

The Economic Affairs Committee

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The Members of the Sub-Committee which conducted the inquiry are listed in Appendix 1.

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NOTE: References in the text of the report are as follows:

(Q) refers to a question in oral evidence

(p) refers to a page of written evidence

The Report of the Committee is published in Volume I (HL Paper 117–I)
and the Evidence is published in Volume II (HL Paper 117–II)

ABSTRACT

This is the sixth report in a series which began in 2003 when the House of Lords Select Committee on Economic Affairs first appointed a Sub-Committee to inquire into selected aspects of that year's Finance Bill.

This year our Report focuses on three topics: capital gains tax (CGT); residence and domicile; and encouraging enterprise. It also considers two issues which cut across these and other topics: first the consultative process around the first two changes; and second how they affect the international competitiveness of the United Kingdom.

On the first cross-cutting issue, consultation, there was a widely held view amongst our private sector witnesses that the consultation on both CGT and residence and domicile had been very poorly handled and fell well short of the good practice they had seen on other topics. Witnesses from HM Treasury (HMT) and HM Revenue and Customs (HMRC) said consultation was a key part of getting tax policy and delivery right and did not agree that a clear policy statement had been lacking or that HMT and HMRC had not worked well together.

We see no reason why there could not have been earlier, better and more open consultation; we are particularly disappointed that the progress which we welcomed last year has not been maintained. We recommend that HMT and HMRC should critically consider why the private sector was so unhappy and thought that their messages were not getting through to Ministers; officials should learn the lessons. We also recommend that they should look at their record as a whole, learning from well-handled examples and striving to apply uniformly the points of best practice. There should be a dialogue between officials and the private sector to develop a code of practice on consultation involving tax policy changes.

The second cross-cutting issue was competitiveness. It is difficult to reach a definitive conclusion on this in relation to CGT. We recommend that the Government and HMT should publish their economic analysis of the case for the new regime, and now work towards reassuring investors and potential investors of the advantages of investing in the UK. We are very concerned by the weight of evidence from private sector witnesses that the proposals on residence and domicile seem likely to have a negative impact on the UK's competitiveness. We think it vital that everything which can be done is done to retrieve the position.

Private sector witnesses cast doubt on how far changes in CGT had met the Government's aim to put the regime on a more sustainable footing and help investors plan for the long term. In our view it will take time for confidence in the system to be restored and for it to be seen as sustainable. We make a number of recommendations aimed at restoring the certainty and predictability which investors need. Although we recognise that the new entrepreneurs' relief is targeted at entrepreneurs, we nevertheless consider that there is a strong case for widening the relief to include the particular areas brought to our attention.

Private sector witnesses were harshly critical of the way of the way the policy initiative on residence and domicile was handled. We cannot support the approach of the Finance Bill not being complete at the time of publication, particularly since

the proposals came into effect at the beginning of the tax year. Despite officials' attempts to reassure us, we recommend that they should carry out a full review of the reasons why there were so many difficulties. We survey the likely impact on individuals at different levels of income and make recommendations. We are particularly concerned as regards compliance difficulties for HMRC and for people of more modest means and we recommend a substantial increase in the *de minimis* level for automatic entitlement to the remittance basis and personal allowances. We also raise concerns over detailed issues and recommend that the Government should carefully consider the case for legislation in next year's Finance Bill providing a statutory definition of UK residence.

We survey the clauses in the Finance Bill and related documents which make changes to the tax rules for encouraging enterprise. We recommend that in this and any future instances the case for change should be made and published. We also survey the targeting and complexity of venture capital reliefs, taking into account the study by the University of Sussex, and recommend further study.

Our overall impression from the evidence we received was that this year the formulation of tax policy has been marked by uncertainty of direction. This has been exacerbated by very poor examples of consultation and has led to a concern that the tax system is no longer sustainable or predictable. The feeling that the system is unstable and subject to severe shocks cannot be good for the competitiveness of the UK economy.

The Finance Bill 2008

CHAPTER 1: INTRODUCTION

1. This is the sixth report in a series which began in 2003 when the House of Lords Select Committee on Economic Affairs first appointed a Sub-Committee to inquire into selected aspects of that year's Finance Bill. The Finance Bill Sub-Committee's inquiries address technical issues of tax administration, clarification and simplification rather than rates or incidence of tax.
2. Each year the Sub-Committee aims to publish its Report in time to enable members of the House of Commons, if they so wish, to draw on its recommendations in moving amendments to the Bill at the Report Stage. This year members of the Commons Public Bill Committee will also be able, if they so wish, to refer to the recommendations of the report in relation to residence and domicile discussed in Chapter 4. The report should also inform the second reading debate of the Bill in the House of Lords.
3. As in previous years the Sub-Committee selected a few topics for close examination. If it chose to examine the whole Bill, its treatment of each topic could only be cursory.
4. This year the Sub-Committee chose three topics which it considered of particular importance. It also considered two issues which cut across these matters and indeed across many other policy initiatives which the Sub-Committee did not examine. First, how the consultative process has been carried out on these topics and whether improvements to the process could be made. Second, how, for better or worse, these tax changes affect the international competitiveness of the United Kingdom.
5. The first topic concerned the changes to capital gains tax announced in the 2007 Pre-Budget Report and Comprehensive Spending Review (PBR). These changes were subsequently complemented by the introduction of the entrepreneurs' relief.
6. The second topic, again announced in the 2007 PBR, related to the new tax rules on residence and domicile, particularly changes to the remittance basis for those who are not domiciled in the United Kingdom. These provisions have subsequently been considerably altered. At the time this report went to the printers, the Government's first draft amendments for the Public Bill Committee had been published for comment and other amendments were beginning to appear on the Order Paper.
7. The third topic involved changes to the Enterprise Investment Scheme—not only the changes in the Finance Bill itself, but three papers published on Budget day. These were "Enterprise: unlocking the UK's talent" published by HM Treasury and the Department for Business Enterprise & Regulatory Reform; "The Enterprise Investment Scheme: a consultation document" published by HM Treasury (HMT) and HM Revenue & Customs (HMRC); and a "Study of the impact of the Enterprise Investment Scheme and Venture Capital Trusts on company performance" by the Institute of Employment Studies at the University of Sussex and published by HMRC.

8. As in previous years, the Sub-Committee conducted its inquiry by taking written and oral evidence from leading professional and business organisations and from HMT and HMRC. This year the Sub-Committee also took evidence from two academic institutions. A list of those who have contributed to the inquiry in this way is given in Appendix 2: their evidence is in Volume II of this report. The Sub-Committee would like to thank all those who have contributed, often at short notice, to its work. Without their help this report could not have been written.
9. The Sub-Committee's findings on the two cross-cutting issues are in Chapter 2 of this report; the three chosen topics are in Chapters 3 to 5. Its conclusions are in Chapter 6.

CHAPTER 2: GENERAL ISSUES

10. During the course of our inquiry, we became aware that there were issues that were common to the topics that we examined. These cross-cutting issues arose mainly from the topics of CGT and residence and domicile, but also to some extent from that of encouraging enterprise
11. Before looking at the detail of the topics that we examined, this chapter examines two major cross-cutting issues: consultation and international competitiveness.

Consultation

The Consultation on Capital Gains Tax and Residence and Domicile

12. It was a widely-held view amongst our private sector witnesses that the consultation on both CGT and residence and domicile had been very poorly handled and fell well short of the good practice they had seen on other topics. Ian Menzies-Conacher for the British Bankers' Association (BBA) thought that "In process terms, this certainly was not a good consultation process" (Q 162). Francesca Lagerberg for the Institute of Chartered Accountants in England and Wales (ICAEW) commented that "They were two very good examples of how not to do consultation" (Q 81). John Cridland for the Confederation of British Industry (CBI) concurred "So I think from the CBI's point of view the consultation was inadequate" (Q 181).
13. Our witnesses had a number of reasons why the consultation on these two topics fell short. It was put to us that there was from the outset a lack of a clear and consistent policy statement. Commenting on residence and domicile Ian Menzies-Conacher (BBA) said "we did not have a comprehensive understanding of the policy rationale that was driving these changes" (Q 140).
14. Others commented on a lack of openness. The CBI wrote of¹ "the 'rabbits out of a hat' announcements in PBR 2007 of changes to come into effect with Finance Bill 2008 came as a shock to those affected". In oral evidence Frank Haskew (ICAEW) said "There is a trend which we cannot ignore which is that there needs to be more open consultation at an earlier stage in policy formulation otherwise we just keep running into these sorts of problems all the time" (Q 81). The CIOT commented² "the process in all these and other areas would have been so much more effective for the development of the UK's tax system had consultation taken place in the right sequence—before the announcement of how changes would be made, not afterwards and against a background of decisions already largely made".
15. Michael Snyder for the Corporation of the City of London (City of London) saw consultation being about "preparedness and really hearing as opposed to going through elaborate listening mechanisms, and being able to get the correct information to Ministers" (Q 158). Alex McDougall for the Institute of Chartered Accountants of Scotland (ICAS) would "like to see the process move more logically to fuller and more effective consultation" (Q 90).

¹ Memorandum of Evidence by the CBI (Volume II p 89)

² Memorandum of Evidence by the CIOT (Volume II p16)

16. Some highlighted what they saw as a further difficulty in a lack of coherent communication and understanding between HMT and HMRC. Michael Snyder (City of London) commenting on a meeting he had had with Ministers “When they [Minister/Special Adviser] understood what was being said, despite the attitude of the Revenue and Customs, which is a major problem in this country at the moment and it is perceived to be a major problem because of the attitude that they adopt, fortunately in this particular meeting it was adopted in such a way that it was obvious to Jane Kennedy and Andrew Maugham that it was ridiculous and therefore they did make some changes” (Q 158). Chas Roy-Chowdhury for the Association of Chartered and Certified Accountants (ACCA) saw things from a different perspective, “I do not think the problem is with HMRC, I think it is with HMT where, because the policy process is now with them, they seem to be on a learning curve and that is one of the reasons why the consultation has not been as effective as one may have hoped” (Q 90).
17. These witnesses considered that these problems had led to proper consultation being late and too short with timetables not being met. The draft legislation on residence and domicile appeared much later than expected; on CGT there was an expectation that an additional relief for businesses was going to be provided long before details of it became available. Francesca Lagerberg (ICAEW) told us “The difficulty we had with this particular series of announcements in the October PBR was that it was in the public domain for quite a long time because there was a very early statement from the Chancellor that there were going to be changes to his original proposals and then it took such a long time to actually find out what they were” (Q 80). The Society of Trust and Estate Practitioners (STEP) wrote of³ “A process of consultation on the domicile regime stretching over many years was suddenly curtailed, leading to rushed changes ...” Isobel D’Inverno for the Law Society of Scotland (LSS) agreed “it seems to us there is absolutely no reason at all why the domicile changes had to be brought in so quickly, with the result that the Finance Bill is only half finished in relation to these provisions and they are being developed on the hoof” (Q 211).
18. As a consequence it was considered that there were harmful uncertainties, raised expectations which were not realised, insufficient time for outside interested parties to react to the changes and for taxpayers’ decisions to be informed. John Cullinane (CIOT) put it this way, “I think the net effect is to create a climate of uncertainty around policymaking which it will take a bit of rowing back to get away from” (Q 56). Francesca Lagerberg thought people “knew changes were coming in from 6 April so they had a real reason to have concern, very limited information on which to act and a very, very long time before they had any concrete proposals on which they could base sensible decisions” (Q 80). Commenting on the residence and domicile provisions, Ian Menzies-Conacher (BBA) said “If you look at the history of it, we have PBR statements, consultative documents, draft clauses, amendments to the draft clauses, letters from the Director General, end of the consultation, the Finance Bill, more promised changes. None of that suggests a clearly thought out rationale” (Q 140).

³ Memorandum of Evidence by STEP (Volume II p 22)

19. There was acceptance amongst our private sector witnesses that welcome changes had been made: the entrepreneurs' relief had been introduced subsequent to the announcement on CGT and helpful changes had been made to the draft legislation on residence and domicile. The IoD wrote⁴ "We would also like to record that once officials did sit down to discuss the details of the proposals, they did so in a very constructive way". Alex McDougall (ICAS) would "accept and congratulate all those concerned on the advances that have been made" on the residence and domicile draft legislation (Q 90).
20. Our private sector witnesses contrasted the experience of CGT and residence and domicile with other consultations which had been handled well. Richard Stratton for the Law Society of England and Wales (LSEW) explained how it might be possible to separate out the high-profile political points from the technical ones "I was reminded of the consultation on REITS, real estate investment trusts, where there were a huge number of technical points. The technical points were all dealt with through a very well organised consultation, a very sophisticated consultation, but there was also the rather controversial issue of how much a company had to pay to get into the REITS regime. The Chancellor cleverly took that point off the table and said, 'I will decide about that point at the end, I will decide whether we are going ahead and go through Parliament and I will announce my proposed number', which he did and it was a good way of taking a controversial element out of the technical side of the structure" (Q 210).
21. Chas Roy-Chowdhury (ACCA) was also complimentary about the consultation on "the income shifting legislation which was proposed to start this year we had a lot of consultation and that has now resulted in a deferral. If you like, that is probably a blueprint of how consultation should progress rather than the way it has happened in these two areas" (Q 80). Isobel d'Inverno (LSS) gave the example of "the recent consultation on the gift aid scheme seems to have been extremely helpful and perhaps the difference there is that it was taking place over a long time and a lot of people who use the system on a day to day basis were involved" (Q 219).
22. We put these points to HMT and HMRC officials. Mark Neale (HMT) said that "consultation is a key part of getting tax policy and delivery right, and I think I can say that in the two and a half years I have been back in the Treasury I have seen a very substantial increase in both the depth and quality of the consultation that we have undertaken on tax matters. I think it is though important to emphasise that we do not consult—and never have consulted—on everything. Governments of both parties have stopped short, for example, of consulting on tax rates and changes in tax rates, and that was what was in issue on both the development of policy on capital gains tax and residence and domicile. What we do do, and what we did in the case of both capital gains tax and res and dom, is consult very extensively about the implementation of the policy, in the case of res and dom publishing a consultation document, and in the case of both CGT and res and dom publishing draft clauses, and inevitably that process of consultation throws up issues to which ministers have responded" (Q 303).
23. Mark Neale (HMT) continued "I do not agree there was a lack of any clear statement of policy on either capital gains tax reform or on res and dom. The capital gains tax changes were very clearly set out in the PBR 07 document,

⁴ Memorandum of Evidence by the IoD (Volume II p 92)

as were the Government's proposed changes to the taxation of non-domiciled residents. The proposals for non-domiciled residents were then further developed in a consultation document which set out the Government's objectives very clearly and we then moved into a consultation on the implementation of those changes" (Q 304). He added that there had emerged from the evidence of private sector witnesses a tension between uncertainty created by consultation and the need to take the time to explore issues fully (Q 304).

24. Mark Neale (HMT) resisted any suggestion that HMT and HMRC had not worked well together, "I do not agree with that. I think we are both concerned with successful tax policy and delivery. That is why the policy partnership between HM Revenue and Customs and HM Treasury was created following the O'Donnell Report" (Q 305).
25. **We are firmly in favour of consultation and, although we have considered carefully what officials said to us, we have little doubt, given the strength of feeling of our private sector witnesses, that something went wrong in the development of these initiatives. We see no reason why there could not have been earlier, better and more open consultation on both CGT and residence and domicile. We are particularly disappointed that the progress on consultation, which we welcomed in last year's report, has not been maintained.**
26. **If clarity and certainty are to be achieved, consultation should in principle take place as early as possible whenever there is any significant technical content. Even if it were necessary to keep back certain aspects—such as the £30,000 charge or the level of the single rate of CGT—we think consultation on many aspects could have taken place on a "what if" basis before announcements. If the argument were—and it was not put by officials—that consultation was not possible in the time available, our response would be that the proposals should not have been announced without that consultation.**
27. **We therefore recommend that HMT and HMRC should critically consider these consultative processes. Officials should analyse why the private sector bodies are so unhappy with what took place and why those bodies thought that what they were saying was not getting through to Ministers. Officials should learn the lessons.**
28. **We also recommend that HMT and HMRC should look at their record of consultation as a whole, learning from well-handled examples and striving to apply uniformly the points of best practice.**

Further Aspects of the Consultation on Capital Gains Tax

29. It has been put to us by some of our private sector witnesses that for a period after the announcement on CGT, the consultation was restricted. As the LSS wrote⁵ "There was an unacceptable degree of uncertainty about the changes in the period since the Pre Budget Report, with announcements promised and then postponed, limited consultation with a very few bodies and the prospect of a relief of some kind but with details becoming available very late in the day".

⁵ Memorandum of Evidence by the LSS (Volume II p 113)

30. This was explained more fully by Isobel d’Inverno (LSS) who said “I am sure we could do better than deal with it in this on-off way as it has been and also involving a number of meetings of a select few behind closed doors; consultation we feel should be open” (Q 211). Francesca Lagerberg (ICAEW) also thought that there was a very closed discussion on the CGT change in itself and a very strange process about how the relief was going to be dealt with (Q 81). Chas Roy-Chowdhury was more specific in his criticism “the point seems to have been specifically with the capital gains tax changes that there was no hook or mechanism to get into the consultation process other than if you shouted loudest, hence four trade bodies were actually brought into the process and were consulted but the people who actually need to make the tax work, the accountants, the lawyers, tax practitioners on the ground, were not at any stage that I am aware of really involved in the consultation process” (Q 80).
31. Officials declared themselves mystified by these comments. Mark Neale (HMT) confirmed that “We have very close relationships with the professional bodies and their associations” (Q 308). David Richardson (HMRC) agreed: “We held a number of meetings with various bodies, I think about 16 different organisations whom we met to talk to, and we had six meetings including one in Edinburgh” (Q 308).
32. **We are at a loss to explain the difference in views as to how open the consultation on capital gains tax was in the period after the PBR announcement. Whatever the position, the important general point is that consultation has to be, and be seen to be, as even-handed as possible. Limited, secretive consultation breeds suspicion and mistrust.**
33. **We recommend that consultation should be even-handed and open, involving as many as possible of the professional bodies and other parties which have a valid interest.**

Further Aspects of the Consultation on Residence and Domicile

34. Residence and domicile had been under review over many years, and no definite proposals had emerged. The present review started in 2002 and there was some consultation with interested parties in the early stages. The review was kept alive over subsequent Budgets and Pre-Budget reports, but our private sector witnesses told us that expectations had faded that anything significant would emerge. The feeling outside government was that change had been put on the back burner.
35. So the proposals came as a complete surprise. As John Cullinane (CIOT) put it “The proposals that were made, and even more than the proposals that were made, but the way they came out a clear blue sky, caused people a great deal of angst” (Q 56). Others saw the emergence of the proposals in exactly the same way. Francesca Lagerberg (ICAEW) said “on the residence and domicile, after years and years of consultation, we suddenly had very dramatic proposals put down in January which seemed to bear no relation to previous discussions” (Q 81). John Cridland (CBI) added that “the furore over this issue was really in the New Year when draft clauses were available which made it clear that the application went well beyond what most stakeholders were expecting at the time of the Pre-Budget Report” (Q 181). Not only were the proposals announced in the PBR unexpected, but also

those set out in the draft legislation of 18 January went much further than indicated by the PBR.

36. Many of our private sector witnesses thought that party politics played its part in the PBR announcement. As Michael Snyder (City of London) said "... and to therefore be forced into a situation of doing something for accidental, political reasons across the political spectrum ... was very unhelpful. I think we ended up in a position which was not very good from a perception point of view in particular" (Q 138). As the BBA wrote in their evidence to us⁶ "Even when external political pressure for change is acute, governments should not be propelled into precipitous action without careful and detailed consideration of the potential outcomes of the proposed changes".
37. Officials responded by pointing to the tension between rapid consultation, and therefore early certainty, and longer consultation which enabled a fuller appraisal of the issues (Q 304).
38. **Although we accept there can be tension between early certainty and full appraisal, we doubt if it applies to the consultation on residence and domicile. A high degree of certainty may not always be attainable in formulation of tax policy. But a review which starts with consultation, continues in a desultory way and appears to have petered out, only to be followed by the announcement of wide-ranging proposals which bear little relation to the matters previously under discussion, tends to devalue consultation.**
39. **We recommend that consultation should be genuine and meaningful and must be active on an appropriate timescale. Subject to limited exceptions, for example rates of tax, it should cover the issues on which Ministers will make decisions. If it is not leading anywhere, Ministers should decide to close down the consultation to provide the certainty that everyone agrees is desirable.**

How should the Consultation Process be carried out?

40. During our evidence session with the accountants, we asked them for supplementary evidence on the essential elements of a good consultation process. ICAEW⁷, ICAS⁸ and ACCA⁹ made many points in common. In their view, consultation should:
 - be the default, the exceptions being extremely rare;
 - take place early in the policy formulation process, discussing options and impacts;
 - take place informally to discuss ideas, before a formal written consultation document; be genuine, with considered and rigorous testing of the ideas and options;
 - feedback should be impartial recognising dissenting views;

⁶ Memorandum of Evidence by the BBA (Volume II p 70)

⁷ Memorandum of Supplementary Evidence by the ICAEW (Volume II p 62)

⁸ Memorandum of Supplementary Evidence by the ICAS (Volume II p 67)

⁹ Memorandum of Supplementary Evidence by the ACCA (Volume II p 61)

- draft clauses should be consulted on and amendments made where necessary;
- a post-enactment review should take place to pick up and address defects in the legislation.

The ICAEW saw the Cabinet Office Code of Practice on Consultation published in 2004 as important and suggested the Code might be extended to include the agreed principles of consultation on tax policy changes.

41. We welcome the ideas put forward and agree with many of them, though we think that some may have to adapt to political realities. We also accept that these ideas come from a limited number of professional bodies and think it important to open a wider dialogue.
42. Mark Neale (HMT) agreed to look at these ideas and others and commented that “We meet the professional associations on a very regular basis, consultation is almost always one of the issues we discuss with them” (Q 311). After drawing attention to a number of favourable comments in the evidence where consultation had been successful he concluded “Clearly we can and will improve but HM Treasury and HMRC get it right much more often than we get it wrong” (Q 311).
43. **We recommend that the professional bodies should send their ideas to HMT and HMRC. And we recommend that HMT and HMRC should come forward with their own ideas on how consultation processes should be handled. There should then be a dialogue between HMT/HMRC and the professional bodies and other interested parties to bring out the essential elements of good and timely consultation on a tax policy initiative and to identify the limited circumstances when consultation would not be possible.**
44. **We further recommend that any agreement reached should be developed into a Code of Practice governing consultation on tax changes, extending and amending as necessary the Cabinet Office Code of Practice on Consultation. The onus would then be on the Government/HMT/HMRC to consult in all circumstances outside recognised exceptions.**

HMT and HMRC Working Together

45. It was put to us by some of our private sector witnesses that the problems with the CGT and residence and domicile policy initiatives might have been partly created by the separation of tax policy and delivery and that there was a case for recombining these in one department. Alex McDougall (ICAS) implicitly questioned the way that HMT and HMRC worked together in the context of the suggested entrepreneurs’ relief for CGT “When we met with HMRC to discuss the PBR in November we raised that issue and were told that HMRC had no knowledge of any relief, the Treasury had not told anybody that there was to be such a relief, even though it was allegedly released to the press” (Q 83).
46. The ACCA was more forthright in the view expressed in their supplementary written evidence¹⁰ “it is becoming clear that the separation of tax policy and tax administration is not working effectively and it is time that the two parts

¹⁰ Memorandum of Supplementary Evidence by the ACCA (Volume II p 62)

were brought back together. The separation happened when HMRC was created and tax policy moved to HM Treasury. Consideration should be given to putting policy and the consultation surrounding its formulation back into a single arm of Government, which should probably be best within HMRC”.

47. Mark Neale (HMT) vigorously resisted such a suggestion “I am a fan of the policy partnership between HM Treasury and HM Revenue and Customs as it currently operates. I think that it has enabled us to deliver better tax policy. I think it is important that ministers have access to professional advice on tax policy which is independent of their delivery arm, HM Revenue and Customs, but that advice should always be informed by a clear understanding of the deliverability of the policies and policy options under consideration. That is why we work so very closely with HM Revenue & Customs” (Q 315).
48. **We cannot tell whether there is any substance in the point put to us by our private sector witnesses that the policy partnership between HMT and HMRC is not working well. We note the forceful rebuttal by officials. We recommend that the review of the consultative processes (which we recommended previously) should include consideration of how well HMT and HMRC are working together.**

International Competitiveness

49. In this section we consider the effect of the changes to CGT, residence and domicile and encouraging enterprise on the international competitiveness of the UK.
50. There are of course other changes which will affect the UK’s international competitiveness. For example¹¹ “the major package of business tax reforms announced in Budget 2007 will take effect from April 2008. The reduction in the main rate of Corporation Tax to 28 per cent will deliver the lowest ever rate in the UK and the lowest in the G7, improving competitiveness and encouraging investment”.
51. Other announcements in Budget 2008 were similarly targeted at enhancing competitiveness. The announcement on the taxation of foreign profits said¹² “Budget 2008 announces that the Government will bring forward proposals and publish a consultation document before summer 2008. The objective of any reform is to enhance the competitiveness of the UK tax framework, while being broadly revenue neutral”.
52. There is also recognition of the importance of the City of London as a financial centre¹³ “The Government is committed to ensuring that the City of London remains the world’s leading international financial centre. The financial services sector makes a significant contribution to the UK economy, accounting for 9.4 per cent of GDP in 2006, up from 6.2 per cent in 1997, and supporting over 1 million jobs. The continued prosperity of the sector is vital to the UK’s national economic interest”.

¹¹ Economic and Fiscal Strategy Report paragraph 3.13

¹² Economic and Fiscal Strategy Report paragraph 3.14

¹³ Economic and Fiscal Strategy Report paragraph 3.20

Capital Gains Tax

53. From the outset of the changes in the Finance Bill relating to capital gains tax, the Government made it clear that one of its aims was that the tax should be competitive internationally. The 2007 Pre-Budget Report said,¹⁴ “The Government is committed to ensuring that the UK has an internationally competitive capital gains tax (CGT) system that promotes flexibility and competition, and responds to the changing needs of investors”. In the debate on the Bill in the Committee of the Whole House the Financial Secretary to the Treasury said,¹⁵ “In progressing the capital gains tax reform, the Government have been guided by three key principles ... Secondly, the Government have maintained a fair and competitive capital gains tax regime ... Overall, the UK continues to be an excellent place to do business”.
54. We have received mixed evidence from our private sector witnesses as to whether the new capital gains tax system, whether before or after the announcement of entrepreneurs’ relief, is internationally competitive: there are different methods of assessment and different comparator countries, which will account for the different interpretations.
55. For example, John Whiting (CIOT) said “In terms of simplifying the system, which undoubtedly it has done, and getting a rate that looks reasonably competitive internationally, going for 18% seems a reasonable compromise” (Q 34). He added “Yes, it is expected to raise more money, and we will have to keep an eye on that, as to whether this is going to work in the longer term, because it is quite possible it begins to look uncompetitive internationally, so it is definitely something to keep under review” (Q 36).
56. By contrast, asked whether this was an internationally competitive regime, John Cridland (CBI) said “I feel it failed the Government’s own test” (Q 170). He gave as reasons the altering of reasonable expectations, that business assets held for a reasonably long period were not better treated than speculative investments, the removal of frozen indexation, and that serial entrepreneurs would not qualify for entrepreneurs’ relief once they had exceeded their lifetime limit (Q 170).
57. Similarly the British Private Equity and Venture Capital Association (BVCA) wrote¹⁶ “The Capital Gains Tax moves announced in the Pre-Budget Report 2007 and which came in to force in April 2008 have made the UK less competitive. The new rate of 18% has pushed the UK down the international competitiveness league, and means capital gains tax is higher in the UK than in other countries including the US, and European competitors like Italy, Belgium and the Netherlands”. Simon Walker (BVCA) spoke to its written evidence in similar terms saying “I think our view was that it [competitiveness] has been very considerably eroded, but perhaps not fatally” (Q 289).
58. Michael Devereux (Oxford University) put things differently: “It depends to some extent on how it is being competitive and the nature of the tax. If it is a tax on UK residents who stay in the UK, this is going to affect the investment decisions of those UK residents. It is rather different from something like corporation tax for example where we are taxing the profits

¹⁴ 2007 Pre-Budget Report and Comprehensive Spending Review Paragraph 5.79

¹⁵ Hansard, 28 April 2008, cols 63 & 65.

¹⁶ Memorandum of Evidence by the BVCA (Volume II, p 132)

which arise in the UK. Having a high tax there may induce companies to move abroad. The comparator here would be whether it induces individuals to move abroad because of high capital gains tax rates. That seems rather less likely than corporation tax” (Q 245).

59. Mark Neale (HMT) had quite different views. He said “[The tax] has met our ministers’ objectives. We believe it is both very much simpler, so reducing costs to business and individual citizens, but also remains very internationally competitive with an 18 per cent flat rate on capital gains and subsequently a slightly different regime for entrepreneurs disposing of their businesses. The international comparisons are not completely straightforward because not many other countries have as simple a regime as we have introduced, but looking at the international comparisons I do think our rate remains very competitive” (Q 316).
60. **It is difficult to reach a definitive conclusion as to the competitiveness of the UK in relation to capital gains tax, given that the Government has not published its economic case for the new regime. However, in the light of developments both here and in other countries, the overall impression being given today is of a less competitive tax environment. We also think that announcing unexpected tax changes adds to the perception of reduced competitiveness.**
61. **We recommend that the Government and HMT should publish the economic case for the new regime, justifying the single rate of 18% as internationally competitive. We also recommend that they should work now towards reassuring investors and potential investors of the advantages of investing in the United Kingdom; and that further unexpected tax changes should be avoided wherever possible.**

Residence and Domicile

62. The consultative document on residence and domicile gave the following as the rationale for the changes¹⁷:

“Maintaining the UK’s competitiveness by ensuring that the UK remains an attractive place for workers with key skills was at the heart of the recently concluded review of the residence and domicile tax rules. Equally important was the principle that the rules applying to people from abroad should operate fairly.

It is only fair that people who have chosen to make the UK their home (and who enjoy favourable tax treatment over the long term, and even pass this on to their children) should make a reasonable tax contribution to the modern public services which support our society”.

The Budget documentation stated that, overall¹⁸ “The package of changes to the rules on residence and domicile announced in the 2007 Pre-Budget Report was intended to strike the right balance between fairness and competitiveness”.

63. There was a widely-held view amongst our private sector witnesses that the Government may have failed to achieve its objective of maintaining the UK’s

¹⁷ Paying a fairer share: a consultation on residence and domicile HM Treasury December 2007

¹⁸ Economic and Fiscal Strategy Report Budget 2008 Box 4.3

competitiveness. STEP wrote¹⁹ “After a leisurely consultation process the speed and intensity with which the Government introduced measures targeted at non-doms and their investments has left this important part of this country’s business community feeling uncertain and unwanted”.

64. In their written evidence the City of London wrote²⁰ “Individuals have already based their decisions to spend significant parts of their careers in the UK on the fiscal status quo. The proposal to impose a levy of £30,000, with no explicit guarantee that it will not be raised in future years and with inadequate time to prepare for the new circumstances, has clearly alarmed many”. And then later in that memorandum they concluded²¹ “In conclusion, it is relatively clear from the City’s view that even in their amended form the proposals have the potential of damaging the competitive position of the UK, especially in the area of financial and related business services—a sector on which the national economy is heavily reliant”.
65. Echoing this concern, John Cridland (CBI) said “I think the damage which has been done is now done and it will be very difficult to unravel that damage. It has damaged sentiment I think more than anything, my Lord Chairman. It is only a year ago, or less, that we prided ourselves that the City of London had through its own good efforts established a significant competitive advantage over a number of other world financial capitals and we have managed to knock ourselves down a pitch” (Q 184).
66. The LSS saw it in these terms²² “There appears to be a perception that the changes amount to a political attack on non-domiciled individuals”. The LSEW was equally gloomy about the effect of these proposals²³ “Many of those affected by these new rules have lost confidence in the UK as a jurisdiction that welcomes foreign investment. Some took immediate action to reduce their links with the UK. Others await the outcome of the deliberations to see if the reputation of the UK can be salvaged”.
67. The IoD wrote²⁴ “There is a very good chance that the Treasury has scored an own goal here, harming the British economy and decreasing total tax revenues”. John Whiting (CIOT) thought it hard to see how these proposals would raise significant amounts of money (Q 64). In response to the question “Has anybody gained from this?”, Richard Stratton (LSEW) replied “I do not think so ... The deeply upsetting thing about this is probably that there is not much gained by these changes. There is just a lot of irritation for people” (Q 230). The BVCA wrote in their evidence²⁵ “The BVCA believes the changes to the residence and domicile regime have had a negative impact on the UK’s position as a competitive place to do business”. And in his evidence before us, Simon Walker (BVCA) said that they were “concerned about the situation that has been created and I do regard it as having this effect on the welcome mat, that it at least is looking pretty shabby” (Q 300).

¹⁹ Memorandum of Evidence by STEP (Volume II p 19)

²⁰ Memorandum of Evidence by the City of London (Volume II p 75)

²¹ Memorandum of Evidence by the City of London (Volume II p 76)

²² Memorandum of Evidence by the LSS (Volume II p 114)

²³ Memorandum of Evidence by the LSEW (Volume II p 103)

²⁴ Memorandum of Evidence by the IoD (Volume II p 91)

²⁵ Memorandum of Evidence by the BVCA (Volume II p 133)

68. Others focussed on the need for a published economic impact analysis to explain the Treasury's thinking and gauge the effect of the changes. Frank Haskew (ICAEW) was less sure that there would be a net loss to revenue, but said that "our main concern is that in previous consultations on this we have said if you are going to make changes you need to do a proper economic analysis of what the result of it is going to be to see whether there is a net benefit to the UK ... the fact is we have not had any figures to justify what is a fundamental change in policy" (Q 116).
69. In his evidence, Mark Neale (HMT) stated that "The Treasury always looks at the economic impact of tax changes because economic efficiency is one of our objectives for the tax system ... In this case we do not expect there to be any material, economic impact as a result of the changes in the taxation of non-domiciles. We expect only a very small number of people to cease to be resident as a result of the changes. We expect that those will [be] people who have the least economic attachment to the UK and the fact that they cease to be residents does not by any means mean that they will cease to spend time in the UK and undertake economic activity here" (Q 347).
70. **We are very concerned by the weight of evidence coming from our private sector witnesses that these proposals seem likely to have a negative effect on the UK's competitiveness. We think it vital that everything that can be done is done to retrieve the position.**
71. **It is clear to us that the Government has failed to communicate successfully the message that these changes are not intended to discourage non-domiciles from coming to the UK and that non-domiciles are important to the health of the UK economy. We therefore recommend that the Government does all it can to communicate this message and to maintain the UK's competitiveness by ensuring that the UK remains an attractive place for workers with key skills.**
72. **We also think it important that those outside Government have the opportunity to see HMT's assessment of the economic impact of these changes so that they might form their own judgment.**
73. **We therefore recommend that HMT should publish its economic impact analysis of these changes to residence and domicile so that everyone can share their thinking on this matter. We also recommend that HMT should update this analysis in 12 months' time in the light of events.**
74. **More generally, we recommend that, in future, economic impact analyses should be published at the same time as any significant tax changes are announced; such analyses are clearly a vital element in the decision on whether any tax changes should go ahead.**

Encouraging Enterprise

75. The venture capital reliefs aim to encourage access to capital for small companies carrying on higher risk activities. Issues of international competitiveness are likely to be less to the fore.
76. Simon Walker (BVCA) however gave us an interesting comparison when he reviewed the position as he saw it of the British venture capital scene:

“I think there is a fundamental problem about a lack of British investment in venture capital in this country. We do not invest nearly enough by comparison with countries like the United States ... So with some venture capital firms 90 per cent of their capital will come from outside the UK and we would like to see much more encouragement of British companies to participate, and we do feel that actually we are not doing that well; there is not enough money flowing into the small end of the whole private equity arena. There is plenty of money coming into the large end to buy-outs which either fix or otherwise change larger companies but really not enough coming in at the smaller end” (Q 276).

77. This perceived shortage of finance for smaller companies is relevant to chapter 5 on encouraging enterprise, where we consider the effectiveness and targeting of venture capital schemes.

CHAPTER 3: CAPITAL GAINS TAX AND ENTREPRENEURS' RELIEF

Background

78. The changes to capital gains tax were announced against a background of unease about the size of the gains being made by private equity concerns, their lack of accountability, and their comparatively low level of tax payments. In the course of introducing the 2007 Pre-Budget Report and Comprehensive Spending Review, the Chancellor of the Exchequer said:²⁶

“The capital gains tax regime here has continued to encourage investment and enterprise. I now propose reforms to make the system more straightforward and sustainable; to ensure that it sets consistent incentives for investment and enterprise; and to ensure that it remains internationally competitive. The new code of conduct for private equity firms drawn up by Sir David Walker will be published next month and will set out much needed steps for increased transparency and disclosure.

I can tell the House that the changes that I propose to capital gains tax also, taken together with the tax loopholes that I am closing, will ensure that those working in private equity will pay a fairer share. So from April next year I will withdraw the capital gains tax taper relief and in its place there will be just one rate of 18 per cent—one of the most competitive single rates of any major economy.”

79. Under the tax regime in place at that time, capital gains were taxed at 40%. However there were two tapers. The amount of the gain chargeable on business assets was tapered so that after an asset had been held for two years the effective rate was 10%. The gains made on other assets were tapered at a slower rate, starting with the third year, so that after an asset had been held for ten years the effective rate was 24%.
80. There had been an indexation allowance during the years from 1982 to 1998 under which the acquisition cost of assets had been indexed in line with the retail prices index so that the tax was charged only on a measure of the real gain. When the system was changed in 1998 and the tapers introduced, indexation was brought to an end, but it was frozen for assets acquired before that year. The Pre-Budget Report Note made it clear that the changes announced by the Chancellor also included the abolition of the frozen indexation allowance²⁷.
81. Other changes included the abolition of the “kink test” which affected assets held on 31 March 1982; the abolition of halving relief which reduced a deferred gain relating to a period before that date; and the simplification, consequential on the changes, of the share identification rules²⁸.
82. This announcement, which in effect increased the rate of tax on gains on most business assets from 10% to 18%, gave rise to many representations from small and medium-sized business interests. In the light of those

²⁶ Hansard, 9 October 2007, cols 170–171.

²⁷ PBRN 17, paragraph 9.

²⁸ PBRN 17, paragraphs 10, 11 and 13.

representations, the Chancellor of the Exchequer announced on 24 January 2008²⁹ that, at a cost of around £200 million a year, the changes he had earlier announced would be complemented by the introduction of the entrepreneurs' relief.

83. He said that the entrepreneurs' relief would provide a special 10% rate on qualifying gains up to a lifetime limit of £1 million: this limit would be kept under review. The relief would be available on the disposal of a trading business carried on alone or in partnership; or on shares in a trading company provided that the individual was an officer or employee of the company and had a stake in it of at least 5%.

84. He concluded³⁰:

“The UK business environment remains one of the best in the world. I am determined to keep it that way. My announcement today, with measures to simplify the regime, will ensure that that continues to be the case.”

Sustainability

85. In announcing the changes to capital gains tax, the Government said that, in addition to its commitment to an internationally competitive system, which we discussed in the previous chapter of our Report, the reform would³¹ “put the CGT regime on a more sustainable footing and help investors plan for the long term”.

86. Our private sector witnesses cast some doubt on how far the Government had been successful in achieving that aim. For example the Association of Tax Technicians (ATT) said³² “If Government policy is to encourage the formation of and investment in new businesses, then entrepreneurs must be able to take a long term view in formulating their plans and judging the likely rewards. In the last ten years they have seen: the abolition of retirement relief, which granted a complete, albeit limited, exemption; the introduction of taper relief which granted a reduced effective rate of tax but on unlimited gains; and now the introduction of entrepreneurs' relief, which continues the effective low rate of tax but now limits that rate to gains of up to £1 million in a lifetime. What is required now is a period of stability.”

87. Likewise Frank Haskew (ICAEW) said “Personally, I do not think that the current regime is on a sustainable footing because people are expecting there are going to be further changes to it. I think a lot of people will be sitting tight anticipating that there are going to be further changes. Also, we do not actually see it as encouraging long-term investment; in fact, if anything, it is going to encourage short-term investment and speculation. It is difficult to reconcile [what was said in the Pre-Budget Report] with what has actually happened on the ground” (Q 91).

88. In its written evidence to us the BVCA said³³ “So far there is no direct evidence that the new, higher rate [of tax] has led to member firms moving

²⁹ Hansard, 24 January 2008, cols. 1627–1628.

³⁰ Hansard, 24 January 2008, col.1628.

³¹ 2007 Pre-Budget Report and Comprehensive Spending Review, para 5.79.

³² Memorandum of Evidence by the ATT (Volume II, p 11).

³³ Memorandum of Evidence by the BVCA (Volume II, p 132)

away from the UK, but decisions affecting location are usually influenced by a range of factors of which tax rates is only one. The important point for the industry now is that we have certainty and stability in the tax regime and that there are no further changes. The fact that leading business organizations were not expecting any change to the general level of CGT added to the sense of uncertainty and engendered a high profile political reaction which itself caused further damage to business confidence”.

89. In responding to a suggestion of a lack of confidence in the system and therefore in its sustainability, Mark Neale (HMT) said “I think the key thing is to put capital gains tax on a long-term basis which ministers certainly now feel they have done with a very clear headline rate for the great majority of people who pay capital gains tax” (Q 317). He added that the changes did not promote speculative investment or gains: the system was neutral between kinds of assets and holding periods, so that people would hold whatever asset was economically sensible for as long as was sensible (Q 317).
90. In response to the suggestion that sustainability was an impossible aim given the history of changes and errors in Finance Bills, he said “I think there is much less scope for re-visiting tax legislation when it is simple and straightforward, and I think the regime we now have on capital gains tax is significantly more simple and straightforward than the regime which preceded it” (Q 318).
91. **In our view it will take time for the certainty and predictability which investors need to be restored, given the shock to which the changes gave rise. Matters have not been helped by the manner in which the changes were introduced, and the legitimate expectations which—rightly or wrongly—investors believed that they had been denied. It may also not help investment that long term gains are no longer treated better than speculative gains: indeed as inflation picks up they are arguably less well treated. It will therefore take time for confidence in the system to be restored and for it to be seen as sustainable.**
92. **We recommend that the Government/HMT should persist in explaining the reasoning behind, and the advantages of, the changes, with a view to restoring confidence in the system, its sustainability and predictability.**

Forestalling

93. The main changes to capital gains tax were announced six months before they came into effect and the introduction of the entrepreneurs’ relief was also signalled well in advance. Hence there was plenty of time for those who were in a position to do so to decide whether or not to forestall the changes. However some people were in a better position to do so than others.
94. The Institute of Directors (IoD) put the point well.³⁴
- “Two modifications of the proposals could have defused complaints of retrospection. The first modification would have been not to take away accrued indexation allowance. The second would have been to allow deemed disposals at 5 April 2008, so that gains accrued up to that point

³⁴ Memorandum of Evidence by the IoD (Volume II, p 91).

were taxed under the old rules. (A decision would then be needed on whether taxpayers would have to pay tax immediately on such deemed disposals. Ideally, they should not have to do so.)

Curiously, transitional arrangements on these lines have in practice been made available, at least to well-advised taxpayers. Taxpayers who are married or in civil partnerships have been able to transfer assets to their spouses or partners before 6 April 2008, converting indexation allowance into base cost and preserving it. And schemes involving trusts have been available to allow gains accrued up to April 2008 to be taxed under the old regime, in some cases without leading to any requirement to pay tax on those accrued gains immediately.

It is not clear whether the Government was aware of these possibilities at the time of the Pre-Budget Report, but it certainly was aware of them within a few weeks afterwards and decided to take no action. Our view is that if opportunities such as these are to be offered, they should be made an explicit part of the proposals so that all taxpayers can take advantage. (Indeed single taxpayers were denied the above easy route to the preservation of indexation allowance, which seems unfair”).

95. Officials pointed out that the aim of the changes was to simplify. Rebasing at 5 April 2008 would have introduced complexity as would have other grandfathering rules. Mark Neale (HMT) said “I think you have to bear in mind that the objective here was to simplify. It would have been very far from simple to introduce provisions that protected the gains already latent in assets that people were holding. Bear in mind too this cuts both ways, people who acquired assets before 1998 would have had a legitimate expectation they would be taxed at 40 per cent, and I have not heard anybody arguing that we should have built in the provision to tax gains on assets accrued before 1998 at 40%” (Q 319).
96. David Richardson (HMRC) added “Rebasing is always a technical possibility. Of course it brings complications of its own. Rebasing by a deemed disposal would mean people being asked to pay tax when they actually have not had any sale proceeds, as it were, which can equally be seen to be unfair. I think really the underlying point behind grandfathering and any other issues is that simplification is a little bit like sand in your fingers, if you are not careful you get many different lobbying interests coming up with regimes to suit their own particular situations, all of which can be quite compelling in one sense, but as soon as you start to take those on board you find simplification has run through your fingers, as it were. Therefore the proposal here was very much around trying to stick to the concept of simplification and having a single 18 per cent rate” (Q 322).
97. In response to the suggestion that only the well advised were able to forestall the changes, David Richardson (HMRC) said “I think it is probably always the case there are some people who have professional advisers and some people who do not, and I think that is true in any particular situation. Obviously everybody had the opportunity if they wanted to of making a disposal before April, but those who did not will benefit from the new 18 per cent which is historically a very low rate for capital gains tax in this country and is internationally competitive” (Q 323).
98. **While we understand the reasoning of officials and are very mindful of the arguments for simplification, we nevertheless think it unfair if**

some people were in a better position to retain the benefits of the old regime than others because, for example, either they were married or in civil partnership rather than single, or the assets were held in trust.

99. **We recommend that, in any future changes of this kind, particular thought is given to the opportunities for forestalling and that either those opportunities are made available to all or denied to everyone.**

Indexation

100. Indexation is important as it ensures that the tax is charged on real gains and not on any gain which has arisen only because of inflation. It is especially important when inflation is at a high rate as it was in some years between 1982 and 1998, but, even when it is running at a lower rate, it can mount up where assets are held for a number of years. Since 1998, when indexation was abolished for the future while being frozen for the past, tapering has to some degree been able to be seen as a proxy for it. Not only however is tapering now being abolished in the Finance Bill, but so is frozen indexation.
101. Our private sector witnesses were not unanimous about indexation. The Oxford University Centre for Business Taxation (Oxford University) wanted to recognise rising prices, but in a simple, albeit rough and ready, way. In their written evidence they said³⁵ “Typically, part of any gain is due to an increase in the general price level. In principle, only the real gain over and above inflation should be taxed. Although the operation of the indexation allowance was complex in certain areas, we believe that in balance it is better to retain such an allowance and to seek administrative solutions to any complexities”.
102. When we pressed the Oxford University witnesses to spell out what they meant by an administrative solution, Judith Freedman said “One of the reasons for the complexity is the continual change. Instead of trying to work at the indexation system and improve it—perhaps one might have to apply some rules of thumb and make it less of an elaborate indexation system but still have an indexation system—we moved to a taper relief which had no logic at all and then we changed the taper relief twice. That is one of the things that has created so much complexity. Complexity is created by constant change as much as by the underlying system. Had we stuck with indexation but worked on improving that it might have been a better way forward” (Q 247).
103. Taking a rather different line on indexation in general, John Cullinane (CIOT) said that there was no need for complex compensation if there were a low rate of inflation. The problem was one of expectations. “For those people who had lost a great deal of past indexation, [the abolition of frozen indexation] must have come as a big shock” (Q 47). John Whiting (CIOT) added “I think [indexation] is another thing to keep under review because if inflation stays low, arguably a low rate of tax will do, but we do have to point to the fact that there is now no inflation protection for what may become inflationary gains when you have held an asset for a long period” (Q 47).
104. Turning to frozen indexation, Andrew Meeson (ATT) did not see a strong case for its retention. He told us “I think it is worth pointing out that those individuals who feel hardest done by from this simplification, the 10% to

³⁵ Memorandum of Evidence by Oxford University (Volume II p 123).

18% people, by and large have least indexation to have lost, because the tendency will be to have had either lower initial base costs for having incorporated from scratch or more recent establishments. It tends to be the land-based gains that are most burdened with indexation. In those instances, quite frequently they have moved down from a 24 to an 18 regime, so there is an element of *quid pro quo*. It is a difficult one because you do not really know until you look at the profile of days that have been taxed what the indexation position is out there” (Q 47).

105. David Richardson (HMRC) made a similar point. He also said that the last statistics showed that 17% of disposals had frozen indexation and that it was part of the complication of the system, in particular because it made pooling of assets much more complicated. He said “Therefore, the combination of the fact that there are relatively few assets now to which [frozen indexation] applies and the fact that it was causing complication pointed to removing it” (Q 324). He added that the situation was different now to what it had been when taper relief was introduced and indexation was frozen. Not all assets now had indexation attached and the 18% rate applied immediately whereas the taper relief had not. “Given those considerations, it is a different situation and therefore ministers took the view that indexation should be abolished” (Q 324). Similar points were made by the Financial Secretary to the Treasury in debate in the Public Bill Committee³⁶.
106. **The abolition of frozen indexation relief has enabled very considerable simplification to take place, and many holders of assets where indexation was significant will have been able to crystallise their gains before 6 April by one means or another. In addition the rate of tax has been reduced.**
107. **Although we recognise the arguments for retaining frozen indexation, on balance we are inclined to the view that its abolition was a reasonable step to take, notwithstanding the disquiet which remains around this issue.**

Simplification

108. The announcement of the introduction of entrepreneurs’ relief, after the original announcement in the Pre-Budget Statement of the single rate of tax and of the abolition of the taper relief and of frozen indexation, has weakened the case for saying that the changes introduce a major simplification of the tax. As Edward Reed (LSEW) said “In the round there is, on the face of it, a much simpler system ahead of us, but the fact of having introduced an entrepreneurs’ relief at the last minute in reaction to representations made by a number of bodies does mean we have a system which pretty much is as complicated as the system it is attempting to replace ... I think in the round I am not sure we have advanced very far” (Q 212).
109. Moreover John Cridland (CBI) doubted whether the case for simplification made by the Government justified the changes. He said “I do not think there were many people outside of Her Majesty’s Treasury arguing for simplification of capital gains tax, it certainly was not an objective of the CBI. Indeed, we were not aware that the current regime was not stable or sustainable, and we are not such avid fans of simplification that we are

³⁶ Public Bill Committee Hansard 8 May 2008 cols 77–88.

prepared to pay the really very serious price of destabilising the entrepreneurial seed bed of our economy on the altar of simplification. So I think that was a somewhat spurious defence by the Government of its own policy” (Q 171). He subsequently made it clear that the CBI were great supporters of simplification generally, but that it had to pass a proper cost benefit analysis (Q 174).

110. The problem of getting effective simplicity was advanced by Richard Stratton (LSEW). He said “I think I am getting to the point where I personally prefer simplicity and if that means fewer special cases and fewer reliefs, then so be it. The difficulty over the years has been that when you look at these regimes, partly because of the taxpayers’ lobbying, you end up with all sorts of special cases, which does not produce simplicity. It is a question of whether you decide that is the appropriate regime” (Q 216).
111. The issues underlying capital gains tax were brought out by Oxford University. The problems included inflation, that gains were not generally taxed until they were realised, and the double taxation which could arise on the sale of company shares. They said³⁷ “These considerations already indicate that an ideal capital gains tax is impossible to attain. In these circumstances there is much to be said for a simple system which may not be perfect, but which is reasonably fair, and which does not create too many economic distortions”.
112. They questioned whether the single rate brought much simplicity. They told us³⁸ “It has been argued that a single rate of capital gains tax represents a simplification. We do not find this argument persuasive, compared with a system in which capital gains are taxed at the same rate as an individual’s taxable income. We believe that the benefits of a single rate are overstated ... What is more important for a simple tax system is that different forms of income and gains are taxed at similar rates.” In oral evidence they also drew attention to complexities brought about by the many representations made about it, and the continual change.
113. The reasons why simplifying the tax was problematic were well put by the ATT. In particular they doubted whether the single rate of tax brought much simplification. They told us³⁹:

“A simple tax system which is fair to all taxpayers is a Holy Grail which has long been sought by politicians, administrators and taxpayers and, like the Holy Grail itself, it does not exist. There can be a simple system which will not be fair or a fair system which will not be simple. A balance has to be struck because over-simplification leads to unfairness.

...

It is understandable therefore that CGT might be seen as a target for simplification; however the complexities are there for a reason: to give relief in cases thought to be deserving or to encourage investment in businesses. The effect of the simplification proposed in the Bill is to increase the potential effective rate of tax on the business community by 80 per cent whilst reducing that on the short-term speculator by 55 per

³⁷ Memorandum of Evidence by Oxford University (Volume II, p 124).

³⁸ Memorandum of Evidence by Oxford University (Volume II, p 124)

³⁹ Memorandum of Evidence by ATT (Volume II, p 11).

cent; a clear example of simplicity leading to unfairness. It is surprising that this was not made clear to the Chancellor before the proposals were announced as part of the Pre-Budget Report.

Quite apart from the issue that “simplifying” the rate of CGT leads to unfairness, it should be noted that the proposals in the Bill do not really amount to simplification in any significant sense—the computation of gains and losses remains as complex as before, and only the very final step of deciding which gains are to be taxed at which rate has been changed”.

114. Officials accepted that the introduction of entrepreneurs’ relief had brought complexity. They pointed out however that the relief was focussed and would not apply to a lot of people: and they had tried to make it as simple as possible. That apart, the removal of the tapers, indexation and the various reliefs and rules to which they gave rise had led to considerable simplification. David Richardson (HMRC) added “I know pages of legislation are dangerous things to equate with simplicity but I did a quick calculation just before coming over here and for those people outside entrepreneurs’ relief the changes lead to a net reduction of 23 pages of legislation and, for those within entrepreneurs’ relief, a net reduction of 11 and a half pages. That just carries a bit of the flavour of the fact that we have got rid of some quite abstruse and complex rules” (Q 326).
115. **The addition to the changes of the entrepreneurs’ relief added a measure of complication especially as it was not, in our view, framed as simply as might have been possible. Nonetheless in general the overall effect of the changes has been a measure of simplification, which we certainly welcome.**
116. **The tax remains complex, however, in particular in relation to establishing what is allowable expenditure and in consequence the size of the gain or the loss. While there is a good argument for letting the dust settle on the changes now being made, at the same time the case for continuing the process of simplifying the tax remains strong, provided that it can be done without importing unfairness.**
117. **We recommend that HMT/HMRC should open up a dialogue with professional bodies and other interested parties to discuss further opportunities for simplification within the new regime so that there can be legislation at an appropriate time.**

Forecasts and the context for simplification

118. One of the major problems in any significant simplification of part of the tax system is likely to be that of winners (who will remain largely silent) and losers (who will complain). Hence our private sector witnesses felt that the best context in which to introduce simplification was one where the overall balance of the change is relieving or at least where it is revenue neutral so that the amount of the losses balances the amount of the gains. Of course there may be more losers losing smaller amounts or fewer losers losing larger amounts, but the broad balance will still be there.
119. For example, the ICAEW told us⁴⁰ “The rate of CGT is ultimately a political question for the Government. Whilst any tax simplification is likely to

⁴⁰ Memorandum of Evidence by the ICAEW (Volume II p 37).

produce winners and losers, this measure was designed to increase the yield from CGT. We think that from a public perception viewpoint, a tax simplification programme should be seen as broadly revenue neutral. It will be more difficult to pursue a tax simplification programme in consultation with stakeholders if the perception is that one of the main drivers to the programme is raising revenue rather than making the UK tax system more straightforward and competitive.”

120. Isobel D’Inverno (LSS) put it rather more strongly when she said “The slightly objectionable thing about these changes is that they are clearly not revenue neutral and to confuse tax-raising with simplification seems to be trying to hoodwink the taxpayer” (Q 222).
121. On the other hand Mark Neale (HMT) felt simplification was an important part of a continuing strategy. He was not sure that revenue neutrality would make it easier: after all revenue neutrality was only the overall position, there would still be losers who would make representations (Q 331).
122. **In our view the possibility of simplifying a tax in the course of a major change should certainly be pursued even when, as in this instance, the overall impact of the change is to raise revenue. However, where revenue is raised, there will be more losers than winners or the amount the losers lose will be larger than the amount the winners win. To that extent therefore the simplification may be less easy to achieve.**
123. In any case there must, in our view, be some doubt about the extent of the current revenue forecasts in this area where so much depends on changes in asset values and the propensity of investors to sell. We noted that the amount forecast by the Treasury at the time of the Pre-Budget Report to be raised by this measure differed from the forecast provided on Budget Day by considerably more than the cost which was given for the entrepreneurs’ relief.
124. Commenting on doubts about the forecast of the yield from the measures, Malcolm Gammie for the Institute for Fiscal Studies (IFS) said “Inevitably with a tax like Capital Gains Tax, which is dependent upon individuals making disposals in particular years, there must be a great deal of uncertainty as to precisely how much gain will be realised by the aggregate of individuals across the year and that will also be dependent upon the performance of, in particular, the Stock Exchange because of the high proportion of share gains which would be in the total” (Q 7). He drew attention to the significant changes in the property and stock markets since the forecasts were made.
125. Mark Neale (HMT) reiterated confidence in the figures and pointed to the vigorous scrutiny of divergences between forecasts and revenues (Q 332). Figures of the yield from CGT with the entrepreneurs’ relief in place would, he said, be published showing how closely they matched the forecasts (Q 334).
126. **We remain surprised at the confidence in the current forecast of the yield from Capital Gains Tax including the entrepreneurs’ relief and recommend that a fuller explanation should be given.**

Avoidance

127. When capital gains tax was first introduced, it was charged at a lower rate than the comparatively high rates of income tax then being charged. This was

so for all gains, and gave rise to very considerable avoidance and a plethora of elaborate and artificial schemes, particularly during the 1970s and early 1980s. These very largely faded away when the rates of the two taxes were drawn together. The question which arises now therefore, as we again see a lower rate of tax on gains than on income, is whether there is any possibility of significant avoidance, particularly in respect of short term receipts, arising again which would in turn give rise to considerable anti-avoidance legislation. No specific anti-avoidance provisions have been included in the Finance Bill to tackle this issue.

128. Our witnesses from the professional bodies were generally inclined to the view that, although there would be some attempts at avoidance along these lines, in general the context was very different today than in those earlier times. The avoidance disclosure rules introduced in 2004 have the effect that HMRC would very quickly learn of any avoidance schemes which might be devised and this would reduce significantly the incentive to introduce them. Nonetheless there is still likely to be some leakage of tax revenue along these lines during the short period before disclosure is made and it may well lead to new anti-avoidance legislation in future Finance Bills.
129. Mervyn Woods (CBI) was alone in suggesting otherwise. He thought that it was inevitable that avoidance would reappear. He said "I suspect, as always in tax, whenever there is a new boundary created or difference in the boundary figures, then somebody will look at that boundary and say, 'Here is an opportunity'" (Q 173).
130. Francesca Lagerberg (ICAEW) suggested that the greater concern should be people trying to use entrepreneurs' relief. She said "The issue is going to be for businesses trying to use the one relief that has been given because they are going to look at entrepreneurs' relief that has been set up on the back of some very ancient retirement relief rules. Retirement relief was removed for a very good reason and now it is back, it is slightly dusted down, a little bit shinier, but it is very much the same regime. It is very easy to go back to the old rules of history because they are easier to get down off the shelf, but there were a lot of problems with retirement relief. I do not think your concern should be about clever planning schemes, it should be about the core people that relief is aimed at, small businesses ... trying to get an effective rate of 10%" (Q 100).
131. David Richardson (HMRC) said that there had been discussions as to whether specific anti-avoidance legislation was necessary, but in view of the large amount of anti-avoidance legislation, the developed body of case law and the disclosure provisions, they had come to the view that it was not necessary. He added "We will keep a very close eye on what is going on and if we find that there is avoidance taking place we would obviously want to bring it to ministers' attention very quickly" (Q 329).
132. **Even though avoidance in this area may no longer be a major issue, the possibility of its re-emergence should be carefully watched. It could be that, depending on the outcome of consultation on the use of principles-based anti-avoidance legislation in the area of financial products, a new approach along these lines might also be useful here.**
133. **We recommend that, notwithstanding the general optimism that there would not be significant avoidance, HMRC should monitor closely what is happening in this area. We hope that it will not be**

possible to devise ways of turning income into gains which are not notifiable under the disclosure provisions, but this possibility should be kept in mind.

Entrepreneurs' Relief

134. The view of the entrepreneurs' relief which was expressed to us by Oxford University was quite different from that of any of our other witnesses. In their opinion the case for the relief was unclear. They pointed out that the document "Enterprise: unlocking the UK's talent" (to which we refer further in Chapter 5 below) listed five strategies to develop enterprise in the UK. None of these strategies included entrepreneurs' relief or any other tax measure. They concluded⁴¹ "Further, an entrepreneur that has already gained the benefit of the relief has a (comparatively) reduced incentive to undertake a new enterprise. This may be thought to balance the need of fairness in the tax system with the need to create incentives to invest. But the basic relief itself, which allows £1 million of gains for a single individual to be tax free, in any case raise questions of fairness."
135. Our other witnesses from the private sector took a relief for business assets as their starting point. But they told us that the entrepreneurs' relief was based on the former retirement relief which had been repealed in 1998 rather than on the business assets tapering provisions which replaced it. The latter, they said, would have been more familiar to HMRC staff and practitioners alike, would have been simpler, more comprehensive, and would have avoided many of the very considerable problems associated with retirement relief, for example the "whole or part of the business test" which was previously a problem for unincorporated businesses.
136. As Edward Reed (LSEW) said, "Retirement relief was a relief which had mainly critics and very few supporters ... There are specific problems with it which have not been addressed ... It does seem slightly peculiar to take a relief which very few people found easy to administer or understand and try to replicate it all these years later when we thought it was consigned to the dustbin" (Q 221). On the other hand, as Francesca Lagerberg (ICAEW) said "I think [entrepreneurs' relief] has missed some opportunities, but the policy around it was meant to be quite restrictive and it has probably done what it said on the tin. I think we would have liked it to have done more but that is a policy decision" (Q 113).
137. A particular concern amongst our private sector witnesses related to the exclusion of many employee shareholdings from the scope of the relief. The relief takes as its test that the individual officer or employee must be selling shares in his personal company, i.e. that he must have a shareholding of at least 5% in the company in order to qualify for the relief: Simon Walker (BVCA) was concerned that there might be cases where there were people working together in a company where one would qualify and another would not. He said "You actually have more perverse incentives where the person at the top is actually doing relatively well compared to his or her colleagues" (Q 291).
138. There were more detailed areas of concern to those witnesses involving circumstances which had been covered by the business taper relief but are

⁴¹ Memorandum of Evidence by Oxford University (Volume II, p 124).

currently excluded under the Finance Bill as published. These relate to trustees doing business and to the structure of the business organisation, in particular since limited liability partnerships are more widely used than they were in the days when retirement relief was on the statute book. There were concerns also about assets held outside a business.

139. These matters were discussed in the Public Bill Committee⁴². We note that there was one specific concern relating to the restriction on the relief where rent has been paid for the use of an asset. The Financial Secretary to the Treasury promised to consider this point before the Report stage of the Finance Bill in the House of Commons. That apart however she resisted the various amendments which were discussed and gave little sign of any further consideration.
140. David Richardson (HMRC) explained that entrepreneurs' relief was a new relief, not a disguised form of taper relief. The objective was to ensure that entrepreneurs selling their businesses should receive relief: business assets taper relief went much wider. Because retirement relief had the same objective, that was a reasonable place to start, but some of the complexities of retirement relief—such as the age and ill-health provisions and the qualifying periods—had been stripped out. He said “It seemed a sensible place to start rather than inventing something new, which is always dangerous and risky, but we have taken out some of the provisions that used to cause problems” (Q 335).
141. David Richardson (HMRC) went on to explain that as for employee shareholdings, the purpose of the relief was to relieve entrepreneurs not any shareholder or employee. Where to draw the line in determining the appropriate percentage was a matter for Ministers, but 5% had been in the retirement relief. Moreover the average gain with all-employee schemes was well below the CGT annual exempt amount (Q 336).
142. As for the different treatment of companies, partnerships including limited partnerships, and sole traders, David Richardson (HMRC) said “The basic principle behind the relief for all of those different situations is exactly the same, which is that the individual needs to be disposing of a share of their interest in the business ... The fundamental point is the same but obviously [the relief] operates in a slightly different way, depending on the particular legal and organisational structure” (Q 338).
143. In their supplementary written evidence⁴³, HMT made it clear, following the oral discussion at Q 340–342, that a director or employee who had a shareholding of 5% or more and retired from the company before selling his shares would qualify for the entrepreneurs' relief only if, on or before he retired, the company had ceased trading or had ceased to be the holding company of a trading group and all the other conditions were satisfied. This would mean, for example, that in most circumstances someone who was unable to find a purchaser for his shares when he wished to retire would either have to stay with the company for longer than he wished, or would not qualify for the relief when finally he was able to sell. This issue may be particularly acute where there is a requirement that a director has to be a shareholder.

⁴² Public Bill Committee Hansard 8 and 13 May 2008, cols 120–157.

⁴³ Memorandum of Supplementary Evidence by HM Treasury (Volume II, p 161)

144. Not dissimilar circumstances involving a withdrawal from a business in stages were discussed in the debate in the Commons Public Bill Committee⁴⁴ to which we referred earlier. Mr Philip Hammond, speaking for the Opposition, said⁴⁵ “It is also likely that [an individual] may cease to be an employee or officer of the company before finally disposing of his shareholding. The tax regime in the Bill will drive structures for exits from businesses and that is undesirable. We think that the tax regime should not drive behaviour that otherwise would optimise the smooth transition of a business from one ownership to another”. The Financial Secretary to the Treasury promised⁴⁶ to keep some of the points made in the debate under review, but was concerned not to lose the focus of the relief on entrepreneurs withdrawing from the business.

145. **We note and understand, both from the debate in the Commons Public Bill Committee and from what officials told us, that the policy of the Government is to focus the relief on entrepreneurs. Nonetheless, within that, we think that there is a strong case for widening the relief, by way of amendments to the Finance Bill at its Report Stage in the Commons, to include the particular areas brought to our attention:**

- **employee shareholdings;**
- **trustees doing business;**
- **assets held outside a business;**
- **withdrawal from a business in stages, particularly retirement as a director before a sale of shares.**

There is also a good case for aligning the treatment of disposals of interests in businesses whatever the form of business structure.

146. **We accept that any widening of the relief would require a measure of further complexity, but, given that we cannot now go back to a provision closer to the business assets taper relief which would have been simpler in both structure and operation, this is a price that may have to be paid.**

Serial entrepreneurs and the lifetime limit

147. The lifetime limit of £1 million on the extent of the entrepreneurs’ relief will cover a very large proportion of cases, and, as noted in paragraph 83 above, when announcing the relief the Chancellor of the Exchequer said that it would be kept under review. But our private sector witnesses were concerned that that assurance might very well not sufficiently satisfy serial entrepreneurs who bring considerable value to the economy.

148. Simon Walker (BVCA) said, “I do not think [the limit] will stop a serious serial entrepreneur, but I think it is a disincentive” (Q 291). Richard Baron (IoD) suggested that the limit might do for a start, but he added, “One can easily see it running out, and of course it is the successful [serial entrepreneurs] we want to encourage” (Q 179). He suggested that checks

⁴⁴ Public Bill Committee Hansard 8 May 2008 cols 120–130.

⁴⁵ Ibid at col 124.

⁴⁶ Ibid at cols 126–130.

should be made on the use of the relief and that the limit should be looked at again in, say, five years' time.

149. The ICAEW believed that the limit should be indexed in line with inflation and would benefit from alignment with the pensions lifetime limit. Frank Haskew (ICAEW) admitted that the two issues were separate, but added "I think it was a question of if you want simplification potentially they were both in the same sort of area, both, if you like, increasing every year, so it was a question of having one limit" (Q 108).
150. Michael Snyder (City of London) was concerned more generally about the message being sent to serial entrepreneurs. He said "In terms of the changes in the CGT and entrepreneurs' relief and the way that gain happens, I will just say it neutrally. Perhaps it was not the most helpful in encouraging people to be serial entrepreneurs. The process of taking retirement relief away, then introducing the ten per cent, then taking away the ten per cent and then having to introduce the £1 million limit was not a particularly helpful way of giving out a message again from government and the Revenue saying, 'We really wish to encourage this area'" (Q 166). He suggested that there might be a revolving limit on the relief, i.e. every five years it might be reinstated to a zero clock.
151. David Richardson (HMRC) said that the relief "does recognise the concept of serial entrepreneurs and that was certainly the intention of the design" (Q 343). However the setting of the level was a matter for Ministerial judgement. The figure of £1 million was not an insignificant amount and, even if that level were exceeded, the gains would be taxed at 18% which was historically a very low figure for capital gains tax (Q 343).
152. When the limit was discussed in the Public Bill Committee⁴⁷, the Financial Secretary to the Treasury was unwilling to accept a formal commitment to review. Nonetheless she assured the Public Bill Committee that it would be kept under active review as part of the normal process of considering policy in the pre-Budget programme of work.
153. **We recognise that the Government has said that it will keep under review the size of the limit to the entrepreneurs' relief and we have seen the assurances which the Financial Secretary to the Treasury gave to the Public Bill Committee. Nonetheless, given the shocks to which these changes to capital gains tax and other events have given rise, we are concerned whether an assurance is in practice sufficient to provide the certainty which entrepreneurs need to see in the tax system.**
154. **Accordingly we recommend that there should be a means of ensuring that the limit keeps pace with events, for example, though not necessarily, through indexation.**

⁴⁷ Public Bill Committee Hansard 8 May 2008, cols106–118.

CHAPTER 4: RESIDENCE AND DOMICILE

Background

155. The normal basis of taxing those who are resident and domiciled in the UK is the arising basis i.e. the person is taxed on worldwide income in the year in which it arises.
156. The remittance basis of taxation applies to those who are resident in the UK, but either non-UK domiciled or not ordinarily resident in the UK. Under this system, UK residents who have foreign income or gains (for non-domiciles) are not taxed on these until such time as they remit amounts in respect of those income or gains to the UK when they are taxed on the amounts remitted.
157. A person is treated as resident in the UK according to rules which are partly statutory and partly practice based on case law. The rules are summarised in the HMRC booklet IR20. Statutorily a person is always resident in the UK for a particular tax year if he spends 183 days or more in the UK in that year. Hitherto there have been no legislative rules determining which days had to be counted and this was set out in IR20: the normal rule was that days of arrival in and departure from the UK were ignored in counting the days spent in the UK.
158. A person regularly visiting the UK is also treated as resident here if after four tax years the visits during those years averaged 91 days or more for a tax year. Longer term visitors are treated as resident in the UK if they come to the UK for a purpose that means they remain here for at least two years.
159. Domicile is a general law concept distinct from nationality or residence. A number of factors contribute to determining a person's domicile, which can be summed up as being the place of a person's permanent home—where a person's roots are. A person can have only one domicile at any time and there are various aspects of the concept such as domicile of origin at birth, domicile of dependency for children and a domicile of choice which may be adopted, but it is quite difficult to change one's domicile and almost impossible for HMRC to show that someone has done so.
160. The most recent review of the rules relating to residence and domicile began in 2002. PBR 2007 announced the completion of the review and a package of reforms⁴⁸ “to make the system fairer while maintaining the UK's competitiveness”. The package comprised:
 - UK residents who are non-domiciled or not ordinarily resident and have been resident in the UK for longer than 7 of the last 10 years having to pay an annual charge of £30,000 to continue using the remittance basis of taxation, subject to a *de minimis* limit
 - denial of personal allowances and the CGT annual exempt amount for those claiming the remittance basis, again subject to a *de minimis* limit
 - changing the day counting rules for deciding whether someone is resident in the UK so that days of arrival and departure would be counted

⁴⁸ 2007 PBR CSR: Press Notices: PN1 Page 5

- addressing anomalies in the present rules for the remittance basis which previously had allowed users to remit amounts to the UK without triggering a charge.

Consultation was promised on the detail and on a wider range of options, including specifically whether those who have been resident here for more than 10 years should contribute more. The proposals proved very contentious, with national press comment and at a more technical level.

161. HMT published a consultation document on 6 December 2007 and draft legislation was issued by HMRC on 18 January. The draft legislation proved even more contentious, particularly amongst the tax professionals. Dave Hartnett (Acting Chairman HMRC) wrote⁴⁹ an open letter on 12 February offering clarifications on the intention of the draft legislation by way of changes from the draft provisions as published. The letter stated that the Government was committed to retaining the remittance basis, however there were issues of fairness that needed to be addressed. The letter went on to explain why the Government was introducing the £30,000 annual charge and why loopholes in the present legislation were being addressed.
162. The Hartnett letter then went on to state that the Government's intention had always been that there would be no additional disclosures of information about a person's income and gains arising abroad, there would be no retrospection in the treatment of trusts, the changes would not apply to gains accrued or realised prior to the changes coming into effect, money brought into the UK to pay the £30,000 charge would not itself be taxable, and it would be possible to bring art works into the UK for public display without incurring a charge to tax.
163. The Budget 2008 set out significant changes to the draft legislation, incorporating, but going further than, the clarification/changes foreshadowed in the Hartnett letter:
- the £30,000 charge would not apply to children
 - the charge should be creditable against foreign taxes where appropriate, in particular US tax
 - there would be exemptions for works of art coming into the UK and other relaxations for assets remitted to the UK
 - the *de minimis* levels would be increased from £1,000 (as proposed in the PBR) to £2,000; where a person had unremitted foreign income or gains of less than £2,000, the denial of personal allowances (and CGT annual exempt amount) and the payment of the £30,000 charge would not apply to them
 - the day counting rules would be modified so that a day would be counted only if a person was present in the UK at the end of the day, subject to an exemption for passengers in transit
 - there would be changes to the loophole closing measures, particularly for offshore trusts
 - there would be relaxations for foreign CGT losses, employee share schemes and offshore mortgages

⁴⁹ HMRC letter from Dave Hartnett, Acting Chairman, 12 February 2008

- the Chancellor gave a commitment that the rules in this area would not be substantially revised for the rest of this or the next Parliament.
164. The legislation for the amended proposals was published in the Finance Bill on 27 March. Clause 22 contains the changes to the residence rules, though the only changes that are made are to the limited statutory rules that presently exist. However the Explanatory Notes to clause 22, produced by HMRC, state⁵⁰ “The changes to the legislation introduced in the clause are in respect of the 183-day test only. However, where current HMRC practice requires the use of day-counting rules to determine residence for tax purposes, that practice will also be changed in line with the statutory amendment introduced in this clause”.
165. Clause 23 and Schedule 7 introduce the changes to the remittance basis of taxation along the lines of the Budget announcement. The Explanatory Notes make it clear that the legislation in the Bill is not complete⁵¹ “Some of the clauses in the published version of the Finance Bill 2008 are not wholly complete. The Government has said it wants to ensure these changes are comprehensive and workable. The areas where legislation is incomplete continue to be subject to ongoing discussions with interested parties to ensure the final legislation is comprehensive, workable and fair whilst delivering the overall policy. Further changes will be introduced by way of Government amendments during the course of the Bill”.

General Handling

166. We asked our witnesses about the general handling of this policy initiative. John Cullinane (CIOT) thought that “In terms of the underlying policy reasons—which is, essentially, that if you have been here longer and have an increasing association with the UK you ought to be able to shoulder more of the tax burden—as a broad principle, I do not think many people would quarrel with that” (Q 56). However, he continued “but one of the unfortunate things is the way in which these proposals came in unannounced, caused brouhaha, and then were subject to a lot of compromises and have generally gone off at half cock. The result of all that is that any kind of genuine, rational, consultative look at the whole thing, to see how we can best give effect to this principle, that the greater your connection with the UK the more of a burden you should bear, has just been ruled out and we have a very complicated regime with as many anomalies as before” (Q 56).
167. Malcolm Gammie (IFS) commented on the “draft legislation that apparently went very much further and had a very much greater impact than had generally been anticipated” (Q 16). He summarised the problems as “I think that really the general uncertainty it generated as to what precisely the rules were going to be, how wide-ranging they were going to be, really led to the degree of outcry that there was and the publicity it obtained” (Q 16).
168. Francesca Lagerberg (ICAEW) thought that “There was a huge amount of concern and a lot of that has been reined back and all credit to the people who have done something about it. I think that was why it blew up in the way that it did” (Q 117). Chas Roy-Chowdhury (ACCA) suggested “that

⁵⁰ Finance Bill 2008: Explanatory Notes: Volume I; Clause 22 paragraph 17

⁵¹ Finance Bill 2008: Explanatory Notes: Volume I: Clause 23&Schedule 7 paragraph 107

there should have been a more formed judgement made before the announcement happened which created the fuss, created the concerns, and then the original proposals tried to have the best of both worlds, the arising basis and the remittance basis at the same time, which is not the way to attract talent and keep talent in the UK” (Q 117).

169. Commenting for the City of London, Michael Snyder did “not really see the policy argument. I can see it in the sense that it is unfair if some people do not pay tax like others who live here but if the reality is that they will not then be here the Exchequer is no better off—indeed a lot worse off because of the indirect tax, the critical mass of businesses that we need to operate the international, financial markets here in London and indeed the foreign direct investment goes, so we are all worse off as a result” (Q 139). Ian Menzies-Conacher (BBA) considered that there was no “clearly thought out rationale” (Q 140). He thought that “on balance it would have been better to have deferred [the proposals] for a year to allow a lot of the detailed problems that they are now seeing emerge to be resolved properly” (Q 140). Though Michael Snyder, whilst accepting that he might be in a relatively small minority within the City, thought it important to have “certainty and closure now. It would be good if it could be closure with the right provisions in it as opposed to some of the wrong ones, in our opinion” (Q 138).
170. Ian Menzies-Conacher (BBA) was also concerned “that we are rapidly running out of time in the present Finance Bill. There are some very constructive discussions taking place with officials. Problems are being addressed but quite late on in the process. There is a great danger in practice, if you draft against rigid timetables, that we are almost as likely to put in new problems as solve old ones because that is the nature of drafting in a hurry” (Q 142). Ian Menzies-Conacher also thought that “We are tripping up against quite serious business consequences which did not have the time to be thought through properly” (Q 157).
171. John Cridland (CBI) saw “the furore over this issue was really in the New Year when draft clauses were available which made it clear that the application went well beyond what most stakeholders were expecting at the time of the Pre-Budget Report” (Q 181). Richard Stratton (LSEW) thought that these proposals had not been thought through sufficiently (Q 238). Simon Walker (BVCA) saw “the introduction of the changes to the non-domicile regime as having been a real shambles” (Q 298).
172. The above paragraphs record much harsh criticism of the way that this policy initiative was handled. Our private sector witnesses would not have used words like “a real shambles” if they did not feel strongly about this. Even though it was accepted that the proposals in the Finance Bill were much better than those published on 18 January, and presumably the amendments still to be made will make the legislation more palatable still, there is clearly much concern that the way in which this was handled will do lasting damage to the view that non-domiciles have of coming to the UK.
173. Officials resisted the idea that this had been badly handled, though they accepted that there had been much controversy surrounding the initiative and that, in some respects, the draft legislation had been out of line with the policy intention of Ministers. David Richardson (HMRC) said “... HMRC put out the draft clauses in January. What became very clear very quickly in January after these clauses went out were three things. The first is that there was clearly some misunderstanding of what the clauses did ... The second

thing ... was that there were some detailed circumstances which the clauses did not address ... The third category of issues ... was ... that the impact of some of the provisions was out of line with the policy, which was to have a regime which was fair and internationally competitive” (Q 345). In support of their acting very quickly as a result of these issues, David Richardson pointed to the letter of 12 February from Dave Hartnett which clarified the immediate issues and that the “Chancellor announced the final shape of the package which had some further changes in it, again in response to the consultation period which went beyond the clarification in February” (Q 345).

174. David Richardson (HMRC) stated that “the Finance Bill contains all of the fundamental provisions in relation to the residence and domicile changes. All of the key substance is there. There are some clauses around some of the detail which were not included in the Finance Bill in time because we had not been able to get those ready in sufficient detail to be confident of them” (Q 345).
175. **Whilst we hear what officials said to us, we cannot accept that there would be the strength of feeling on the handling of this initiative relating to residence and domicile if everything had proceeded as smoothly as they seek to suggest.**
176. **We recommend that, if they have not already done so, HMT and HMRC should carry out a full review of the reasons why there were so many difficulties in the development of this policy initiative. They should ensure that the lessons are learned so that these problems do not emerge in other initiatives.**
177. **We also recommend that if another policy initiative gets to the point where the legislation cannot be finalised for inclusion in the Finance Bill, that initiative should not be included in the Bill, or, if feasible, the part which is not finalised should not be included. We cannot support the approach of the Finance Bill’s still being subject to much amendment at the time it is published, particularly when the proposals come into effect from the beginning of the tax year, as in this case.**

Compliance Issues

178. Our private sector witnesses have brought home to us a large number of compliance issues which trouble us. Malcolm Gammie (IFS) was the first to alert us to these “Standing back and looking at all of those changes, inevitably if one is going to bring within the scope of United Kingdom tax a larger proportion of the income and gains enjoyed by individuals in this position the likelihood is that their tax affairs will become more complicated” (Q 1). He contrasted the implications for the wealthy with those of more modest means (Q 1). The ATT in their written evidence wrote⁵² “What all will find is an overall increase in their tax *compliance* burden”.
179. John Whiting (CIOT) refined the categories of non-domiciles affected by these proposals. He singled out a third category, those “higher up the income scale, perhaps employed by the archetypal city bank” (Q 67). So the compliance issues are likely to be different for the wealthy, the middle

⁵² Memorandum of Evidence by the ATT (Volume II p 16)

income executives and those of more modest means. This section looks at these three categories.

High Net Worth Individuals

180. For the very wealthy, Malcolm Gammie (IFS) concluded that “whilst it will complicate their tax affairs, I am not sure their tax affairs will become, in terms of administrative and simplistic considerations, significantly more complicated than they probably already were. This is a highly specialised area in which most of the wealthy individuals will have separate professional advice and they will have been taking a great deal of that advice in recent times” (Q 1). This view was generally held amongst our private sector witnesses. For example, the view of Michael Snyder (City of London) was that “the difference that it will make to the very wealthy is irrelevant” (Q 149). Whilst the ATT accepted that⁵³ “There are those (the multi-millionaires) for whom an increase of £33,902 to their UK tax bill is a minor inconvenience and who will absorb these new provisions in their stride”, they did point out because of the need to keep track of what is, and what is not, remitted to the UK their compliance burden will increase and “The new definitions (section 809K *et seq*) of situations which constitute a remittance will cause much confusion and not a few tribunal or Court cases”.
181. David Richardson (HMRC) pointed out that the effect of these proposals on the wealthy will depend on the circumstances of any individual. “For the wealthy, the £30,000 charge is probably the most significant issue. They will have the option to pay that £30,000 and stay on the remittance basis ... The wealthy staying on the remittance basis will have to apply the new, tighter remittance rules. That seems fair ... The wealthy tend by definition to be quite well advised. Whilst the rules are complex in some respects, I imagine their advisers are well up to dealing with them. The other area probably of most concern to the most wealthy is the issue about non-resident trusts, which is an issue that we have responded to quite significantly as a result of the consultation process. Those provisions are now much more in line with what they were looking for. The answer to your question is it depends but the rules are as simple as they can be to deal with the complex affairs that perhaps some wealthy people have” (Q 353).
182. **For high net worth individuals there are additional complexities in these provisions. This complexity is undesirable, even though these individuals will have access to the best professional advice.**

Middle Income Executives

183. We now turn to the middle income earners, for example the City executive on a tour of duty in the UK. Michael Snyder was concerned about these people “what we are really concerned about frankly, the middle earners that are over here on secondments, not normally for two or three years these days as you will know, but who could be here for ten years or longer. They may not call it their international headquarters but it is *de facto* their international headquarters in the City. This is really important, so I think we have to just try and resolve a few of the issues that will affect those middle income earners” (Q 149).

⁵³ Memorandum of Evidence by the ATT (Volume II p 16)

184. John Whiting (CIOT) suggested that “it is the bank/the employer who is going to pick up the cost” (Q 67). Mervyn Woods (CBI) agreed with this confirming that he saw increasing employment costs as a consequence of denying personal allowances from day one on an employee’s tour of duty in the UK (Q 194).
185. Ian Menzies-Conacher (BBA) was also concerned “The middle is the problem for employers because either they are an assignee from overseas in which case you will have to do a lot more paperwork for them ... We do not know how the circle is going to be squared between the fact that you have PAYE ongoing obligations in relation to the current year which is impacted by an election that you are going to make after the year” (Q 153). The LSS wrote⁵⁴ “The potential loss of personal allowances will also result in increased compliance burdens for employers”.
186. David Richardson (HMRC) pointed out that “The legislation in general does not impose any additional burden on employers. The legislation is essentially about an individual’s liability to tax and the self-assessment system is the key vehicle for ensuring that” (Q 361). Though he went on to accept that some employers with foreign executives here choose to provide assistance to them through, for example, tax equalisation packages. “That is a matter for them. That is not something that the tax system imposes on them” (Q 361).
187. David Richardson (HMRC) pointed out that “If you take the example of a foreign executive over here who has a significant amount of foreign income, if they do not remit that over here, the only burden on them is that they will lose the personal allowance” (Q 361).
188. **We remain concerned that there might be significant compliance burdens on those employers who have a large number of overseas executives working for them. If there are, they will be in sharp contrast to HMRC’s programme to cut compliance costs which we commended in last year’s report.**
189. **We therefore recommend that HMRC should monitor closely the effect of these proposals on UK employers over the next couple of years and take all possible steps, with the operation of PAYE for example, to ensure that their compliance burdens are minimised.**

Those of Modest Means

190. It is the impact on those of more modest means—the migrant worker from Eastern Europe, for example—that was of most concern to our private sector witnesses. If that person has unremitted foreign income of less than £2,000 he will be entitled to the remittance basis automatically and personal allowances will not be denied. However, a person who has unremitted foreign income of £2,000 or more will need to make a decision as to whether to:
- claim the remittance basis—in which case he will be denied personal allowances from the day that he arrives in the UK, or
 - be taxed on the arising basis—in which case he will be taxed on his worldwide income, including any foreign income and will have to cope

⁵⁴ Memorandum of Evidence by the LSS (volume II p 114)

with offsetting foreign tax against UK tax to prevent double taxation on income or gains.

191. Malcolm Gammie (IFS) put it this way “For those individuals with much smaller income and gains there is, of course, a considerable question which surrounds the £2000 *de minimis* exemption ... Precisely how it will be possible actually to administer that exemption and how Her Majesty’s Revenue and Customs will actually be able to check whether people are doing this correctly is, I think, one of the more significant questions which arises from an administrative perspective in relation to these arrangements” (Q 1).

192. John Whiting (CIOT), who has a particular interest in these matters as a member of the Low Incomes Tax Reform Group, expressed his concerns this way:

“It is of great concern that we have here a provision that will affect a considerable number of the vast majority of non-domiciles who are not only unaware of the term “non-domicile” in many cases ... but because of the situation back home ... because of the work they do back home, or their summer job back home, or the rent on their flat, are suddenly losing their personal allowances ... It seems unfair, at best, and, actually, totally impractical, because all the evidence we have gathered from talking to HM Revenue & Customs is that they are simply not geared up to cope with this” (Q 60).

The CIOT’s written evidence underlined this⁵⁵ “The low paid, who will, in great numbers, unwittingly breach the new rules and so risk a future penalty”.

193. In her response Francesca Lagerberg (ICAEW) agreed that there were problems for both taxpayers and HMRC in administering these provisions. “I think with *de minimis* it is very hard to see how that message is going to get across. English might not be the first language ... and, yes, from a resource perspective, HMRC are going to police whether that £2,000 *de minimis* is being properly operated and that is a big ask ... do they have the resources to do that, the training to do it and the understanding of the issues around it? It is a massive undertaking. We were very concerned about the compliance, the admin work placed upon HMRC and upon the taxpayer that that particular *de minimis* will bring” (Q 128).

194. All our private sector witnesses concurred. And they were also agreed that, in fact HMRC would not be able to cope. Isabel d’Inverno (LSS) said “I am sure that the Revenue, in relation to the lower paid, will have to simply ignore the issue because I do not see how they will have the resources to police it. That means that many taxpayers yet again will be in a non-compliant state through no fault of their own” (Q 224). Ian Menzies-Conacher agreed that “There will be substantial non-compliance with this” (Q 153). Richard Baron (IoD) addressed the point in a slightly different way “it is pretty unlikely that the Revenue are actually going to collect the money which might be due from people who have a foreign income of marginally over £2,000” (Q 187).

195. Malcolm Gammie (IFS) commented on another aspect of these proposals “The removal of the personal allowances and the Capital Gains Tax

⁵⁵ Memorandum of Evidence by the CIOT (Volume II p 17)

exemption effectively across the board I think was something which had not necessarily been anticipated, and because that affected a much broader population of individuals again it was going to raise questions both as to fairness and as to the practical way in which it could be administered” (Q 16). The removal of personal allowances is something that applies to everyone claiming the remittance basis whatever their level of wealth. Malcolm Gammie put it in this context because the number of non-domiciles falling into the lower income ranges is likely to be substantially greater than the middle income or the wealthy.

196. In commenting on this John Whiting (CIOT) expanded it into a related point “Indeed, we are still, even today, finding that they [HMRC] have not realised that there are issues when, for example, here in the UK we may try to deny a low-income person a personal allowance but under the double tax treaty they are still entitled to it, so they, therefore have to deny it on the one hand and then give it back again—all of which sounds hopelessly impractical even if it is fair, which we would argue it is not” (Q 60). Andrew Meeson (ATT) thought that to levy the £30,000 was sufficient to address the “purported abuse, as it were, ... that the non-domiciliaries are in some way unfairly benefiting from sheltering their offshore income and gains from UK taxation” (Q 60) Then to go further and remove personal allowances “seems to be almost, to put it callously, putting the boot in when someone is down” (Q 60).
197. HMRC did not seem overly worried by the compliance issues. David Richardson (HMRC) thought that “In reality it is quite simple for most people ... Although some choose to present it as complicated, I think it is nowhere near as complicated as some people might suggest” (Q 357). “There is the £2,000 *de minimis* which is equivalent to, if somebody has a foreign bank account with a five per cent return, something like £40,000 held offshore which is not an insignificant amount. If foreign income is below £2,000 they will be able to keep the personal allowance and stay on a remittance basis without further action. There will be no need for them to contact HMRC at all. It will simply follow naturally that their overseas income will not be taxable. In theory, that is simpler than the current provisions” (Q 355).
198. When asked how he expected people to decide whether or not to claim the remittance basis or to keep their personal allowance, David Richardson (HMRC) said that he “would expect them to go through a calculation of working out how much additional tax would they pay by losing their personal allowance and how much additional tax would they pay if they were on the arising basis and taxed on all their foreign income taking into account double taxation relief?” (Q 355)
199. Commenting on the HMRC resources that would be needed, David Richardson (HMRC) saw the “issue [as] about providing adequate guidance to people rather than about an issue of any significant increase in resource for HMRC. We are working on that guidance at the moment and we are looking at making sure that our contact centres fully understand the rules and advise people on what they should do. We are looking at a leaflet for migrant workers when they come into the UK to explain the provisions ... We have started talking to the Low Incomes Tax Reform Group around making sure that we get publicity material that works for some of those lower income groups” (Q 355).

200. **In our view HMRC are greatly underestimating the compliance difficulties for people of more modest means. We are firmly of the view that something further has to be done to make these provisions workable.**
201. Two possible approaches were put to us by our private sector witnesses. The first was to raise the *de minimis* limit to a level where the vast majority of these lower income people are not troubled by these provisions i.e. the remittance basis would apply to them automatically so they would not be taxed on their foreign income if they did not remit it, and they would not lose their personal allowances.
202. Most of our private sector witnesses preferred this approach though there was quite a variation in the level to which they would raise the *de minimis* limit. For the ICAEW, Francesca Lagerberg said that they would raise the *de minimis* limit to a level round about the personal allowance (Q 129). Alex McDougall (ICAS) said that “the reason we suggested £5,000 instead of the original £1,000 was really ... to try and equate it broadly to the level of the Personal Allowance” (Q 129). Richard Baron (IoD) said that he was “not sure what data the Revenue have on how many people would drop out of their tax net if they put it up to £3,000 or £4,000, the idea is to get it to a point where most people can say, ‘I know my income from letting out my flat in Warsaw, or whatever it is, is definitely below that, so I am in the clear’” (Q 187).
203. Penelope Williams (LSEW) said that they “would say that *de minimis* levels of, say, £10,000 of income and perhaps a disposal consideration of four times the annual allowance for capital gains tax might be appropriate” (Q 224). Michael Snyder (City of London) thought the £2,000 limit ridiculous (Q 151) and that it should be raised to about £30,000 (Q 152).
204. John Whiting (CIOT) saw an alternative approach as preferable. “Undoubtedly the best answer is that this loss of personal allowance only trips in, along with the £30,000, after seven years” (Q 67). On this approach, the only people who would be denied personal allowances would be those who had been resident in the UK for longer than 7 of the last 10 years and for whom it was beneficial to claim the remittance basis i.e. their foreign income would be in excess of around £80,000 per annum and it would be beneficial for them to keep that income out of the scope of UK tax, pay the £30,000 charge and suffer the denial of personal allowances and CGT annual exempt amount.
205. The second approach, suggested by the CIOT, would allow personal allowances to everyone during their early years in the UK, independently of their level of income or gains. It would therefore apply to the wealthy and all the middle income executives. We can see the administrative attractions of this but it is likely to be more expensive than the option of simply increasing the *de minimis* limit. It would affect the Budget arithmetic to a greater extent and is therefore likely to be less acceptable to Government. In any case, our primary concern is with the lower paid.
206. **In our view the provisions as drafted with a *de minimis* level of £2,000 are essentially unworkable in practice. To address this, we prefer the approach of increasing the *de minimis* limit. However, so far as we are aware, there is no detailed work on what the *de minimis* level should be to ensure that the great majority of these people are not**

troubled by these provisions and that HMRC is not burdened by compliance problems. Unless HMT/HMRC has some work of which we are unaware, or can produce some on a very short timescale, any increase will be a stab in the dark.

207. **We recommend that the *de minimis* limit should be increased to a level to take a big majority of the lower paid non-domiciles out of the scope of these provisions. The Government should introduce an amendment to achieve this. If there is no better basis for estimating what that level should be, we recommend that in this year's Bill the *de minimis* level should be increased to the amount of the individual's personal allowance (which this year is to be £6,035).**
208. **We further recommend that HMRC should monitor over the coming year the effect of the increased *de minimis* level and, if it transpires that there is a large number of lower income workers still with compliance problems, the Government should provide a further increase in next year's Finance Bill, having established to what level the *de minimis* limit needs to be raised.**

Detailed Issues

209. Particularly in the written evidence we have received, a large number of more detailed issues have been put to us as in need of change. This is against the background of some strident criticisms which have been made about the complexity of the legislation. As the LSS said in its written evidence⁵⁶ "The legislation is so complex that it will be impossible for most taxpayers to understand what the provisions mean. Although this may not be a problem for the well advised, those of lesser means will not be in a position to complete self assessment tax returns because of the complexities of the legislation ... The complexity of the legislation seems to be out of all proportion to the tax it is intended to raise, and given the detailed record keeping requirements there will be a disproportionate compliance burden for taxpayers affected by the new regime".
210. This section of our report looks at what were put to us as the more important of these issues. But that is not to devalue the other issues and we hope that HMT/HMRC is carefully reading the evidence that we have received with a view to suggesting to Ministers changes that could be made to make the provisions work more satisfactorily. As Malcolm Gammie (IFS) commented in his evidence "on the highly technical aspects of these particular rules I think the Revenue probably had some difficulty in formulating exactly what changes they wanted to make" (Q 16).
211. One aspect which concerns us is not particularly technical. It involves the treatment under these rules of those who are in full-time education in the UK and the fact that when their education comes to an end they may already be approaching falling foul of the 7 years out of 10 rule and so be dissuaded from taking up employment in the UK. Many of our private sector witnesses were concerned about this.
212. John Whiting (CIOT) put it this way "We here in the UK try to attract overseas students to take A-levels, degrees, *et cetera*, probably in the hope that they will continue to work here, but you might just note that by the time they

⁵⁶ Memorandum of Evidence by the LSS (Volume II p 114)

have done A-levels, degrees and had a gap year or whatever, they are virtually into seven years' residence, so that this new system is probably an incentive to go home at the end of it" (Q 67). Others made the same point. When asked what changes he would want to see, Ian Menzies-Conacher (BBA) said "The simple thing is we would like to see time spent in full time education simply disregarded in terms of calculating the seven years. Our problem is that we would like to recruit non-residents—Chinese, Indians—for obvious reasons. If they have been educated in the UK, that is absolutely ideal but by the time they have been educated in a UK university with an MBA they are starting to approach the end of the seven years before we have even got them on board" (Q 154).

213. For HMRC, David Richardson said that they "have noted all the points that have been coming up in your evidence and that people have given us ... Obviously decisions on those matters are for ministers. They have all been brought to the attention of ministers" (Q 362).
214. **We are persuaded that it is in the interests of the UK economy that something should be done for those in full-time education in the UK. We therefore recommend that the years spent by overseas students in the UK for full-time education should not count towards the test of whether they have been here for longer than seven years out of the last 10.**
215. There is a clutch of other issues that have been raised by our private sector witnesses. We did not explore these in great detail with those witnesses, but they did identify for us which they saw as the more important:
- the implications—suggested as unintentional—for all-employee share schemes and the need to include those subject to the remittance basis⁵⁷ (BBA⁵⁸, LSEW⁵⁹)
 - concerns with the detail of the remittance rules: their complexity (ATT⁶⁰ and more generally); property being brought into the UK (ICAS⁶¹); remittances by offshore trustees/companies being treated as remittances of the settlor/shareholder (City of London⁶²)
 - a bias in the legislation in favour of offshore trusts to the disadvantage of holding through offshore companies, or directly; a bias where gains are realised as against offshore income gains (City of London⁶³, LSEW⁶⁴)
 - the changes to the source ceasing rules are retroactive and could give rise to compliance problems in terms of producing evidence for a long-ceased source (CIOT⁶⁵, City of London⁶⁶)

⁵⁷ Just before this report went to press, HMRC published draft amendments to cover these points

⁵⁸ Memorandum of Evidence by the BBA (Volume II p 72)

⁵⁹ Memorandum of Evidence by the LSEW (Volume II p 109)

⁶⁰ Memorandum of Evidence by the ATT (Volume II p 15)

⁶¹ Memorandum of Evidence by the ICAS (Volume II p 45)

⁶² Memorandum of Evidence by the City of London (Volume II p 79)

⁶³ Memorandum of Evidence by the City of London (Volume II p 78)

⁶⁴ Memorandum of Evidence by the LSEW (Volume II p 108)

⁶⁵ Memorandum of Evidence by the CIOT (Volume II p 18)

⁶⁶ Memorandum of Evidence by the City of London (Volume II p 79)

- concerns about the rules for mixed funds (City of London⁶⁷)
 - how PAYE will operate for subsequent years and on the transfer of securities to an employee (BBA⁶⁸, LSEW⁶⁹)
 - the implications for professional service providers—even if the concerns raised by the BBA are addressed, the problem might go wider (CIOT⁷⁰, LSEW⁷¹)
 - the grandfathering of offshore mortgages (BBA⁷², CIOT⁷³)
 - some concerns around the definition of ‘relevant person’ being too widely drawn (LSEW⁷⁴, ICAS⁷⁵)
 - some detailed drafting issues on ITEPA (LSEW⁷⁶)
 - aspects around the creditability of the £30,000 charge against foreign taxes (CIOT⁷⁷).
216. **We are pleased to hear that HMT/HMRC are discussing with Ministers the detailed issues which were raised with us. We recommend that, where necessary, HMRC should do all it can to discuss these issues with the professional bodies with a view to resolving them as rapidly as possible and that the Government should bring forward amendments as necessary, certainly not later than the Report Stage of the Bill.**

A Statutory Definition of UK Residence

217. There was a universal view amongst our private sector witnesses that it would be better to have a comprehensive legislative definition of UK residence rather than continue to have to rely on case law precedent and HMRC practice as set out in the Revenue booklet IR20. Much of the written evidence set out the case for this as did many of our witnesses when they appeared before us. The written evidence by the City of London stated that⁷⁸ “The UK remains one of the few OECD countries without a comprehensive statutory code of residence for modern living and working practices”.
218. John Whiting (CIOT) said “Certainly the CIOT is strongly in favour of a statutory residence test that can be applied mechanistically rather than by HMRC judgement” (Q 62). Francesca Lagerberg (ICAEW) agreed (Q 121) and Chas Roy-Chowdhury (ACCA) pointed to much material having been worked up in 2003 (Q 123).

⁶⁷ Memorandum of Supplementary Evidence by the City of London (volume II p 102)

⁶⁸ Memorandum of Evidence by the BBA (Volume II p 72)

⁶⁹ Memorandum of Evidence by the LSEW (Volume II p 109)

⁷⁰ Memorandum of Evidence by the CIOT (Volume II p 18)

⁷¹ Memorandum of Evidence by the LSEW (Volume II p 108)

⁷² Memorandum of Evidence by the BBA (Volume II p 73)

⁷³ Memorandum of Evidence by the CIOT (Volume II p 18)

⁷⁴ Memorandum of Evidence by the LSEW (Volume II p 108)

⁷⁵ Memorandum of Evidence by the ICAS (Volume II p 45)

⁷⁶ Memorandum of Evidence by the LSEW (Volume II p 109)

⁷⁷ Memorandum of Evidence by the CIOT (Volume II p 18)

⁷⁸ Memorandum of Evidence by the City of London (Volume II p 78)

219. Alex McDougall (ICAS) thought there would be uncertainty as to whether the new day counting rules applied to the extra-statutory guidelines (Q 124) and made the point that the guidelines rely on case law from a different era (Q 125). Alex Henderson (City of London) echoed this “There are two problems with relying on Revenue practice. One is that it is Revenue practice. It does not give certainty for the taxpayer that legislation gives. The other is that the Revenue practice draws heavily on the case law but the case law is now something like 100 years old and clearly has not adapted to modern living and working conditions with regard to residence” (Q 143).
220. Alex Henderson (City of London) went on to say that the issue “was raised as recently as last Friday [2 May] at the Finance Bill open day with HMRC who referred it back to the Treasury as a policy matter” (Q 144).
221. In their written evidence the ICAEW expressed the point this way:⁷⁹

“The explanatory notes state that the Finance Bill change was introduced because ‘the UK was out of step with ... its international partners.’ However, the more important reason the UK is out of step is because it is one of very few developed countries that does not have a statutory test. We believe that there are suitable models of statutory residence tests that the UK could use to develop its own rule. A suitable example is the Irish statutory residence rule, which was first introduced in 1994 ... and which we understand works well although we recognise that it is (by UK standards) quite generous. An alternative less generous model is the US residence test”.

At our request, the ICAEW provided for us summaries of the Irish and US residence tests⁸⁰.

222. When the point was raised with officials, David Richardson (HMRC) said that “the existing rules have stood the test of time. They have been with us for an awfully long time and have worked reasonably well ... Obviously this is a policy matter and it is something that normally I would expect the Treasury and HMRC to keep an eye on and listen to representations on” (Q 369). When pressed on whether legislation might be a possibility for next year, he responded that “It is an issue, like all parts of the tax system, that ministers and officials would want to watch. I would not give any commitment either way” (Q 370).
223. We were unable to glean from officials why legislation was not included in this year’s package. They did not present the case for inclusion or against. It is disappointing that officials were less than forthcoming on this important issue.
224. **We recognise that it will not be possible to include a comprehensive statutory definition of UK residence in this year’s Bill.**
225. **However, we think this is something which should be taken forward as rapidly as possible so that Ministers are able to come to a view in good time before next year’s Bill. We therefore recommend that HMT and HMRC should consult with the professional bodies over the coming months, building on the work which was done in 2003.**

⁷⁹ Memorandum of Evidence by the ICAEW (Volume II p 39)

⁸⁰ Memorandum of Supplementary Evidence by the ICAEW (Volume II p 65)

226. **We further recommend that the Government should carefully consider the case for legislation in next year's Finance Bill to eliminate any uncertainties which are seen to be present in the current regime.**

Addressing Defects and Anomalies

227. In his Budget Statement, the Chancellor promised that the rules in this area would not be substantially revised for the rest of this or the next Parliament. We do not take this to mean that there will not be legislation in coming Finance Bills to address defects in the current legislation. We think it inevitable that, given the evident pressure under which this legislation was produced, there will be such defects.
228. Our private sector witnesses pressed on us the case for addressing these defects. John Whiting (CIOT) said "HMRC and the Treasury, needs to commit to keeping this under review and making further changes" (Q 70). Jacob Rigg (STEP) was keen to point out that "having changes every single year, where things are tightened up or loosened inadvertently or what-have-you in a sort of hotchpotch manner, would not be good for the UK competitiveness. It would be incredibly damaging for us all" (Q 71). In response John Whiting confirmed that all he would be looking for was sorting out the anomalies (Q 71).
229. David Richardson (HMRC) was careful not to undermine the Chancellor's commitment not to make substantive changes: this was a very real commitment. But he accepted that the wording was drafted in the way that it was to allow some flexibility to address minor technical anomalies (Q 368).
230. **We recommend that once the legislation has been enacted, a dialogue should be opened up between HMRC and the professional bodies and other interested parties to identify any anomalies or defects which prevent the legislation working as intended. An agreed way should be found of dealing with these. The Government should bring forward amending legislation as early as possible in succeeding Finance Bills.**

CHAPTER 5: ENCOURAGING ENTERPRISE

Background

231. There are three small clauses in the Finance Bill which make changes to the tax rules for encouraging enterprise. The one we are mainly concerned with in this inquiry is clause 28 which increases the maximum amount of investment in qualifying companies in respect of which an individual may obtain relief in any year under the Enterprise Investment Scheme (EIS). The increase will apply only when it has been brought into effect by Treasury Order. Clause 29 features to a much lesser extent. This clause and associated schedule add shipbuilding and coal and steel production to the activities excluded from the EIS, the Venture Capital Trusts scheme (VCTs) and the Corporate Venturing Scheme (CVS),
232. The EIS was introduced in 1994 and replaced the Business Expansion Scheme by being better focussed. Its purpose is to help small, higher risk, unquoted companies to raise external growth capital. An investor subscribing for new shares will get an income tax reduction of 20% of the cost of his investment for the year. The limit of the relief was raised from £200,000 to £400,000 in 2006; a further increase to £500,000 is now proposed. To retain that income tax relief the investor has to retain the shares for three years and if he does this, he will also obtain relief on any capital gain on the disposal of the shares. Any loss on disposal (restricted for income tax relief already given) can be set against income.
233. The payment of tax on any other capital gain can be deferred where the gain is reinvested in shares of an EIS qualifying company within certain time limits. Income tax relief is denied if the investor is connected with the investee company; a connection can be established either by a financial interest or by being a director or employee, though there is an exception for business angels who become directors on making an investment. Relief is also available for investment through an EIS fund which will invest in a number of EIS qualifying companies.
234. There is a large number of rules that the company must satisfy: be unquoted; not be controlled by another company; rules regarding its subsidiaries; its gross assets cannot exceed £7 million before the investment and £8 million after (reduced from £15/16 million in 2006); have fewer than 50 full-time employees; be carrying on a qualifying trade (most trades qualify except for those which are detailed in a list to which clause 29 adds). There are also rules around the amount of money that can be raised and how and when the money raised can be used. These rules are intended to target the type of company that can qualify, but they are detailed and complex and they led to much comment during the course of our inquiry.
235. Venture Capital Trusts (VCTs) were introduced in 1995 and are for investors who want to invest in the sort of companies which qualify for EIS but wish to invest through a managed fund. The fund has to be structured as a company listed on the London Stock Exchange. Investors can subscribe for, or buy existing shares in a VCT. The listed company must be approved and to achieve this there are detailed rules that it must satisfy including the requirement that 70% of its investments must be shares in companies which qualify under the scheme (essentially the same type of companies as qualify for EIS relief).

236. The investor originally received relief at 20% of the cost of his investment; this went temporarily up to 40% and is now 30%. The maximum investment which attracts relief is £200,000. Any dividends from shares in the VCT are exempt and CGT relief is available on disposing of the shares in the VCT provided they were within the permitted maximum for the year in which they were acquired. Dividend relief and CGT relief are available for new and second-hand shares, but the 30% income tax relief is available only for newly subscribed shares. The VCT itself is exempt from corporation tax on its chargeable gains.
237. The Corporate Venturing Scheme (CVS) provides tax relief for companies which invest directly in the same sort of companies as attract EIS relief. Relief is given at 20% of the amount invested, provided the shares are held throughout a qualification period. Capital gains on the disposal of shares carrying investment relief can be deferred if the gains are reinvested in new shares for which investment relief is obtained. Loss relief against income is available on the disposal of qualifying shares. CVS did not feature in the evidence we heard.
238. At the same time as the announcement of the increase in the limit for a qualifying investment under the EIS, there were a number of other documents published in Budget 2008:
- *Enterprise: unlocking the UK's talent*⁸¹: this is a very wide ranging document floating various ideas to unlock talent through five 'enablers': culture; knowledge and skills; access to finance; regulatory framework; business innovation. The discussion of the access to finance enabler contains only a brief reference⁸² to the EIS and VCTs, outlining the amounts which these schemes have raised.
 - *The Enterprise Investment Scheme: a consultative document*⁸³: this document is in general looking for ideas as to how the EIS might be simplified, administrative and regulatory burdens reduced and awareness among potential investors raised;
 - *A Study of the Impact of the EIS and VCTs on Company Performance*⁸⁴: this is an econometric study published by HMRC but carried out by researchers from the Institute of Employment Studies at the University of Sussex.

The Need for an Increase in the Limit for the Enterprise Investment Scheme

239. One of the causes of complexity in the tax system is the amount of change. Although an increase in the limit for EIS is not in itself a major complication against the background of a Finance Bill of over 400 pages, the recent doubling of the limit and the opening of a debate on support for enterprise generally with the publication of a number of documents on Budget Day, there needs to be a good case for making a further small change this year.

⁸¹ Enterprise: unlocking the UK's talent published by HM Treasury and the Department for Business, Enterprise and Regulatory Reform March 2008

⁸² Enterprise: unlocking the UK's talent published by HMT & BERR March 2008 paragraph 4.10

⁸³ The Enterprise Investment Scheme: a consultation document published by HMT and HMRC March 2008

⁸⁴ Study of the Impact of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) on company performance published by HMRC as Research Report 44, March 2008

240. We asked our private sector witnesses how they saw the case for this change in the EIS investment limit. None of our witnesses was aware of any direct evidence suggesting that the present limit of £400,000 was restrictive. John Whiting (CIOT) thought that “It seems a bit odd to start a general review of this and then say, ‘Here is part of the answer,’ just as you are starting a review” (Q 72). Richard Baron (IoD) did “not think that the increase to £500,000 was necessary” (Q 197), but he added that he saw the increase in the limit and the consultation document on the detail of the EIS as being pretty well independent of each other.
241. In their written evidence the ICAEW stated that⁸⁵ “the changes in this Finance Bill are unlikely to improve the attractiveness of the schemes”. The CBI wrote⁸⁶ “While the increase is welcome, it is likely to have little effect as very few investors have sufficient resources and income tax liability to invest such a sum in EIS investments and benefit fully from the tax relief”. Malcolm Gammie (IFS) thought that “the Government, I assume, reviews the limits which are put in place for these schemes and decides whether or not there will be some incremental value by increasing their limits” (Q 32). The view of Simon Walker (BVCA) was that “every little bit helps” (Q 273).
242. We asked officials about the case for change. Mark Neale (HMT) did not see the increase as “a self-standing measure. It was part of a package of measures in the Budget to ease access to finance for small entrepreneurial businesses. That was against a background when there were concerns that the disruption of financial markets might attenuate access to finance” (Q 372). In the Public Bill Committee⁸⁷ the Exchequer Secretary to the Treasury said that the increase was intended to stimulate further investment in small or high risk companies by offering greater incentives to business angels and others, particularly in the light of the current financial situation. She added that the increase had been well received by industry.
243. In their supplementary written evidence, HMT confirmed⁸⁸ that “no economic case was published” for “the increase in the enterprise investment scheme investment limit”. However, “the Treasury considered a variety of factors such as potential cost and impact, before making this policy change”.
244. **We are not persuaded that there is a strong case, economic or otherwise, for the increase in the EIS investment limit now. Whilst we accept that the cost of this increase is relatively small, we nevertheless think that the case for change needs to be made and that that case should be published before, or at the same time as, such a change is announced.**
245. **We recommend that before any further changes are made to the investment limits in any of the venture capital schemes, the economic case for change should be assessed and published, so that it is clear to everyone on what basis the change is being made.**

⁸⁵ Memorandum of Evidence by the ICAEW (Volume II p 40)

⁸⁶ Memorandum of Evidence by the CBI (Volume II p 88)

⁸⁷ Public Bill Committee Hansard 20 May 2008 col 280.

⁸⁸ Memorandum of Supplementary Evidence by HMT (Volume II p 161)

The Effectiveness of the Reliefs

246. There is a large number of different schemes, by no means all in the tax system, which are designed to help small and medium-sized businesses, each having their own rules and restrictions. There are also many regulations which they have to observe. How to strike a balance between all the different considerations goes beyond our remit, but looking at the EIS and the other tax reliefs for venture capital, a relevant question is whether it really is worth all the complexity for businesses, their advisers and HMRC if the rates of tax could be reduced in consequence of their abolition.
247. When asked about this, John Cullinane (CIOT) qualified his answer by stating that the CIOT's members were largely tax practitioners, not economists nor econometricians, and therefore the evidence he received was largely anecdotal. But "Generally we are rather sceptical of the value of these reliefs, while being open to the fact that we would not see all the evidence and we have not undertaken the scientific evidence, if I may put it that way" (Q 73). John Whiting (CIOT) referred to the survey that his firm, PricewaterhouseCoopers, had done and explained "Of potentially eligible companies, we found that two-thirds had heard of the relief, and of those which had used it, precisely half said it had influenced the decision. In other words, half 'would have done it anyway and thank you very much for the relief' and half, 'Yes, it had influenced it'" (Q 73). He concluded that the general message of the survey "was that the message coming back from business ... was that they would prefer a lower rate of tax, a simpler system, and less reliefs" (Q 74). In their written evidence the CIOT put it succinctly⁸⁹ "A key consideration is surely whether the reliefs change taxpayer behaviour at all".
248. In their written evidence⁹⁰ the IoD stated that "it is worth considering whether the extension of existing special reliefs is a sensible way to develop the tax system. There is a case for using any scope for tax reductions to reduce tax rates across the board, rather than to create or extend special reliefs". Frank Haskew (ICAEW) was equally unsure of the benefits of these reliefs "Our experience so far is that, following the changes two years ago to the gross assets test, where effectively the limits were halved, which we understand was the result of problems with state aid, there is very little interest now in EIS schemes, and that the actual volume of investment going into them is quite small" (Q 130). He went on to convey the ICAEW's view "Our suggestion was that there should be a wider-ranging review of the whole enterprise culture. We were not necessarily saying that the scheme should be abolished but we do have a concern that tax is just one part of the wider raft of issues that small businesses in particular need to consider, and that tax is probably potentially quite a small element of that" (Q 131).
249. John Cridland (CBI) echoed the thought of putting these tax schemes in a wider context "If I may comment on the enterprise strategy: there were many elements of the enterprise strategy which the business community will welcome ... So we do not have a problem with what is in the enterprise strategy, we have a problem with what was not in the enterprise strategy ... what was not in the enterprise strategy was an enterprise tax strategy and until and unless the Government is able to reassure small businesses it is with

⁸⁹ Memorandum of Evidence by the CIOT (Volume II p 18)

⁹⁰ Memorandum of Evidence by the IoD (Volume II p 92)

them on enterprise taxation ... I think the enterprise strategy is going to have to work very hard to convince the business community that it is valuable” (Q 199). Later he commented “Yes. The CBI Taskforce Report made very clear that there is more benefit for business in Government introducing lower rates of business taxation with fewer allowances delivering an overall simpler system” (Q 201).

250. In their written evidence Oxford University wrote⁹¹ that “the jury is still out on their effectiveness”. Chas Roy-Chowdhury said that the ACCA was in favour of the EIS scheme but agreed “that a closer look needs to be had at the tax breaks for this scheme” (Q 130). Richard Stratton (LSEW) still believed that the venture capital reliefs were a good thing (Q 239), but later in his evidence he accepted that “It may be best if the tax based schemes are looked at in the light of everything else” (Q 241).
251. It was to our minds surprising and interesting that the paper published on Budget Day “Enterprise: unlocking the UK’s talent” had very little to say about taxation. It was also of interest to us that there was quite a ground swell of opinion that it might be better to abandon these complex, targeted reliefs. Those who would prefer a lower rate of tax, a simpler system and fewer reliefs certainly made their case before us, while others thought that the reliefs did encourage some funds for investment into riskier projects which might not otherwise arise, and that the credit crunch would be a particularly inopportune time to withdraw them.
252. Against this background, we noted the views of officials. Mark Neale (HMT) saw it as “important to emphasise that the scheme is targeted on a specific market failure. It is aimed at easing access to finance for the small, entrepreneurial businesses that might not otherwise be able to obtain finance” (Q 376). He gave his view that “The Enterprise Investment Scheme is working well. It is targeted at a specific market failure. If we did away with it, that market failure would continue and small businesses would find it harder to get access to finance. Its total cost is not very great. It is about 160 million, whereas reducing the corporation tax rate by a penny would cost well over a billion” (Q 377).
253. **We find it interesting that there was by no means general acceptance that these reliefs should remain; indeed amongst our private sector witnesses a degree of scepticism existed. However, like those witnesses, we do not know whether the net benefit of these targeted reliefs outweighs the benefits which would flow from a lower rate of tax generally. Only a review which put these tax reliefs in a wider context and had as its central objective assessing their net benefit would be able to answer that. We are firmly of the view that such an exercise would be very worthwhile.**
254. **We therefore recommend that a review should be carried out, putting these targeted tax reliefs in the context of other schemes targeted at small business, weighing the economic benefits of retaining them against the economic benefit of their removal, so allowing a modest contribution to a reduction in tax rates across the board and getting rid of much complexity.**

⁹¹ Memorandum of Evidence by Oxford University (Volume II p 125)

