not only on the premises from which a business operates, but also on the value of any plant, equipment or fittings that are part of a building. Consequently, they increase operating costs and understandably play a part in business decision-making.

According to EEF, the manufacturers' organisation, levying business rates on machinery can be 'enough to put off capacity increasing investment'. For decisions where returns are marginal, the addition of rates costs might well be enough to tip the balance. Margins in the sector can be thin – the Office for National Statistics reports an average net rate of return of 8.3% over the past decade – and quickly eroded by incremental costs. Alternatively, businesses could be forced to scale down, cancel or move investment overseas.

The government seriously considered a moratorium on business rates for new plant and machinery investments in 2015, with Sajid Javid the then-business minister backing the move as part of his five-part plan for Britain after Brexit. The Financial Times reported on 26 February 2016, that exempting all plant and machinery could cost around £1bn; this figure would be difficult to absorb, particularly if other reforms were targeted at the same time. Hence, Javid proposed to exempt new plant and machinery specifically, which would slow the erosion of the tax base. Others have called for particular plant categories, such as green technology, to be exempted. However, despite speculation that the 2016 Budget would include a move in this direction, no such relief was targeted. The problem again was the scale of the fiscal consequences.

For economists the answer is clear: taxing business inputs discourages activity. The link is particularly acute in plant and machinery investment decisions, as these require a positive return to be worthwhile.

DELIVER MORE FREQUENT REVALUATIONS

In its plans to reform business rates, one of the government's key commitments has been to carry out more frequent revaluations, at least every three years. Recently, however, a revaluation originally meant to be carried out in 2013 (five years after the previous exercise) was controversially delayed until 2015, with some commentators criticising the delay as 'politically motivated'. Although its stated intention was to provide stability, it baked in pre-financial crisis valuations, which then persisted until 2017. The result is now well documented: winners and losers, with strong criticism from many quarters. It is difficult to see the fiscal benefit from delayed revaluation, as the multiplier is reset on revaluation to preserve the same level of revenues. Politically, however, the deferral may have delayed the animosity that the revaluation was to cause.

More frequent revaluations are intended to alleviate such pressures, smoothing changes to market rent levels so that relief can be given more quickly when valuations fall and adjusting in more frequent, smaller increments when they rise. However, while this may help with business planning, it does not change the underlying economics. A second measure – changing the level of annual increases in rates bills to track the CPI rather than the RPI – does reduce annual increases. The difference may be marginal (the CPI was 2.8% and the RPI 3.9% in November 2017), but the benefit accumulates over time, as the CPI has remained consistently lower than the RPI.

Many of those calling for reform have welcomed the prospect of more frequent revaluations, and the government has committed to a triennial system from 2021. Yet, moving to a more frequent system also raises practical issues. The Valuations Office Agency (VOA) was previously criticised for its slow resolution of rating appeals, 199k of which remained outstanding against the 2010 rating list in September 2017. Although the new 'check, challenge, appeal' system introduced for the 2017 revaluation appears to have reduced this workload, questions remain regarding the VOA's capacity to deal with more frequent revaluations. On 28 November 2017 the Financial Times reported that the agency will close half of its 52 offices and lose 1,000 staff by 2021 (a quarter of the current total). It will clearly be difficult to reconcile such reductions with the heavy workload implied by more frequent revaluations, although extending small business relief might be expected to generate some efficiencies.

In March 2018, the Treasury published the results of a consultation on how it might deliver more frequent revaluations, proposing a new system to deal with the additional workload based on either self-assessment or a formula. Many businesses were already challenging the VOA's valuation with their own assessments (2.2 million requests for re-assessment from the 2010 rating list were submitted), and self-assessment was seen as a way of streamlining this process. Ultimately however, a radical new approach to assessment was rejected. While a three-year cycle coupled with the new appeal process may make the workload manageable, the results of more frequent revaluations will not become apparent for several years.

It should be noted that, although the government has rejected annual revaluations as impractical, this change has recently been implemented in Hong Kong and the Netherlands, where it has significantly reduced appeals and lessened extreme fluctuations in rateable values. While the measure clearly raises practicality issues (the Netherlands for example must revalue 8 million properties annually), the burden is shared between municipalities and private firms. Revaluation has also been made much more efficient with the use of new 'computer assisted mass appraisal' technology.

FIGURE 4: KEY DATES FOR BUSINESS RATES

1601

Poor Relief Act
Formalises collection of rates to fund local services.

1988

Local Government Finance Act
Establishes 'business rates'

2013

Scheduled revaluation of non-domestic properties

2015

Revaluation finally carried out.

2017

New valuations take effect.
'Check, Challenge, Appeal' system introduced

MINIMISE THE COST OF APPEALS

Another difference between corporation and income tax and business rates is that, for the former, a business pays the amount for which it believes it is liable and HMRC must then investigate and appeal. For business rates, this process is reversed: businesses must pay the rates demanded and then investigate and appeal themselves. This costs businesses more in money and time, and has immediate cash-flow implications.

In introducing its new 'check, challenge, appeal' system in 2017, the UK government acknowledged the problems with the previous appeal system. In particular, MPs were concerned that the system had been bogged down by the many unsuccessful claims (72% on the 2010 list). Lengthy backlogs of appeals against the 2010 list appeared and it became clear that the system had failed to cope with the volume of appeals.

The new system comprises three parts: check, challenge and appeal. Under this system, the assessment must be checked before it can be challenged, and the ratepayer only gains the right of appeal after the VOA has conducted a review. Appeals are further limited by a new stipulation that they can only be successful if the valuation is not 'reasonable'. While the threshold for 'reasonable valuation' has yet to be decided by tribunal, we might see a margin of error (say, 15%) before claims could be successful. These changes were designed to make the system simpler and easier to use for smaller businesses, which comprise by far the majority of rateable premises. A business can manage the process through its online government gateway account, although it must complete a number of registration stages before it can initiate the 'check'.

The new process aims to provide early certainty to businesses that the rate they are paying is appropriate. It also raises the bar further by inserting a 'margin of error' before claims can succeed. Given that most claims under the previous system were ultimately unsuccessful, it is assumed is that only a minority of cases would proceed to challenge and appeal.

However, the new system has come in for significant criticism. In August 2017 Colliers International claimed to have submitted a freedom of information request revealing that, of 847 respondents to a user survey, 89% were dissatisfied or very dissatisfied with the new service. Comments left by respondents criticised the lack of clarity around how to use the system and highlighted technical difficulties. In particular, negotiating the three-stage progress can be very time-consuming. Moreover, the government will soon be changing the appeals system further by introducing a time limit on appeals. Together, these measures will make it significantly more difficult to challenge valuations.

It was understandably necessary to do something to address the very high volume of challenges to the 2010 assessments, and a standardised online process could clearly help improve efficiency. But so far the feedback on the operation of the new system has been troubling. In principle the appeals system should enable claims to be resolved efficiently, fairly and transparently. Undue delay would be inconsistent with this. For businesses planning for the future and carefully managing cash flows, uncertainty around such a major expense can be difficult to manage.

CONSIDER FURTHER TARGETED RELIEFS

There are limited exemptions from and reductions in business rates available, the largest category being those for very small businesses. The qualification thresholds were enlarged significantly in the 2016 Budget, lifting thousands of businesses out of the tax altogether. Business premises in England and Wales with rateable value under £12k (Wales: £6k) now qualify for 100% relief, with tapered relief for properties up to £15k (Wales: £12k). Although it gets more complicated when a business has multiple premises. Small businesses in England with rateable values below £52k also benefit from a reduction applied to the 'multiplier' used to calculate the rates bill. These reliefs affect large numbers of businesses. Of the total 2.0 million rateable properties in England and Wales, 1.2 million are valued below £12k and a further 0.2 million at between £12k and £15k. Reliefs are also available to rural shops and pubs where they are the only such facility within a community, and to charities. Agricultural premises are exempt.

Offering these reliefs costs £3.4bn annually in England and Wales, 12.5% of gross rates payable. Although this is a large amount of money, in context, it only represents half of the increase in collections over the past 10 years.

Reliefs have historically been used to achieve policy objectives by addressing areas facing particular pressure; for example, community pubs and local newspapers have both benefited from relief in recent years. However, these policy measures have typically been limited in extent; the relief offered for pubs is an annual discount of £1k, costed at £30m. Local authorities currently have very limited discretion to offer additional reliefs. Although a business can apply for hardship relief, this is a final measure and a business must show both that it would be in financial difficulties without it and that granting the relief is in the interests of the local community. Generally, rates do not scale to a business' ability to pay. Could a case be made for further targeted reliefs, or greater flexibility in granting them? The challenge for government is in matching the benefits from relief to the fiscal cost in granting it. Recent reforms in Wales have created further targeted reliefs there.

OTHER REFORMS

A number of other reforms could also be considered to make the administration of business rates more efficient and less burdensome for business. These include:

Making tax digital (MTD): The roll out of MTD will entail significant cost to business. This investment might be made more efficient by incorporating business rates into a business' digital tax account, thereby gathering all tax administration into one place. The data that MTD will make available to government may also make it feasible to link business rates to profitability in some way, subject to full consideration of the consequences. Including rates in MTD might also make self-assessment more practicable.

Fixed multiplier: To keep the tax take stable, the multiplier currently changes annually for the RPI (soon to be the CPI) and at revaluation. The system could be simplified by maintaining a stable multiplier. Coupled with annual revaluations this would mean that bills should fluctuate only with the rateable value while still capturing the value of inflation and new development for government.

SHARE YOUR VIEWS

By publishing this paper we want to move the debate forward. We are interested in what you think. Join the discussion on ion.icaew.com/taxfaculty, on Twitter using #BizRates or email us at: businessrates@icaew.com

Useful links

Valuations office agency: Introduction to business rates

The Mirrlees Review: Reforming the Tax System for the 21st Century

ICAEW: Ten Tenets for a Better Tax System

MPs concern on introduction of 'check, challenge, appeal' system in 2017

Treasury: Business rates: delivering more frequent revaluations

BPF – Regeneris: Business Rates: Who Pays and Why it Matters

Local authority finance

IFS: The local vantage: how views of local government finance vary across councils

IFS: Councils concerned about impact of cuts – and uncertain about effects of the business rates retention policy

IFS: The business rates revaluation, appeals and local revenue retention

Bodies campaigning on business rates

Federation of Small Businesses

British Retail Consortium

Campaign for Real Ale

EEF: How the government can improve the business rates system for manufacturers

London Chamber of Commerce and Industry

Statistics

PwC: Total tax contribution of the 100 group

Valuation Office Agency: non-domestic rating statistics

Land value tax

IEA: The case for a Land Value Tax

London Assembly planning committee: Tax trial - A Land Value Tax for London?

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