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Select Committee on Economic Affairs

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The Finance Bill 2008

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Written Evidence

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Minutes of Evidence

TAKEN BEFORE THE SELECT COMMITTEE ON ECONOMIC AFFAIRS (FINANCE BILL SUB-COMMITTEE)

WEDNESDAY 23 APRIL 2008

Present	Barnett, L	Sheppard of Didgemere, L
	MacGregor of Pulham Market, L	Vallance of Tummel, L (Chairman)
	Moonie, L	Wakeham, L
	Paul, L	

Examination of Witnesses

Witness: Mr Malcolm Gammie, QC, Research Director, Tax Law Review Committee, Institute for Fiscal Studies, examined.

Q1 *Chairman:* Good afternoon and welcome again, as an old hand, to the Committee. This is the first public session of the Sub-Committee on the Finance Bill for 2008 and, as you know, we will be focusing on three main aspects of the Bill, that is Capital Gains Tax for Residence and Domicile and Encouraging Enterprise. In previous years you have been very good to us and given us a good background to the topics we have been choosing to look at, and I hope very much that we will be able to do that again this afternoon. So after that brief introduction, let me hand over to you.

Mr Gammie: Thank you, my Lord Chairman, and I am very happy to be here again, although I feel this year I may have rather less to say than I have in previous years because although two at least of the topics which you have chosen to look at have attracted considerable publicity and attention, of course that has been on aspects of those proposals which are not principally your concern, but I will obviously aim to cover the administrative and simplicity aspects of those particular proposals. Of the three which you have chosen perhaps I can start with Capital Gains Tax. Clause 6, Schedule 2 of the Finance Bill introduced the very considerable changes which are being made to Capital Gains Tax which were announced in the Pre-Budget Report last year. The principal elements of those proposals include the introduction of a single rate of 18% for Capital Gains Tax, the abolition of taper relief for Capital Gains Tax, which was introduced by the current Government in 1998, and in 1998 when they introduced taper relief they froze the indexation allowance which had been accrued on assets held at that time and the frozen indexation relief is also being abolished. Under previous reforms which were made by the Conservative Government at the time most assets were re-based at 31 March 1982 (in other words in calculating the gain one took the market value of the asset at 1982) but there were still options to elect to take an earlier value in calculating the gain and those rules are also being abolished. With the clearing out of taper relief, the residual elements of indexation relief and the few assets which could take an earlier value than 31 March 1982, the rules for computation of Capital Gains Tax for individuals and trustees have, of course, been very considerably simplified and that also means that the special rules which apply to what are called fungible assets, principally shares and securities where it is not possible to identify a particular asset from the disposal of a pool of assets, those rules for dealing with fungible assets can also be very considerably simplified. In effect, the reforms which are in this year's Finance Bill return us to the situation of Capital Gains Tax which existed between its introduction in 1965 and 1982 when the first elements of indexation were introduced, although obviously the rate at 18% is considerably lower than the rate which applied between 1965 and 1982 of 30%. Of course, previously from 1989 the rate of Capital Gains Tax was theoretically the income tax rate, although both indexation and taper relief had the effect of reducing the rate of charge on capital gains, and the link between the income tax rate from the Capital Gains Tax rate is another element of the system which can be abolished. So whilst the schedule dealing with the changes is a very large schedule and the changes which are being made to the Capital Gains Tax Act are very considerable, they do in total, I think, add up to a very considerable simplification of Capital Gains Tax computations. The one complication (if one wants to put it that way) which has been introduced is, of course, the introduction of entrepreneurs' relief in clause 7 of schedule 3 of the Bill. This, of course, allows claims to be made on disposals of businesses, including shareholdings in trading companies and groups and certain other business assets, to reduce the rate of tax on gains on those assets from 18% to 10% subject to a cumulative lifetime limit of £1 million. The provisions which are introduced for entrepreneurs' relief look very similar to what was previously known as retirement relief and which goes back again to the beginnings of Capital Gains Tax but which was phased out by the current Government when it introduced taper relief. The relief for business assets taper relief and the entrepreneurs' relief do not entirely correspond, but the provisions which are in schedule 3 have many common and well-recognised features for these types of relief and while obviously being able to meet all the various conditions and comply with the requirements to get that particular relief involves some complication, I would have said it is no greater complication than has previously existed with retirement relief, or indeed with many of the reliefs which have been introduced over the years for entrepreneurs or to encourage entrepreneurial investment, some of which we will come to when I talk about the third item which you have chosen to look at. I think that is all I wish to say about the Capital Gains Tax changes. If I could now turn to the second topic, the changes to residence and the remittance basis. In relation to the changes on residence, of course whether or not an individual is resident in the United Kingdom is fundamental to their liability to both income tax and Capital Gains Tax and the rules which have been used over the years for determining whether or not an individual, in particular individuals who move between this country and other countries, are resident in the United Kingdom is based very largely on case law with a minimal amount of statutory provision. In practice, the Inland Revenue has developed over many years guidelines which it published in a booklet known as IR20, which for practical purposes has served for most people in this position in determining whether they are or have become either resident in the United Kingdom or non-resident. Those rules of determining residence are principally, of course, determined by counting the number of days which an individual is present in the United Kingdom during the tax year and the change which is being made this year is principally as to how you count those days. Up until now days of arrival and departure have not been included in the count of days present in the United Kingdom. Now under the new statutory rule being introduced a day will count if the individual is present in the United Kingdom at the end of the day, in other words midnight, counting midnight as the end of the day rather than the start of the new day, subject to some relief for individuals who are transiting through the UK and who are not performing any other function in the UK beyond that involved in their travel arrangements. I do not think this will make any significant difference in terms of the obligations it imposes upon individuals in this position to count the days. It will obviously make a difference in the number of days they may be present or counted as present in the United Kingdom and they will have to change, perhaps, the basis of their record keeping. To disregard days of arrival and departure is relatively easy. There will be some slight change in perhaps counting whether you are here at the end of a day. It may make some difference as to whether you choose a flight arriving in the United Kingdom early in the morning or leaving the United Kingdom late at night, but I am sure that will not affect the airlines significantly. The changes in the remittance basis are obviously very much more fundamental. Of course, historically foreign income for all persons, whether resident, domicile or whatever in the United Kingdom, was on a remittance basis, if we think back to the nineteenth century, and over the years the remittance basis has by governments of all complexions been restricted in one way or another until we reached the situation where it is limited to individuals who are not domiciled in the United Kingdom or not ordinarily resident in the United Kingdom. The changes which are being made this year are perhaps the most fundamental changes which have been made for some while to the remittance basis and they restrict the ability to claim the remittance basis, in particular for long-term residents who are resident in the United Kingdom for seven out of ten years who to claim the remittance basis will have to pay effectively a £30,000 toll charge for the ability to keep their foreign income and gains outside the scope of the United Kingdom tax. Of course, that is a toll charge which will only apply to those extremely wealthy individuals who have significant foreign income and gains which they wish to shelter from the United Kingdom tax even though they are resident in the United Kingdom. More significantly, individuals who want to claim the benefit of the remittance basis will no longer be able to claim their personal allowances or their annual Capital Gains Tax exemption in a year in which they claim the remittance basis. This may obviously affect a much wider group of individuals who are resident in the United Kingdom but not domiciled here and who have much smaller income and gains outside the United Kingdom which otherwise they would shelter on a remittance basis. A de minimis exemption is introduced of £2,000 so that individuals who have foreign income and gains unremitted to the United Kingdom of less than that amount will be entitled to the remittance basis without the necessity to claim it. The other main changes which are being made are of a far more technical nature and really account for the significant amount of legislation which can be found in the Finance Bill. There has been a variety of ways in which individuals have been able to effectively enjoy the benefit of foreign income and gains in the United Kingdom without technically remitting them to the United Kingdom and therefore having to pay tax on in. There are various changes to the rules to ensure that if somebody does enjoy income and gains in the United Kingdom they will pay tax on the basis that they have been remitted. There are many other far more technical modifications being made to the taxation of foreign income which are consequent upon these changes in the remittance basis. Broadly speaking there is, of course, a large number of rules which tax the foreign income of UK residents whether they enjoy it directly or whether they enjoy it through offshore companies or trusts and these are extremely technical rules. Most of those provisions dealing with the taxation of foreign income have embedded within them special rules for individuals who are resident but not domiciled in the United Kingdom to give effect to the benefit of the remittance basis within the context of those particular rules. Of course, all of those technical changes, in particular to trusts and to offshore companies, are having to be modified to fit within the policy of this year's legislation, and indeed the Finance Bill legislation is not entirely complete in this respect because Her Majesty's Revenue and Customs are still working on the details of some of those rules and amendments will be introduced as the Bill passes through the other House. 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. In particular, for those wealthy individuals who in particular may have trusts and offshore companies and a great deal of offshore income there will have to be considerable restructuring of their arrangements, and indeed much of that will probably have gone on before 6 April 2008 in anticipation of these changes. That is an inevitable consequence of the change in policy which this Government has introduced this year. 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. For those individuals with much smaller income and gains there is, of course, a considerable question which surrounds the 2000 de minimis exemption. Essentially, as I have said, the position will be that you will have to claim the benefit of the remittance basis and if you do you will lose the benefit of your personal allowances and the annual Capital Gains Tax exemption, but if you can say that you have less than £2,000 foreign income and gains which you have not remitted, then of course you do not have to claim the benefit of the remittance basis, you just file your tax return on the basis that you have not remitted that foreign income and gains and you are not liable to pay tax on it. 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. If I could then just pass on to the question of the venture capital reliefs. The changes which are made in the Finance Bill this year are in fact extremely minor. It is an increase in the permitted amount of investment in the enterprise investment scheme and one minor change to the definition of "prohibited" or impermissible activities, if you like, under the enterprise investment scheme and venture capital trusts to exclude shipbuilding, coal and steel activities, to comply with European law. The implementation of the increase in the EIS limit is, of course, subject to European approval under the state aids provisions, but in expectation that that will be achieved the Bill gives the Treasury power to introduce the increase in the limit from £400,000 to £500,000 per annum by statutory instrument but with effect from 6 April 2008. The change which has been made in the Finance Bill, though, has come with the publication of three documents. The most relevant from my own perspective and from the perspective of the tax legislation is a consultation document published by the Treasury and Her Majesty's Revenue and Customs with the Budget called the Enterprise Investment Scheme: A Consultation Document, the aim of which is to examine the requirements of that particular scheme to see in what way the scheme could be simplified, the administrative and regulatory burdens reduced and how awareness of the scheme could be raised amongst potential users. The Revenue's consultative document provides a very good outline of the scheme and raises a variety of questions for consultation from interested parties with an eye to achieving those three aims. Of course, the common feature of the Enterprise Investment Scheme, venture capital trusts and also the Corporate Venture Scheme, and also the entrepreneurs' relief introduced for Capital Gains Tax, is that they aim to incentivise or secure the raising of capital (in the case of the EIS, for example) for smaller, higher risk companies by lowering the tax burden on income and gains which are generated from investments in those companies. So the investment under the EIS scheme provides tax relief on the amount of investment, exemption for capital gains arising from that investment and enhanced relief for any losses incurred. A common feature of any of those schemes is that they have to cast around with conditions so that the policy aims of the scheme can hopefully be reflected in the detailed statutory conditions laid down. Inevitably those conditions bring complication and as the Revenue's consultative document highlights, one of the problems with the EIS scheme is the accidental breaches which occur in the conditions which then lead to the reliefs being withdrawn and the aims of the scheme being confounded. It is very difficult, I think, to suggest in what way these schemes can be simplified in terms of reducing the conditions because, as I say, they effectively reflect the policy aims which Government had in introducing these reliefs. One can obviously focus upon the guidance which the Revenue can provide and the clearances and other assistance which the Inland Revenue can provide to the taxpaying companies and the investors in seeking to obtain relief under these schemes and those are certainly aspects of the consultation which Revenue and Customs hope will produce improvements both in raising awareness and ensuring compliance. My Lords, I do not think I should say any more, but I would be happy to answer any questions which you have.

Q2 ***Chairman:*** Thank you very much indeed for a very comprehensive review of all three topics. What we will do is we will ask questions on each of the topics in order, starting off with Capital Gains Tax. I wonder if I can start off myself? With Capital Gains Tax at the rate of 18% for all gains, including short-term gains, there will be an incentive to turn income which is taxed at 40% into capital gains taxed at 18%. Do you think there is sufficient protection in the legislation to prevent this happening?
Mr Gammie: My Lord Chairman, that of course was a particular issue up until 1982, when although we had a 30% Capital Gains Tax of course personal tax rates were very much higher then and so there was a similar incentive. Since that time, of course, there has been a great deal of other change in the tax system which to an extent has reduced the opportunities which were perhaps available in the 1970s and 1980s when, of course, there were many artificial schemes implemented, particularly either to convert income into capital or to avoid tax on capital gains. I do not think these provisions in themselves contain a great deal of added weaponry for Revenue and Customs to deal with that sort of activity but there has been, as I say, change elsewhere within the tax system which will ensure they have greater scope to counter it than they did previously.
Chairman: Thank you.

Q3 ***Lord Barnett:*** Good afternoon, Mr Gammie. It is nice to see you again. The Capital Gains Tax changes, whilst controversial for the obvious reason of an increase from 10 to 18% for some people, overlooked the reduction from 40% to 18% for others, like any major changes, but do you see it as a simplification? Is it welcome in that sense?
Mr Gammie: There is no doubt that Capital Gains Tax computations will be significantly simpler under this system than they were before. As your remarks may have recognised, if you make a change which reduces the tax rate for some but increases it for others, the people you tend to hear from are those who suffer the increase in the tax rate and to an extent when you have a taper relief system, as we had, because that requires people to hold assets for certain periods it builds into itself an expectation that the rate is not going to change if people do actually hold the asset for that period, which may have accounted for some of the –
Chairman: This is what we all dread! I am afraid we are going to have to interrupt briefly to vote.

The Committee suspended from 4.34 pm to 4.44 pm for a division in the House

Q4 ***Chairman:*** You were in mid-answer to Lord Barnett, I think, so if we could ask you to resume?
Mr Gammie: My Lord Chairman, I think I had just about completed it because I was giving Lord Barnett the assurance that it does result in a simplification in the computations, even though, as he noted, fixing a rate of 18% benefits some and disadvantages others.

Q5 ***Lord Barnett:*** It is a simplification but too high?
Mr Gammie: Well, my Lord, I think the choice of rate is effectively a choice for the Government. I am not sure that in making the proposal it was necessarily intended to find some happy medium between the lower rate for non-business assets, which was 24%, and the lowest rate for business assets, which was 10%. If you aggregated them and divided by two it would not come to 18.

Q6 ***Lord Wakeham:*** The Government have made no attempt to conceal the fact that they want to raise more money from Capital Gains Tax than they have in the past under these changes?
Mr Gammie: Certainly they have indicated that they expect to raise more revenue under this change, yes.

Q7 ***Lord Barnett:*** But it is so complicated, an issue like Capital Gains Tax. Is it not rather difficult to judge just how much revenue you are going to get, because nowadays anything less than about £10 billion is petty cash? How can the Government be sure that they are going to collect up to £500 million in three years' time?
Mr Gammie: My Lord, I think you would probably have to ask Revenue and Customs or the Treasury as to precisely how they have arrived at that figure. 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. One can well imagine that those estimates which were made last year and again at the Budget in March may not have factored in significantly changes in the property market and the stock market since, but precisely how those figures were arrived at I cannot comment.
Lord Wakeham: I am very interested in this. As a matter of fact, I put a written question down for the Government when they brought in the concession for entrepreneurs and I asked how much this was going to cost them, and if I remember rightly they said £200 million. I said, "How do you estimate it?" and they were very confident in their basis of estimation. They were absolutely sure they knew how to do it.
Lord Barnett: They were getting their estimates from the Revenue, but the Revenue had not got a clue either. That makes it very difficult.
Lord Wakeham: The Government gave no indication that they thought their estimates were in any way other than pretty firm.
Chairman: Shall we pass on? Lord Paul, do you have anything you want to ask on this topic?

Q8 ***Lord Paul:*** Yes. The press carried a lot of reports about people selling assets before 6 April 2008 to obtain these benefits. Should this have been anticipated by the Revenue and perhaps we could have had some legislation to stop this happening?
Mr Gammie: It is always possible, of course, when you announce a change well in advance to anticipate that that will be the consequence and to introduce forestalling legislation to deal with that. I suspect that because of the nature of this change, in particular the increase in the tax rate for some from 10% to 18%, the view was taken that individuals should have the opportunity to reorganise their assets and affairs if they felt it was appropriate to do so, given the change, and of course although they will be paying tax at a lower rate, if they have realised, at 10% before 6 April 2008, they will have accelerated their liability because they will now have to pay tax much earlier than they would otherwise do.

Q9 ***Lord Paul:*** One of the main things they said when they started with the Budget was that life would be much less complicated after this Budget. How far do you think they have succeeded in that?
Mr Gammie: I think from my previous remarks, they have succeeded very well and I have no doubt that the aim to simplify the Capital Gains Tax computations was one of the principal factors underlying this reform and the complication for some of entrepreneurs' relief is offset by the fact that they get the benefit of a lower tax rate.
Chairman: Are there any other questions on Capital Gains Tax?

Q10 ***Lord Sheppard of Didgemere:*** Let me go back to the point you touched on earlier, the question of avoidance and going back to pre-1982, when a lot of accountants, and I suppose lawyers, made a lot of income by advising on switching between the two income sources. Surely that complexity is bound to come back again and all the avoidance legislation is going to be complicated, is it not, by these changes?
Mr Gammie: Obviously in every Finance Bill in recent years, over many years but in particular in recent years, we have seen a large amount of anti-avoidance legislation and this year's Finance Bill is no different in that respect. Her Majesty's Revenue and Customs now have disclosure rules, of course, which were introduced in 2004 and those disclosure rules at least allow the Revenue to react more quickly to avoidance arrangements, and that in part accounts for the increased flow of anti-avoidance legislation in Finance Bills. So whilst your point may be absolutely correct that the difference in rates will inevitably drive people to look for ways in which they can get the benefit of the lower rate and that may generate a certain amount of avoidance activity, which will generate anti-avoidance legislation, that is a process which is already going on within our tax system more generally and it is one to which the Revenue has directed its attention in particular areas to see if it can find a better way of dealing with avoidance than current ways of specific legislation and it may generate proposals from the Revenue next year, not specifically in relation to Capital Gains Tax but in other areas, which if successful may be adopted elsewhere. So I do not offer any sort of optimistic reply to your question in the sense that there will not be complication, but this has to be seen as a much broader issue about how we deal with avoidance within the tax system.

Q11 ***Lord MacGregor of Pulham Market:*** That is also the point which I think was causing us most interest following the Chairman's question because I too well remember the period when some of these schemes were coming forward and I think it was one reason why Capital Gains Tax was put at the same rate as the higher rate of income tax. When you talk about the anti-avoidance side, have you in mind in particular the provision now that accountancy firms and others have to submit schemes which look as though they are getting around certain rules, or any schemes of that sort which they are putting to their clients, or is there something more specific, because I find it quite difficult at the moment to see exactly how this will work out, whether there will be ways of

devising means of transferring income to capital gain without having to have a scheme itself? It is that you are really thinking of, is it, the fact that accountancy firms now have to submit any proposals they have of that nature?
Mr Gammie: That was certainly what I was referring to in terms of the disclosure rules, yes. That, as I say, has so far tended to generate increased anti-avoidance legislation in Finance Bills, as the Revenue have closed off schemes and arrangements which have been disclosed to them. That is a process which will continue and to the extent that there is increased avoidance activity in relation to Capital Gains Tax because of the change of the rate, one would expect the same process to go on there of disclosure and specific provision to deal with it. But as I say, the Revenue, certainly in the financial products area, have been looking at trying to adopt a different approach to avoidance legislation which they hope will provide a more satisfactory remedy. That is something they are continuing to consult on and if it is successful in one area, no doubt it is an approach they may try and adopt elsewhere to resolve the issue.

Q12 ***Lord MacGregor of Pulham Market:*** Exactly how does that latter point work?
Mr Gammie: The particular provisions they have been consulting on is what they have called principles-based avoidance legislation, so that instead of having highly detailed technical legislation they try and express the purpose or the principle which is embodied in the legislation in more general language, which will then hopefully be more effective at catching particular arrangements. That is in the financial products field they have been looking at it, but obviously if they could develop something successfully there they might well look elsewhere.

Q13 ***Lord MacGregor of Pulham Market:*** I see, it is the principles-based bit that you are referring to really?
Mr Gammie: Yes.
Lord MacGregor of Pulham Market: It will be interesting to see.

Q14 ***Lord Wakeham:*** Just really following on that, surely what will happen, to some degree in any case, is that it will not be avoidance as such, it will be activities which create a genuine capital gain which will be much more favourably attractive to people? For instance, you might be a dealer in land, buying and selling land. You will be an investor in land and you will turn it over much more slowly and you will be able to argue, with some reasonableness, that if you held it for a sufficient length of time you get the lower rate of tax. That is not a scheme, it is just a pattern of life based on the tax system, is it not?
Mr Gammie: Yes, you are absolutely right, my Lord. If you introduce differential rates for either activities or investments where you can substitute one for the other, then inevitably the tax system has a distortion in it which will tend to make people favour activities and investments which carry the lower rate. That is the inevitable consequence and, as you say, it is not all necessarily described as avoidance, and that will happen.
Chairman: Are there any other questions on Capital Gains Tax?

Q15 ***Lord Barnett:*** Yes. On the entrepreneurs' relief, is there any evidence as to how the number, if any, of companies or individuals starting up businesses has reduced or came in late because of the changes in Capital Gains Tax?
Mr Gammie: I do not think, in relation to the changes which have been introduced now, it would be possible to asses what the behavioural effect of those may or may not be. Inevitably in relation to all of the sorts of reliefs we have had over many years for favouring entrepreneurial investment or for raising equity, such as the venture capital relief, there is a certain amount of evidence now as to the impact they have had on either allowing capital to be raised or in terms of business formation or business growth, but inevitably all of these things are extremely difficult to assess with any degree of accuracy.

Q16 ***Chairman:*** Shall we move on to residence and domicile? May I just kick off again and ask a general question, and that is to ask you why you think the PBR announcement and the subsequent detailed proposals caused so much controversy, and should that have been anticipated and headed off in some way?
Mr Gammie: The idea of changing the rules for non-domiciled individuals has, of course, been one which has been around for a long time and this Government announced some years ago that it was reviewing the position, but because it had made no announcement I think it was getting to the point where people were anticipating there was not going to be any change. Inevitably, when you change rules such as these you are going to stir up a large response from those who are liable to pay more tax under it and I think in particular the concept of just having a sort of £30,000 toll charge is a new concept, something we have not previously seen in the tax system, and I think that of itself was going to raise questions as to whether that was a fair way of changing the rules and of dealing with a particular situation. The removal of the personal allowances and the Capital Gains Tax 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. I think one of the problems, of course, in this particular area is that particularly high net worth individuals who are in this position will put in place arrangements which are built around the existing rules and which are not necessarily easy to restructure in terms of trusts and offshore investments and the way in which they have structured their investment into the United Kingdom. Of course, the Revenue are not necessarily conversant with all the ways in which these things are structured because they are structured in a way which does not require any report necessarily to the Inland Revenue of what has been done. Therefore, 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, and of course when they published draft legislation that apparently went very much further and had a very much greater impact than had generally been anticipated, even from the announcement in the Pre-Budget Report, especially as to whether or not some of the changes are going to operate retrospectively in the sense that income and gains could be taxed in the current year which had effectively accrued before any of these changes had been made. 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.

Chairman: Thank you very much. I am going to have to leave you at this point, but I am handing over to the capable hands of Lord Wakeham. Thank you very much indeed.

In the absence of the Chairman, Lord Wakeham took the Chair

Q17 ***Lord Barnett:*** The £30,000 a year annual charge would not be made if the unremitted foreign income and gains are less than £2,000 a year. How on earth would the Revenue ever know the size, whether it is more or less than the £2,000?

Mr Gammie: Maybe I did not make it absolutely clear. I should explain that the £30,000 charge and the £2,000 de minimis are entirely separate aspects of these proposals. The £30,000 charge only comes in for long-term residents, individuals who have been resident in the United Kingdom for seven years out of ten. The £2,000 charge is related to whether individuals want to claim the benefit of the remittance basis, even when they are not long-term residents, so it has a much broader effect than the £30,000 charge. As to how easily the Revenue will be able to monitor whether individuals are filing their self-assessments correctly when they have got foreign income and gains of more or less than £2,000 I think is a major question and it is left entirely to the individual to file his self-assessment, as I say, as he thinks fit. He obviously has to file it according to the rules, but how you actually check what their foreign income and gains are I think is extremely difficult to fathom.

Q18 ***Lord Barnett:*** Yes. The long-term residence of course is a point you have made, seven out of ten years before the annual tax charge of £30,000 takes effect, but there are some rather complex rules about residence. They are going to charge a person who spends from midnight at the end of a day. Are they going to have something on a tax return saying, "Did you leave at midnight or 11.55?" How on earth are they going to be able to administer such a residence rule?

Mr Gammie: Of course, for the vast majority of individuals there is no doubt as to where they are resident. The change in the rules of residence and counting the days by reference to whether you are here at midnight will normally be for those people who want to claim they are not resident in the United Kingdom because they are not spending enough time in the United Kingdom to make them resident here and the complexity which surrounds that is not significantly different from the complexity which is already in the system because at the moment we still have to count days to work out whether somebody is resident or not, it is just that we ignore days of entry and days of leaving. So you just exclude them from the calculation. Now we will still have to count days but it is just that we will use a different basis for doing so. So it has changed, but it is not more complicated.

The Committee suspended from 5.05 pm to 5.12 pm for a division in the House

Q19 Lord Paul: Mr Gammie, as you said, this has been going on for almost 50 years, this discussion about being non-domiciled or domiciled. The press have raised a lot of questions for the last ten years almost and governments did not come to any decision, neither of the governments in the last few years. All of a sudden, once the Government announced it, the press went exactly opposite to what they were saying before this announcement. It started with a reaction from one party, whether it was a teaser or whether it was thought of or anything, I do not know, £25,000, and then the Chancellor jumped it to £30,000. Can you tell us what tempted him to amend it later?

Mr Gammie: I think in relation to the press comment, obviously the press tends to react to the sort of information it is fed, I think, and whilst the press prior to the announcement of any changes had obviously been very hostile to the idea that there should be individuals here who are paying far less tax because of their domicile status, then of course when the proposals come out I suppose the press starts picking up the reactions from individuals, from the City and from others and it reflects that. It may not say very much about the way in which the press analyses the information which comes through to it.

Q20 ***Lord Paul:*** But I am still not sure whether Britain has gained from it or lost. Have you any view on that?
Mr Gammie: One of the large problems in this particular area is that most of what is said and most information available is very anecdotal, so it is extremely difficult to know precisely what the impact of these sorts of measures are. Inevitably, any government making any change has to approach that change with that view, that it is quite difficult to predict.
Lord Paul: I do want to declare that I am non-domiciled and very proud of that status.

Q21 ***Lord Sheppard of Didgemere:*** All the press comments seem to have been about the resident test applied to non-Brits working in Britain, mainly in the City, but there was also an issue, for executives who had gone and run bits of companies all over the world and were not therefore paying UK tax, and suddenly—because they used to be very careful in counting their days—now they have to count them slightly differently. I do not know if it becomes more complex, but it becomes another calculation to do, does it not, both for the firm and for the individual?
Mr Gammie: It becomes a different calculation for the individual to do and it will be less favourable for the individual in the sense that more days will now be counted than was previously the case under the old rule. As I say, it is different but it is difficult to say that it is more onerous than was previously the case. It may mean that some individuals who were managing to maintain non-resident status will either have to alter their practices or –

Q22 ***Lord Sheppard of Didgemere:*** It gives them another reason for not coming to a UK board meeting of the parent company!
Mr Gammie: Certainly for counting their days or spending less days maybe doing that, yes.

Q23 ***Lord MacGregor of Pulham Market:*** Can I go back to the question of the £2,000 de minimis limit for personal allowances and Capital Gains Tax exemptions and just ask you not a political question but a really technical question? How is this actually going to be operated? If you take a high net worth individual, presumably the Revenue have some suspicions that his foreign income is not less than £2,000 and will wish to ask him questions about it. I do not know whether that is right or whether that is all they can do. If you take the question of the Polish plumber, for example, people of that sort who are doing a self-assessment and maybe have substantial property back in Poland, or wherever, is there any way that the Revenue can get at that? I understand perfectly well that in the UK under self-assessment they have lots of means of going to UK banks and other institutions and finding out what you are actually earning and interest, but there is no provision whereby you can do that with other countries, is there? Therefore, how are they actually going to make it work?
Mr Gammie: As a general matter, they are only going to make it work, I suspect, if they enquire into an individual's self-assessment return. So people will self-assess on a particular basis that they are entitled to this de minimis exemption and if nothing is done to enquire into their return then that will just be taken to be a truthful return. If the Revenue chooses to enquire into the self-assessment, they can obviously ask the individual questions. To the extent they need to obtain information from other countries, then generally speaking they would have to look either to the United Kingdom's double taxation agreements with other countries to see whether or not they had powers to get information under that, or within the European Union of course there is a Mutual Assistance Directive and they would have to look to those sorts of powers to be able to get information from the other country about what income or gains the individual was reporting there, or what information they could supply. But administratively it is a complicated, difficult and time-consuming exercise to do all that.

Q24 ***Lord MacGregor of Pulham Market:*** So presumably it is going to be directed more at high net worth individuals than the average plumber who is assumed not to have that income or capital gains, or it is just not worth following up?
Mr Gammie: I think that is a fair assumption to make, yes.

Q25 ***Lord MacGregor of Pulham Market:*** Could you just explain a bit more how the EU thing works? They may have the right under it to find out from the opposite number at HMRC in another EU country what the tax returns of that individual are, is that right, or can they even go further and see whether, in the same way as they can do here, those tax returns are accurate?
Mr Gammie: They would not have exactly the same powers under either the Treaty or the Directives to be able to get information as they have, for example, powers here to get information from third parties and from the taxpayer himself. As I say, to invoke those powers is time-consuming and difficult and one suspects that unless they believe there was a

significant amount of tax at stake I would not imagine they would go to the trouble to do that.

Q26 ***Lord Sheppard of Didgemere:*** The other problem with this is that one does not know the economic effect long-term until long-term? In other words, you cannot measure the psychological effect on whether people are willing to com to this country or not until after maybe some years' time?

Mr Gammie: I think there are two comments one could make on that, for example in relation to the remittance basis but also the residence rules. To the extent you are dealing with high net worth individuals, whether one likes the statement or not the reality is they are not in business to pay more tax to the United Kingdom than they absolutely have to, so one can assume that under the new rules, just as under the previous rules, they will take whatever measures are open to them to minimise their liabilities. That does not necessarily mean that they leave the United Kingdom or that they do not invest in the United Kingdom. They will just structure their arrangements in a way which minimises their tax, and that is an inevitable consequence. The question of whether or not it has a broader economic impact, for example on the City of London, because people are no longer prepared to come to the United Kingdom because of the greater tax or greater administrative burden, I think is extremely difficult and that is where I say information is largely anecdotal, but one would assume that at the margin at least there will be some impact on individuals staying for more than seven years, for example. Quite how large that effect is and whether it is significant I think is probably impossible to say, but you would expect it to have some small impact at the margins.

Chairman: I would like to move on. Lord Barnett has one short question.

Q27 ***Lord Barnett:*** The Revenue reckons that all the loopholes and anomalies of the remittance-based rules have been removed. Would you agree with that?

Mr Gammie: I would say a significant number of the more obvious loopholes have been removed. It would be optimistic to think that highly paid lawyers and accountants will not be scrutinising the new legislation extremely carefully to see what alternative loopholes may have been created.

Q28 ***Chairman:*** The last topic we have taken is encouraging enterprise and, as you rightly say, there is a very small change in the Finance Bill relating to it, but we were also quite interested in the University of Sussex's study. Most of us have been Treasury ministers and quite a few around here have all been busy promoting these schemes over the years and they are great things for politicians to make speeches about, and of course they have some effect on the individuals who use them because they get tax relief from doing it. The question I am interested in is whether they have any serious economic effect on the country and the prosperity of the country generally. Is there any evidence of that at all?

Mr Gammie: My Lord Chairman, I have obviously seen the report. I will not necessarily claim to be an expert in the sorts of things which that report is looking at, so I read it and I am sure your assessment of it is probably better than mine, but I did not take away from it the impression that these had been particularly significant. On the other hand, of course, they represent a series of measures which over many years, I think probably starting with Lord Howard about 1981with the business start-up scheme, governments have introduced to try and encourage equity investment in smaller businesses. If we had never had them, would we be in a significantly worse position or are we in a significantly better position because we have had them? I think that is very difficult to assess.

Q29 ***Lord Barnett:*** Do you know any small businesses which read econometric studies?

Mr Gammie: Not many, no, but I know some small economics businesses which probably do, but there are not many of them.

Q30 ***Lord MacGregor of Pulham Market:*** I do remember one scheme at that particular period because I was minister for small businesses at the time when the business start-up scheme was starting, and so on. We had one to encourage investment in small workshops, which were almost non-existent at that time, and it was so successful that we actually felt after a while that we had achieved our objective and stopped it. So it can happen and it can also, I think, change a culture and that cannot be demonstrated in an econometric study. So the question really is what things would have been like if you did not have them, and that is the one which, as you say, is difficult to assess?

Mr Gammie: Yes, indeed. Inevitably most of these schemes have targeted at what governments have tended to describe as sort of high risk businesses, and so on. Inevitably, as soon as you put a tax relief into the system people look to find the securest investment which will meet the conditions laid down for the relief. So the incentives can work both in a good way and in a perverse way, but as you say it is extremely difficult to say what the impact would be if you had never had them.

Q31 ***Lord MacGregor of Pulham Market:*** Were you aware of any demand for an increase in the EIS investment limit?

Mr Gammie: Not specifically, no.

Q32 ***Lord MacGregor of Pulham Market:*** So it is probably a lollipop rather than something which is responding to a real requirement?

Mr Gammie: Well, inevitably 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. In this case the EIS, I think, has gone up from £200,000 to £400,000 and now £500,000 and that is presumably based on some assessment that it is having some impact upon firms and the capital they can raise.

Q33 ***Lord Sheppard of Didgemere:*** Certainly in terms of impact they are quite useful, as a small company, for individuals (not so much institutions obviously) to be able to say to the potential investors other than, "We're marvellous!" Whether they believe you is another question.

Mr Gammie: It must be true to an extent. Again, I suspect this is anecdotal rather than anything else, but there is a number of reasonably wealthy individuals who would probably not know about specific small investments but who, through either the venture capital trusts or through EIS funds, are able to put some money in that direction which otherwise they would just invest or spend, or do something different with but would not put it into a small business.

Chairman: If I may say so, you have once again not disappointed us by coming and getting us going at the beginning of our inquiry into the Finance Bill and, as usual, we are extremely grateful to you for doing just that. Thank you very much for coming and thank you very much for your informative start to our proceedings.

MONDAY 28 APRIL 2008

Present	Barnett, L	Powell of Bayswater, L
	MacGregor of Pulham Market, L	Wakeham, L (Chairman)
	Paul, L	

Memorandum by the Association of Tax Technicians (ATT)

CAPITAL GAINS TAX—ENTREPRENEURS' RELIEF

The Association of Taxation Technicians (ATT) is delighted to have the opportunity to present its evidence on this topic to the Sub-Committee for their consideration.

General Observations

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.

The Chancellor's desire to simplify capital gains tax (CGT) amply illustrates this point. There is no doubt that there is uncertainty and complexity in the capital gains system; uncertainty because many calculations of liability include one or more valuations which have ultimately have to be agreed with HMRC and cannot be predicted with any certainty at the time of the disposal and complexity because of the various reliefs and exemptions which may be involved.

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% whilst reducing that on the short-term speculator by 55%; 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.

Entrepreneurs' Relief

It is generally accepted that this relief was hurriedly devised to preserve the 10% effective rate on businesses whilst still allowing the abolition of taper relief as originally proposed. It is largely based on the former retirement relief which was a feature of CGT since its introduction in 1965 until it was phased out over the period from 1999 to 2003. (Ironically this was on the grounds that it was too complex.) It is perhaps stating the obvious but it does need to be stressed that drafting legislation "on the hoof" has a potential for inconsistencies and anomalies. In this case it was perhaps felt the risk was lessened by simply dusting off legislation used earlier.

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 10 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.

Although largely based on retirement relief, entrepreneurs' relief is a direct replacement for taper relief as it applied to business assets, and its effects need to be measured against that latter relief in judging whether it achieves its aim of maintaining the status quo for businesses.

Focus of the relief

Taper relief was entirely focused upon the individual business assets. Entrepreneurs' relief, however, restores the old retirement relief concept of a disposal of the whole or part of a business. That concept led to a string of court cases which sought to decide whether the sale of some, but not all, the assets of a business was a disposal of part of a business. The new relief, as proposed, will mean that a gain on a single asset sold by a sole trader will no longer attract an effective 10% tax rate and could provide scope for further litigation on the question of what constitutes a part of a business.

No doubt it could be argued that relief for the sale of a single business asset is available to the sole trader under TCGA 1992, section 115 (roll-over relief) provided he reinvests the sales proceeds in new qualifying assets. However this relief will not apply in all cases; in particular where financial circumstances mean that the proceeds are required to supplement the working capital or the business or to repay borrowings. We believe that entrepreneurs' relief could easily be granted for such sales by amending the definition of a material disposal of business assets in the proposed section 169I(2)(a) to refer to assets used for the purposes of a trade carried on by the individual.

Business assets eligible for relief

A further change from taper relief is that the owners of properties let to businesses with which they are unconnected will no longer qualify for the 10% relief. Whilst this was always the case for retirement relief and, initially at least for taper relief, Finance Act 2003 relaxed this requirement and permitted taper for assets used in a business carried on by any individual or partnership. This was a sensible move; if Government policy is to encourage the formation of new businesses, it must accept that those businesses will need premises and will find it difficult to finance their purchase (especially in the current credit crisis). We believe that the Government should therefore continue to encourage property owners to provide premises to businesses by means of the 10% capital gains tax rate which they have been led to believe would be levied on a future sale.

Associated disposals

Another instance where "cutting and pasting" from the former retirement relief legislation brings a significant change from taper relief is in the situation where a partner or family company shareholder/director owns, in a personal capacity, an asset, usually premises, which is used in the business carried on by that partnership or company. Retirement relief was restricted where the individual received rent or any other form of consideration for its use. There was no such restriction under taper relief, but now there will be again.

Frustrating as such changes may be, the real point here is that the reintroduction of this restriction brings with it an element of retrospection. The proposed new section 169P(4)(d) applies the restriction where rent has been paid for the whole or part of the period for which the asset has been in use for the purposes of the business, which, of course, would include any period before 6 April 2008 when the receipt of rent was unobjectionable. We believe that the restriction should be removed completely in order to maintain the status quo, or, at the very least, to prevent retrospection, periods before 6 April 2008 should be ignored.

Personal companies

Relief is available for disposals of shares in a trading company which is the individual's "personal company". Stated simply, this is one in which he holds not less than 5% of the ordinary share capital and voting power. In addition the individual must be an officer or employee of that company.

Under taper relief the shares were a business asset if the company was unlisted, if the individual was an officer or employee or if he could exercise not less than 5% of the voting power. These three conditions were options. Thus an employee who held less than 5% of the voting power would benefit from the relief as would someone holding more than 5% who was not an employee.

The new requirement that the individual must both be an employee and hold more than 5% of the voting power means that from 6 April many people will be faced with an increased potential capital gains liability. Principally affected will be those employee-shareholders who have small holdings derived from share incentive schemes.

It is unfortunate that the definition of "personal company" for the purposes of entrepreneurs' relief differs from that already in force for the purposes of roll-over relief in TCGA 1992, section 157(b). The latter definition only requires the holding of not less than 5% of the voting power; it does not require the individual to be an officer or employee. Interestingly, that roll-over relief definition derives from the earlier retirement relief definition.

We believe that there should be consistency in defining common terms in order to avoid misunderstandings and aid clarity. Preferably, the definition of shares which qualify for entrepreneurs' relief should be the same as that which has applied for taper relief—failing that, the definition of family company should be aligned with the existing definition.

Effect of annual exemption

In most cases, it might be thought that the overall effect of entrepreneurs' relief is to leave the tax burden on businesses unchanged from that which would have applied under taper relief. In the case of modest gains the effect of the annual exemption, where this is not set against other gains, is actually to increase the tax burden.

Take the case of a gain of £36,800 in the last tax year. It would be reduced by three-quarters to £9,200, which would be equal to the annual exemption and thus no tax would be payable. That same gain arising in the current tax year would result in a liability of £1,952 (£36,900 x 5/9ths = £20,444 less £9,600 = £10,844 @ 18%). In order to be fully covered by the annual exemption, the gain in future must be £17,280 or less.

If the intention behind entrepreneurs' relief is to maintain the status quo for business disposals, this effect alone suffices to defeat that aim. A gross gain of £50,000 would, if realised on 5 April 2008, have resulted in a tax liability of £1,320—an effective overall rate of 2.64%. The same gain realised on 6 April 2008 would, *ceteris paribus*, result in a liability of £3,272—an effective overall rate of 6.54%, more than double.

The Abolition of Indexation Allowance

Along with taper relief, the Bill abolishes Indexation Allowance (IA) for gains realised after 5 April 2008. The overall effect of this provision is harder to assess, since the effect of IA is incredibly variable. Where an asset was owned on 31 March 1982, the effect of IA is (broadly) to double the individual's base cost (which, in such cases, is normally the asset's market value as at 31st March 1982). Where the assets consist of shares subscribed for at par since 1982 (a very common instance), IA has virtually no effect since the base cost which IA increases is usually negligible.

The rules for indexation are quite complex, since it is necessary to distinguish between assets held at 5 April 1965, assets held at 31 March 1982, assets acquired before 5 April 1985 and assets acquired between then and 5 April 1998. Calculations can in many cases be cumbersome, with relatively limited reduction in the tax liability.

Indexation Allowance ceased to accrue (other than for companies) from 6 April 1998, with the result that the proposal will not change anything for disposals of assets which were acquired since that date.

The abolition of Indexation Allowance is certainly a simplification. Apart from the (relatively few) cases where it will result in a significant increase in liabilities, it should be welcomed as a positive step.

Conclusions

The substitution of a flat rate of 18% in place of the individual's marginal income tax rate might—at a stretch—be described as a form of simplification. In fact, it does nothing more than add yet another tax rate to the many (10%, 20%, 32.5%, 40%) which already bedevil personal taxation.

The consequence (one hopes unintentional) of undoing the 10-year-old distinction between business assets and non-business assets is to increase the tax charge on the former and to reduce substantially the tax rate on the latter. That this is an instance of simplification generating unfairness goes without saying; the possibility that the Government actually wishes to disadvantage the small business community while benefiting buy-to-let landlords and short-term speculators defies credibility.

The introduction of entrepreneurs' relief, undeniably a hurried response to hostile commentary by professional and industry bodies, attempts to reduce the unfairness which the 18% rate imposes on the small business community. Unfortunately it does so only to a very limited extent. The new relief is limited to £1,000,000 of gains over a lifetime (whereas taper relief applied to unlimited gains). It applies to a much more restricted range of shares than before (most employee share participation which qualified for taper relief will fail to qualify for entrepreneurs' relief). Being based on a "retirement" concept, it excludes many disposals which were covered by taper relief. It excludes—arguably retrospectively—many disposals of "associated assets" which would have qualified for taper relief (ie where a rent has been charged for commercial property). Disposals where the annual exemption is available are taxed more highly than was the case under taper. Overall it is fair to conclude that entrepreneurs' relief is at best a very partial compensation for the loss of business asset taper relief.

Because the new relief fails to make use of existing definitions of assets, but rather imposes a new set of definitions based in part upon long-defunct legislation, it cannot be regarded as a simplification. Taxpayers and advisers who had for 10 years grown accustomed to one set of definitions now have to cope with a different, more restrictive set. On that basis it cannot be said to offer any degree of clarification either.

Judging on the basis that a tax system should seek to optimise the balance between simplicity and fairness, we are obliged to conclude that, unfortunately, the new provisions for CGT manage to satisfy neither. The new provisions are no less complex than those they replace, and treat entrepreneurs and members of employee share schemes unfairly.

It is hoped that the comments made in this submission will be helpful to the Sub-Committee, although we shall be pleased to answer any questions which the members have.

April 2008

Further memorandum by the ATT

RESIDENCE AND DOMICILE

The Association of Taxation Technicians (ATT) is delighted to have the opportunity to present its evidence on this topic to the Sub Committee for their consideration.

Residence—Clause 22

Clause 22 amends three existing provisions by amending the manner in which an individual's presence in the UK is to be calculated. The three provisions are: sections 831 and 832 of the Income Tax Act 2007; and section 9 of the Taxation of Chargeable Gains Act 1993.

These three sections deal solely with individuals who are "present in the UK for some temporary purpose only, with no intention of establishing permanent residence in the UK", and (broadly) provide that overseas income, earnings from employment whose work is carried out overseas, and capital gains on the disposal of chargeable assets, will only be taxable in the UK if the individual spends at least half the tax year in the UK.

Clause 22 does not therefore amend the law with regards to individuals who are already established as resident in the UK, and in particular with regard to individuals who are seeking to terminate residence in the UK. In this respect it may be regarded as a relatively minor amendment. So far as its scope extends, it is nonetheless an appreciable simplification.

The two income tax provisions are aligned so that in each case the individual is treated as not resident if he spends less than 183 days in the UK; the capital gains tax provision (which currently talks in terms of months) is amended so that the individual is resident only if he spends 183 days or more in the UK. In all cases, the test for whether a given day counts as spent in the UK is clarified.

Under the new test, an individual is not present in the UK unless he is present at midnight on that day. Furthermore, he is not present in the UK if he spends midnight in the UK simply because he is in transit between other locations.

A valid mark of success in tax legislation is whether it can easily and clearly distinguish between its legitimate targets and the innocent bystander. The new "transit" test appears to cope admirably, since it contains sufficient flexibility to enable its disapplication in cases of genuine abuse—for a midnight not to count as UK presence, the individual must have arrived that day as a passenger, must depart the next day, and in the intervening time must "not engage in activities that are to a substantial extent unrelated to the individual's passage through the UK". Thus, business "commuters" who fly into the UK for meetings or to sign contracts will rightly be attributed with a day of UK presence, whilst travellers who merely choose to break their journey in the UK will not.

This level of clarity and simplicity stands in contrast to the clutter of statutory and extra-statutory guidelines still surrounding the residence status of those individuals seeking to sever their established UK resident status. Those guidelines were harshly criticised by the Special Commissioner in her October 2006 ruling on Gaines-Cooper (SpC 568). If Clause 22 is to be the initial step in a wholesale simplification and clarification of how residence status in the UK is determined, we welcome it heartily. If this is merely a single step, which clarifies one small aspect of residence but leaves the greater mess unresolved, we still welcome it while regretting the lost opportunity.

Remittance Basis—Clause 23 and Schedule 7

Clause 23 introduces Schedule 7, which in turn amends the Income Tax Act 2007 by inserting a new Chapter A1 into Part 14 of that Act.

The background to this legislation is the long-established and much-discussed "remittance basis", whereby an individual who is resident in the UK but either not domiciled in the UK or not ordinarily resident here is not taxed in the UK on income and gains arising overseas unless (and to the extent that) they are remitted into the UK. Discussion of the merits or otherwise of this basis of taxation is outside the scope of this submission, which is solely concerned with the issues of administration, clarification and simplification; the Sub-Committee will in any event be aware of the lively debate on the subject and of the widespread public confusion over its application.

The new legislation begins from the basic premise that—in the absence of the remittance basis—all income and gains of a UK resident individual, wherever they may arise, are subject to the scope of UK tax.

An individual may keep his overseas income and gains outside the scope of UK tax (without need of a formal claim) in any tax year when his "unremitted foreign income and gains" is less than £2,000. He may also do this if he is a minor or has been resident in the UK during no more than six of the preceding nine tax years, as long as he has no UK income and remits no overseas income into the UK during the year. These two provisions (new sections 809C and 809D) have the effect of relieving from a UK tax compliance burden three types of individuals:

- — those who, while resident in the UK for a brief period, have little or no UK economic activity and who keep their non-UK wealth entirely offshore;
- — the children of economically-active UK residents as long as they themselves bring no overseas income into the UK; and
- — long-term UK residents with negligible overseas incomes (or those with substantial overseas incomes, virtually all of which is remitted to the UK and taxed here).

Individuals who are not able to take advantage of either section 809C or section 809D may only have the benefit of the remittance basis if they make a formal claim under section 809B. This claim, if made by an individual who is either under 18 or has not been resident in more than six of the preceding nine tax years, involves the forfeiture of the personal allowance and the CGT annual exemption but no more stringent costs. Otherwise, in addition to forfeiting these tax-free allowances, a claimant under section 809B is required to "nominate" overseas income and gains which will be subject to the notorious £30,000 "levy".

The manner in which the levy works is not entirely straightforward. The income and gains "nominated" by the taxpayer are not themselves subject to the remittance basis. Instead, they are subject to a minimum tax liability of £30,000. (First compute the tax due on the nominated income on the normal "arising" basis; then compute the tax due on the same income if the remittance basis had applied; the difference between the two is the "relevant tax increase". If the relevant tax increase is less than £30,000, the liability is increased by the shortfall).

We appreciate that one of the reasons for computing the "levy" in this manner was a desire to make it easier for the £30,000 charge to qualify for overseas double taxation relief—such relief is possible under most treaties against the liability upon a given source of income or gains, whereas a free-standing charge would be unlikely to qualify. The chosen mechanism, however, is neither simple nor clear.

One would imagine, having come so far, that all this was complex enough; one would, however, be mistaken. There follows (as sections 809H to 809Y) a sequence of sections of astounding complexity and opacity designed to identify when, to what extent, and in what order, funds are deemed to have been remitted into the UK. The purpose of this is to prevent individuals from remitting their "nominated income and gains" (upon which they have paid the £30,000 levy) instead of other income and gains. To quote from the explanatory notes: "this is to ensure that all untaxed and unremitted income and gains are treated as remitted to the UK before any nominated income or gains upon which the [remittance basis charge] has been paid".

We do not propose within this submission to dwell upon the detail of these clauses. Suffice it to say that they introduce a large number of provisions, complicated in purpose and supremely complex in execution.

Remittance—Summary

The overall effect of this massive Schedule is easily expressed: individuals who have been resident in the UK for at least seven of the preceding nine tax years, and who do not wish to be taxed in the UK on their worldwide income and gains, will be obliged instead to suffer the following liabilities in addition to UK tax on those income and gains they remit into the UK:

— An additional amount of up to £2,174 on their UK-sourced income (as a result of foregoing the personal allowance).

— An additional amount of up to £1,728 on their UK-sourced gains (as a result of foregoing the CGT annual exemption).

— An additional £30,000 on their non-UK income and gains which are not remitted into the UK.

The alternative is to suffer UK income tax and CGT on an arising basis on all their worldwide income and gains.
In either case, relief is potentially available under double taxation agreements against the overseas liabilities. If the overseas tax rates are higher, there will probably be no net increase in the individual's overall tax costs; if the overseas rates are lower, the additional UK tax will represent a net increase in global tax costs.

The decisions which this will force upon individuals are not always straightforward. 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. Others, providing they can obtain sufficient relief under double taxation provisions against their overseas liabilities, may find the new provisions adding little to their global tax costs. Others yet will find these new provisions adding significantly to their global tax burden.

What all will find is an overall increase in their tax *compliance* burden. As well as keeping track of what is remitted into the UK, individuals will need to keep track of income and gains which are not remitted into the UK in case these are needed to replace remittances out of "nominated income and gains". 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.

We suspect that the increased compliance burden will fall disproportionately upon the less well-off among the non-domiciled community—the genuinely rich will be able to retain £30,000 worth of "nominated income" permanently outside the UK, and so will never need to worry about section 809H *et seq*).

Overall, even if one accepts the need to place severe restrictions on a tax basis which has long been a part of the UK tax system, Schedule 7 appears to be a cumbersome means of achieving this end, which will lead to lead to increased compliance costs.

It is hoped that the comments made in this submission will be helpful to the Sub-Committee, although we shall be pleased to answer any questions which the members have.

April 2008

Memorandum by the Chartered Institute of Taxation (CIOT)

Introduction

The Chartered Institute of Taxation (CIOT) is pleased to have the opportunity of submitting comments to the House of Lords Finance Bill Sub-Committee in relation to the Finance Bill 2008. We note the three areas of focus for the sub-committee, on which we comment below. We have also drawn attention at the end of this note to two other areas which fall into the sub-committee's remit of tax administrative matters, of which we feel the sub-committee should be aware.

As an introductory comment, we think that one general lesson to be drawn from this Budget/Finance Bill is, once again, the importance of consultation—consultation that is timely, properly managed and includes working with the right people and organisations, and having regard to what they say. A number of measures of considerable significance (for example Income Shifting, Residence and Domicile and Principles-based drafting) show welcome evidence of listening and an ability to make some changes in consequence. However, 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. Hasty and ill-considered announcements do not just lead to bad law: a hostile reaction will in turn lead to the possibility of real, coherent reform being precluded—as has happened with residence and domicile.

Capital Gains Tax and the Entrepreneurs' Relief—Clauses 6 and 7, Schedules 2 and 3

The introduction of a new 18% flat rate of tax is welcome as a simplification, although we did not endorse the way in which it was suddenly announced without consultation. It inevitably creates winners and losers, the latter including people on low incomes who would probably also be involved with long-held assets.

The proposed "entrepreneurs' relief", on gains up to £1 million, appears to be based upon the old retirement relief rules, which brings with it significant complications. Our key concerns are that the entrepreneurs' relief does not appear to be available for:

— certain assets used in a business, such as a property owned outside a trading or farming company and rented to that company—even where the company stops paying rent from April 2008; and

— most employee shareholdings—where the employee is not an owner manager. Whilst approved share schemes still offer tax advantages, employees have lost their 5%/10% CGT rate.

There will be an additional burden in retaining details of records over many years. We question how practical or effective this will be.

In the context of another of the topics for the sub-committee, we note that the relief is a one-off £1 million; although a significant benefit, it does not send the same signal to the serial entrepreneur that the 10% CGT rate did.

Residence and Non-domicile Issues including Reference to Non-compliance—Removal of Personal Allowances—Clauses 22 and 23 and Schedule 7

HM Revenue & Customs (HMRC) are to be congratulated on listening to the (strongly expressed) concerns with the original proposals on Residence and Domicile and moving to alleviate a good number of them. The result is an improved package that is less likely to act as a deterrent to investment in the UK; its element of retrospectivity has also been mitigated. However, its impact on the UK is still potentially adverse, and one change we would strongly recommend is that the "seven-year test" should only start after an individual has finished full time education. Otherwise, an individual who studies in the UK for A levels and a degree is almost immediately into the £30,000 charge—and so much less likely to stay here to work.[1]

We think four areas still need attention:

(i) **Personal allowances**—the doubling of the de minimis amount of foreign income to £2,000 does not solve the unfairness or impracticality of the denial, from day one, of personal allowances for anyone who claims the remittance basis. This will catch two groups in particular:

— The UK employer (often a foreign bank) of non-domiciles who are on a tour of duty to the UK. For all that the remittance basis claim will be down to the employee, the employer will have to take an interest in the issue, explain, monitor and modify the payroll accordingly and, in most cases, compensate affected employees through a tax equalisation payment or face a demand for higher pay. Whatever HM Treasury (HMT) says about employees having a choice, the result will be that many non-domiciled employees will face additional UK tax and look to their employers for compensation, thus increasing employment costs.

— The low paid, who will, in great numbers, unwittingly breach the new rules and so risk a future penalty. The de minimis amount is unlikely to cover everyday situations such as the rent on the let-out flat back home, or earnings from helping with the family farm in the summer, or a student's summer vacation job at home or simply the vagaries of currency fluctuations. HMRC are simply not in a position to cope with the practicalities of educating and coping with this community and we do not believe the practical implications for this community have been thought through.

The only fair and practical solution to this issue is to harmonise this loss of personal allowances with the £30,000 charge, to come in after seven years rather than immediately. In any event, there should be no loss of the CGT annual exemption when the non-domiciled person is likely to be exposed to gains through currency fluctuations.

(ii) **Residence test**—the modification to count only days where the individual is in the UK overnight is welcome and sensible, but has to be set against the lack of a UK statutory residence test. We are still largely dependent on case law and on HMRC practice. This also orientates towards a 91-day test, out of line with other countries. The UK needs a statutory test of residence that is clear and easy to work with; there needs to be a commitment to develop such a test.

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[1] It is worth noting that the LSE's analysis of their undergraduates shows a breakdown by domicile of: UK: 47.6%; Asia 28.4%; Rest of Europe 13.3%; N America 7.7%; Africa 2.2%; Other 0.8%.

(iii) **Technical points**—There remain concerns with the definition of the remittance basis (eg fees paid to fund managers) and aspects of the £30,000 charge (eg creditability against other countries' tax). These will need continued discussion and modification, and show that these complex reforms are being brought in too quickly and without proper advance consultation. Some of the changes have wider impact than seems fair—the "source ceasing" rules are very retroactive and the offshore mortgage grandfathering is rather capricious.

(iv) **Confidence rebuilding**—many in the non-domiciled community have, rightly or wrongly, gained the impression that the UK no longer welcomes them as much as it used to. There is work to be done to ensure that the UK is still perceived as an attractive location for work and investment, especially in relation to the financial sector. We need to have a commitment from HMT/HMRC to continue to listen to practical issues that arise over these changes.

Encouraging Enterprise—Clauses 28 and 29 and Schedule 11, plus Consultations

The Finance Bill contains a number of changes to the rules relating to various targeted reliefs already in the tax code: for example, the changes to R&D tax credits, vaccine research relief and enterprise management incentives. We have to point out that such targeted reliefs do in many ways run counter to the Government's overall aims of simplifying the tax system, increasing the compliance burden and cost for both taxpayers and HMRC. (We do appreciate that some of the changes proposed this year are a result of EU measures.) But there is some evidence that many taxpayers would prefer a lower overall tax rate without these reliefs.

A key consideration is surely whether the reliefs change taxpayer behaviour at all or whether they simply reward actions that would have been taken anyway. Again, the evidence is mixed at best[2] and, in this context, we note with interest Clause 27 with its introduction of a requirement for the taxpayer to make a declaration that (in effect) the availability of the relief has changed their behaviour (though the lack of a defined baseline will make compliance tricky).

Considering the three documents relating to Enterprise, a general comment is that they are less about taxation, our area of expertise, than finance and other areas. Some points we would make are:

1. **EIS consultative document**—the steady restriction of the size of company to which the EIS applies raises the question of how effective a relief this is for encouraging growing businesses. Is there too much focus on establishing new businesses? We would also question whether the list of excluded businesses is outmoded with the current gross assets test and, as a practical measure, whether HMRC could give advance clearances for EIS availability to make things easier for claimants. We assume the consultation will take into account the behavioural issues associated with the relief.
2. **Study on EIS/VCT**—this has some interesting findings (eg on survival rates for assisted businesses, perhaps showing that the reliefs are going to riskier businesses that would otherwise have greater difficulty raising finance). It would, though, have been useful to test whether behaviours had really changed with the availability of this financing, as well as whether the results of any changed behaviour are, overall, a real enhancement.
3. **Enterprise: unlocking the UK's talent**—this is a wider ranging document that raises a lot of issues. Tax is only mentioned briefly. In many ways this is correct, in our view, despite the importance which we naturally attach to taxation. Our point is that we prefer a system of reduced complexity and light regulation. To this end, we would expect to see the document record such axioms as the objectives of any reform; and that Government action would be limited to removing barriers or addressing shortcomings, not trying to create additional incentives that serve mainly to confuse. Some of the comments in the Regulatory framework chapter do point in that direction. We would have expected Chapter 6 to critically review the success of the R&D tax credit rather than simply refer to it in passing (paragraphs 6.5 and 6.6).

Retrospective Legislation—Clause 55

While we appreciate the need for the Government to clamp down on what is perceived as abusive tax avoidance, we can see no justification for the introduction of such legislation with such extreme retrospective effect. The proposal to backdate this legislation to the 1987 legislation is excessive and, whatever the concerns about avoidance, unjustified.

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[2] See, for example a PricewaterhouseCoopers survey on "Enterprise in the UK: Impact of the UK tax regime for private companies" at http://www.pwc.co.uk/eng/publications.

This sort of move gives rise to significant concerns about not only the proportionality of the measure but whether the UK tax system has any certainty and whether the UK is a stable place in which to invest.

HMRC Powers—Part 7—Clause 108 Onwards

Many of the provisions have been reviewed over the last year by way of a thorough consultation. However, we have a number of concerns about the breadth of some of the new proposed powers and would like to record that a number of the issues raised during the consultation have not been addressed. The consultation finished only days before the Budget and we consider that this has not provided adequate time for the issues to be properly considered—especially given their importance to the whole tax system. It does give the unfortunate impression that the consultation was not a true one and that decisions had already been taken.

We give two examples of areas of concern

- Clause 108 and Schedule 36, paragraph 10—deep concerns are expressed regarding the breadth of the power to visit virtually any business anywhere, anytime, with minimal safeguards. This was raised during the consultation on several occasions and it is disappointing to see little change to the original proposals.
- Schedule 36, paragraphs 21–24—this is enacting HMRC's view of legal professional privilege (LPP), with which the profession does not agree.

We would be pleased to amplify our concerns or comment on other areas if that would be of assistance to the sub-committee.

21 April 2008

Memorandum by the Society of Trust and Estate Practitioners (STEP)

RESIDENCE AND DOMICILE

1. Key Points

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.

Reputations are slowly built and quickly destroyed. STEP welcomes statements from HM Treasury and in particular the Chief Secretary to the Treasury highlighting the positive role that non-doms play in the UK economy. The more Ministers make these statements the quicker the reputation of the UK as a destination for foreign investment will be repaired.

STEP also welcomes the industry engagement by HMRC following the outcry triggered by the hastily drafted proposals. This has resulted in a deepened dialogue between STEP and HM Government.

- Non-doms pay UK tax once money comes to the UK, ie is remitted. Non doms pay at least £7.1 billion in tax.[3]
- Non-doms bring significant inward investment to the UK.
- The UK tax system is not peculiar compared to the rest of Europe—other countries also compete for foreign investment.
- Media reports suggest that uncertainty around the Government's proposals is causing damage to the UK economy.

[3] In the tax year to end April 2006 non-doms who filed self assessment returns paid £3.9 billion in Income Tax. Research by Stonehage, a wwelath management company, suggests that the average proportion of VAT to income tax receipts over the last seven years has been 57%. There is no reason to believe Non Doms as a population sample pay a significantly different proportion (if anything they are likely to pay more). In the tax year ended April 2006 the average tax paid by non-doms was £34,210 compared to the UKU national average of £4,250.

2. Non-doms Pay UK Tax once Money comes to the UK, ie is Remitted. Non-doms Pay at Least £7.1 Billion in Tax

Non-doms bring between £65 and £80 billion in Foreign Investment[4] and spend £16.6 billion per year on goods and services in the UK.[5]

The new remittance rules contained in the Finance Bill (the rules that govern when money or property is brought into the UK for tax purposes) mean that the UK will remain competitive as a destination for foreign capital, which brings over £100 billion into the UK economy per year.[6]

According to a report by Think London, an organisation funded by HM Government, foreign investors are responsible for more than a quarter of London's economy and 13% of its jobs. Between 1998 and 2004, foreign investment produced approximately 42% of London's economic growth.

At a time when UK companies are finding it harder to raise capital on UK markets stability of the tax regime and therefore of incentives for foreign capital to come to the UK are maintained.

STEP shares the Government's stated desire of developing a working system which introduces greater equity into the system but maintains the UK's competitiveness for attracting foreign direct investment.

3. The Tax Regime for Non-doms

UK resident foreign domiciliaries already pay £7.1 billion in UK taxes. As the tables below show, resident non-domiciliary (RND) individuals and settlors of non-UK trusts pay UK taxes on income, gains and inheritances when they arise or are brought to the UK. These changes will see both wealthy and less wealthy non-doms pay more in tax.

TAXES PAID BY THE INDIVIDUAL NON-DOM

Status	*Pay Income Tax?*		*Pay Capital Gains Tax?*		*Pay Inheritance Tax?*	
	On UK Income	*On non-UK Income*	*On UK gains*	*On non-UK gains*	*On UK assets*	*On non-UK assets*
Individual RD	√	√	√	√	√	√
Individual RND	√	X unless remitted	√	X unless remitted	√	X unless deemed domiciled
Individual NRND	√ (some income exempt)	X	X	X	√	X

NB: 1. Table relates to investment income and gains
2. RD means resident and domiciled in the UK, RND means resident non-domiciled, NRND means not resident and not domiciled in the UK.

4 HM Treasury estimates contained in the following document: http://www.hm-treasury.gov.uk/consultations_and_legislation/residence_domicile/consult_residence_domicile.cfm show that foreign source income for non-doms is in the region of £65 and £80 billion.
These HM Treasury figures corroborate estimates made by the Chartered Institute of Taxation. http://www.tax.org.uk/attach.pl/6231/7215/ForeignDomsResidence%20final201107.pdf
On this basis, our experience is that there are perhaps 50-60 organisations which offer trust services on what might be described as a "systematic" basis (ie ignoring the "boutiques" which may administer only a handful of trusts). These larger organisations, in our experience, will usually have a "book" of anywhere between 100 and 1,000 trusts, with an average perhaps being around the 300–400 mark.
This would suggest that there are between 15,000–25,000 such offshore structures. A few such structures may exist for UK domiciliaries, but these are increasingly rare since tax changes in 1991 and 1998 and do not form a significant part of the total.
This figure would broadly tie in with the 15,000 figure which HMRC gives for those who claim the remittance basis on their self-assessment returns and who have unremitted income in excess of £75,000 (thus making the £30,000 charge worthwhile).
Such offshore structures are, in our experience, rarely cost-effective to manage where assets are less than around £1 million. CIOT estimated the median size of a non-resident trust fund to be in the region of £4–5 million. This would put the bottom end of the estimates for the sums held in non-UK trusts at £60 billion and the upper band at £125 billion. CIOT then estimate that around 50-75% of these funds would be invested in the UK.

5 Research by wealth management group Stonehage conducted in 2007 suggests that Uk resident non-domiciliaries spent £16.6 billion in the UK in 2006 excluding housing and non-VAT items. This figure is reached by calculating what the sum of spending was that yielded VAT receipts ie. 100% of the 17.5% of VAT.

6 This figure is arrived at by adding up the Foreign Source Income estimates, the annual spending figures from 2006 and the tax receipts from non-doms.

TAXES PAID BY SETTLORS OF OFFSHORE TRUSTS

Status	*Pay Income Tax?* *On UK Income*	*On non-UK Income*	*Pay Capital Gains Tax?* *On UK gains*	*On non-UK gains*	*Pay Inheritance Tax?* *On UK assets*	*On non-UK assets*
Individual RD	√	√	√	√	√	√
Individuual RND	√	X unless remitted	√	X unless remitted	√	X unless deemed domiciled
Individual NRND	√ (some income exempt)	X	X	X	√	X

NB: 1. Table relates to investment income and gains
2. Ordinary residence is ignored

4. Other Countries Offer Significant Incentives for Non-doms

Other countries within and outside the European Union compete with the UK in offering tax incentives and schemes to attract foreign capital. They do so because they believe that spending and investment in their countries by foreigners and foreign companies provides a substantial and justifiable benefit to their economies.

Netherlands

In recent years a number of amendments have been made to the Netherlands tax code:

— Under the Netherlands tax code, a Dutch "holding company" that owns "at least 5%" of the value of the paid-in capital in another foreign or domestic company from the beginning of the fiscal year can receive dividend distributions from this "subsidiary" 100% tax free.

Ireland

Ireland has a similar set of rules to the law in UK prior to the Finance Bill 2008. This makes Ireland an attractive destination for foreign capital and individuals.

Belgium

Belgian holding companies that hold a participation in other companies can exempt 95% of any dividend received from such companies provided the other company is not located in a country that (1) does not tax corporate income or (2) which has a tax regime, which is substantially more favourable than that in Belgium.

In addition, capital gains from the disposition of participation shares are 100% tax free from the 1992 tax year onward.

Dubai

Amongst the incentives offered to companies operating within the Jebel Ali Free Zone and the Dubai International Finance Centre are:

— ***Corporate Income Tax***: No corporate income tax on profits. The exemption is for a period of 15 years with a guarantee of an extension for a further 15 years in the event that corporate income tax is introduced in Dubai. Currently only banks and oil companies are assessed for corporate income tax in Dubai. The key difference with companies operating in the Jebel Ali Free Zone is the guarantee of exemption in the event that corporate income tax is imposed by the Government.

— ***Withholding Taxes***: No withholding taxes.

— ***Import Duty***: Exemption from all import duties on goods imported into the free trade zones. For all other imports, duties have been largely standardised at 5%.

Other

Several other states offer regimes designed to attract inward investment based on low or zero tax rates or exemptions for foreign capital.

- — The USA does not tax foreign shareholdings of a US company.
- — In India, as of 2008, equities are considered long term capital if the holding period is one year or more. Long term capital gains from equities are not taxed. However short term capital gain from equities held for less than one year is taxed at 15% (increased from 10% to 15% after their Budget 2008-09). This is applicable only for transactions that attract Securities Transaction Tax (STT).

Conclusion

These states are not "tax havens". The Netherlands is the archytype of the European social model yet it provides significant incentives to attract globally mobile capital from abroad. The incentives on offer take very different forms and will not be an attraction to all investors but they provide a significant draw for foreign capital from individuals in different circumstances.

5. Rushed Changes have Caused Uncertainty and Reputational Damage

Following a lengthy process of consultation on the domicile regime (since at least 2002), the timetable was suddenly truncated in October 2007.[7]

This meant that policymakers in HMRC and HM Treasury were forced to work too quickly with extremely complicated draft legislation and the changes eventually announced, particularly in draft legislation in January, bore every indication of being rushed. The planned draft legislation had to be significantly amended, as indicated in letters, FAQs on the HMRC website, and comments in meetings with the Acting Chairman of HMRC. People need to be able to understand their tax position from actual legislation.

All this has damaged Britain's reputation as a destination for investment with a stable fiscal regime. As the clauses on residence and domicile took effect on or before 5 April 2008, it was important for taxpayers to understand their tax position. Even though the retrospective provisions in the draft legislation have been ameliorated, the uncertainty created by the provisions has already caused many non-doms to consider their position as investors or residents in the UK.
Even at this stage HMRC anticipates significant amendment to the Finance Bill.

6. Conclusion

The new remittance rules in the Finance Bill (the rules that govern when money or property is brought into the UK for tax purposes) mean that the UK will remain competitive as a destination for foreign capital bringing over £100 billion into the UK economy.

Resident non-domciliary (RND) individuals and settlors of non-UK trusts pay UK taxes on income, gains and inheritances when they arise or are brought to the UK. UK resident foreign domiciliaries already pay £7.1 billion in UK taxes. The changes in the Finance Bill will see both wealthy and less wealthy non-doms pay more in tax.

Other jurisdictions see the value of the wealthy and their investments and provide significant incentives for non-doms to move to or invest in their countries. These countries are competing with the UK for the foreign capital of non-doms.

A process of consultation on the domicile regime stretching over many years was suddenly curtailed, leading to rushed changes that have damaged Britain's reputation as a destination for investment with a stable fiscal regime.

April 2008

[7] A Law Commission paper –was issued in 1985. A review of the taxation of non-doms was first announced in the March 2002 Budget and again in the Pre-Budget Report in November 2002. A background paper was issued April 2003; and non-doms were again addressed in the pre-Budget Report in December 2003 and the Budget "Red Book" Report in March 2004. Concrete changes were announced in the Pre-Budget Report in October 2007 and draft clauses published in January 2008.

Examination of Witnesses

Witnesses: Mr Andrew Meeson, Council Member and Chairman designate of the Technical Committee, Association of Tax Technicians (ATT), Mr John Cullinane, Immediate Past President, and Mr John Whiting, Chairman, Tax Policy Sub-Committee, Chartered Institute of Taxation (CIOT), and Mr Jacob Rigg, Press and Parliamentary Officer, Society of Trust and Estate Practitioners (STEP), examined.

Q34 ***Chairman:*** Good afternoon and welcome to the Committee. I propose, if you think it is sensible, to take the three subjects separately: competitive capital gains tax; residence and domicile; and, then, encouraging enterprise. The October 2007 Pre-Budget Report said, "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 . . . [The reform] will put the CGT regime on a more sustainable footing and help investors plan for the long term." How successful do you think they have been in achieving those aims? If not, where do you think they fell down?
Mr Whiting: My Lord Chairman, I think there is an element of "It's a bit early to say" because capital gains tax, by its very nature, looks at longer term gains, and "Let's see how it goes." 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. There are issues as to getting there, and winners and losers, but, standing back, the rate is reasonable and looks quite promising in many ways.

Q35 ***Chairman:*** Is everybody happy with that?
Mr Meeson: By and large, my Lord Chairman, and up to a point, because, of course, as we all know, the devil is in the detail. It is not really an instance of comparing the new 18% rate with an old 40% rate, because not every taxpayer paid tax either at a headline rate of 40% or certainly at an effective rate of 40%. Because the old system saw so many different effective rates: 40, 24, 10, 12, 5 and 2.5% in very extreme cases, the 18% absolutely is a simplification, but where it lies in the realm of being a good simplification or a bad simplification rather remains to be seen, I think.

Q36 ***Chairman:*** It is designed to be an increase in the revenue, is it not as well? I think the Chancellor said so, did he not?
Mr Whiting: The estimate is that it will raise additional revenue. That is simply the fact that it will raise more from the business asset, be it private equity, the entrepreneur, or whatever, versus the ones who on second properties or whatever see a tax cut. 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.

Q37 ***Lord Paul:*** The main purpose of this was to try to simplify things. I am glad you have confirmed that it has simplified things. Is there any way one can work out that there are no losers and only winners? Is that possible at all?
Mr Whiting: I suppose if you had abolished the entire tax, most people would come out winners, my Lord, but, apart from that, it is very difficult to get a balance.

Q38 ***Lord Powell of Bayswater:*** Except the Treasury.
Mr Whiting: Except the Treasury, my Lord. I agree with you, of course. How to avoid or at least cater for winners and losers? Two factors particularly. One is consultation, so that by consultation and debate you at least work out who are the potential winners and losers. Then, of course, give careful consideration to grandfathering, that the transition is good, so that, if somebody is to lose, you have at least considered as to whether you give them, in capital gains terms, a possibility of some sort of election, in terms of the old treatment, before you switch to the new. It is really how you do something as much as what you do.

Q39 ***Lord Paul:*** Whenever the Treasury and the Cabinet people come they say that they have had a lot of consultations amongst themselves and with outsiders, so somewhere, when they come out, there must be some facts and figures?
Mr Cullinane: In the case of the capital gains tax rate, there has been a lot of consultation with the private equity industry. It was issues raised about that industry which probably started the immediate thought process. But obviously there were large numbers of people affected—employee shareholders, other business asset taper relief payers—for whom the whole change was a bolt from the blue. While you are always going to have winners and losers and the losers are never going to be that pleased about it, we think it is worse if you spring it on people. If you have a process of consultation, at least people are on notice that there is a change of direction, as mooted in the consultation document, and it gives them time, frankly, to acclimatise to the idea and to plan, and, in some instances, it will enable the Government to temper the blow of change with more considered transitional measures.
Mr Whiting: To give one particular example, I do not think the impact on the insurance industry was appreciated until after the announcement. This change has tilted what was a fairly level playing field against investing via insurance products as opposed to investing directly. The impact on the insurance

industry is still under discussion with the insurance industry, because, as I say, this has given something of a tilt in the playing field, which really should have been bottomed out through consultation or at least forward thinking.

Q40 ***Chairman:*** I wonder if you could elaborate a bit on that. I think there are still some discussions going on with the Chancellor about insurance bonds, are there not? What is the current view? What are your concerns there?
Mr Whiting: Perhaps you are talking to the insurance industry but the main fact is that by going and investing directly into shares, you are looking now at an 18% rate; whereas investing via an insurance-based product which derives income, you are taxed at potentially 40% and, therefore, we now have something of a bias against going in through the insurance industry. It may be that is just how it is—and, of course, there are various bits of, as it were, double tax relief coming out and it can get quite involved—but one feels that this was not quite thought through, as to whether this was going to be part of a package which, overall, as we alluded to earlier, raised a little extra money or whether it was just an accidental by-product.

Q41 ***Lord Powell of Bayswater:*** Is it not worse than that? Is there not quite a lot of unfairness here? There will be quite a lot of people who have built up their businesses on a certain view of the tax system who are now going to lose out pretty considerably because they will lose the sort of relief that they had before. As you have said, there has been no transitional relief, no transitional period, no grandfathering, and there are people in the employee share schemes who are going to suffer from this. I can see there is a good side to it too, but the bad side is somewhat greater than you are suggesting, is it not?
Mr Cullinane: To be honest, I think people exaggerate that. After all, if the Government had simply not changed the structure but increased the rates—which governments clearly have a right to do and have to do from time to time—then you could say all the same things. There are numerous examples in the tax system where you get expectations and there is a different tax result at the end. It is just that in this instance, where there was a more overall change in structure, we think it would have been better had they been consulted. But, in all honesty, I do not think there are many businessmen who, if they had known at the outset they were going to pay 18%, would have said, "I'm not going to bother to build up my business then" or "I'm going to a completely different country to do it." I can see why the people in that position are aggrieved, because they have had ten years of being told they were entitled to pay only 10%, but I doubt in all honesty whether many of them would have acted very differently.

Q42 ***Lord Powell of Bayswater:*** There is quite a lot more who are going to find themselves within the £1 million ceiling.
Mr Whiting: It is this legitimate expectation: "We were led to expect that the rate would be 10% if we built up a business and sold it—and, indeed, if we did it again it would be 10% again."

Q43 ***Lord Powell of Bayswater:*** But you could get over that if you grandfathered it and started it with anyone entering the scheme now, as it were.
Mr Whiting: There would be a strong argument for grandfathering or at least allowing some sort of election which could conceivably even allow you to go for the 10% rate, and maybe pay some of the tax upfront, but at least you have fixed that 10% rate.
Mr Meeson: My Lord, one of the issues that led to the unfairness is the brevity with which the exercise was carried out for most of the business community. I appreciate that those elements of the business community who were being specifically targeted on this were talked to, but the vast majority of small businesses and certainly the vast majority of employee shareholders were not consulted. Suddenly, in October 2007, they are told, "Come 6 April 2008, the world will change and you will be paying nearly twice as much capital gains tax on your disposals." Speaking as a private practitioner, I have been deluged with business clients desperately trying to do something—in some cases something quite artificial, which is quite appalling—to crystallise the 10% taper while they could, because of this "buy now while stocks last" mentality which putting a short deadline on something like this brings about. Of course, it does not have the same effect in the other direction. Those who were looking to pay anything between 24 and 40% on their disposals, woke up in October and suddenly thought, "That's wonderful. All we have to do is sit there a little longer and life gets better." The ones who had been expecting 10% are faced with this awful decision: "Do we do something or face life getting appreciably worse?"

Q44 ***Lord McGregor of Pulham Market:*** You will recall previous issues about capital gains tax being different from income tax and the reason for the original 40% capital gains tax rate. Do you see the prospect of a lot of people now having an incentive to turn income into capital gains because of the difference between the 40% and 18% rate as was argued in the past? If so, is there sufficient protection in the legislation to prevent this happening?

Mr Whiting: I think it is inevitable if you look at the two rates, which, as you mentioned, my Lord, at least at the starting point, were the same. You now have a rate of 40% for income, potentially plus national insurance, if that is relevant—so potentially even higher—versus 18% capital gains. Inevitably people are going to look to realise capital gains. But, then again, that is only a continuation of what we have, because, in many ways, people would have been looking at 10%—admittedly after two years—versus 40% upwards. Is there enough protection? There is a great deal of protection in the tax system, not least the disclosure regime which has been in place since 2004. Is that sufficient protection? I guess time alone will tell, inevitably, but there is a lot of protection within the system of specifics. There are some general targeted anti-avoidance rules; there is disclosure; there is a great deal of, shall we say, armour-plating there for the Revenue's benefit.

Q45 ***Lord McGregor of Pulham Market:*** I was thinking of particular individuals rather than businesses—you know, the incentive to move into contrived schemes to convert income into capital. I presume you would think that most of these will now be caught by the new regime.
Mr Whiting: I think a lot of the contrived schemes will be disclosable by the promoter through disclosure or under the various and targeted anti-avoidance rules. Although, in many ways, I suspect we may be revisiting something that came up in a Royal Commission report back in 1955, *Badges of Trade*, when something is to be categorised as a trade rather than a non-trading transaction, I do wonder if we will be revisiting and refreshing those principles at some stage.

Q46 ***Lord McGregor of Pulham Market:*** So that the simplification becomes more complex again.
Mr Whiting: The simplification moves on to another part of the forest, as it were, yes, my Lord.
Mr Cullinane: The degree of simplification is in doing away with the taper relief which led to varying rates between 10% and 24%, and outside those parameters in some cases. This division between income treatment at 20% or 40%, plus maybe national insurance, and capital treatment is not new. As John was saying, it has been there all along. The simplification question is whether you would go further and tax everything at the same rate. There is a lot of logic and equity in saying that but I acknowledge that those people who are complaining about moving up from 10% to 18% would look even less favourably on that step being taken further. There is also the international competitiveness argument, as many countries have lower rates of capital gains tax. I do not think it is as a result of the simplification that has taken place that we have this capital/income divide. It was there anyway and it would be there if we followed international comparisons.

Q47 ***Lord McGregor of Pulham Market:*** You referred to the taper relief. Do you think that the removal of indexation up to April 1998 is justified in the context of the overall package? That was obviously designed to deal with a very inflationary period to some extent and was a protection against that. Do you think that is justified?
Mr Cullinane: I think pretty much what I thought about the other aspects of it, that in the abstract I think you can argue that if you have a low rate, therefore do you need other more complex compensations if you already have a low rate to start with. The problem is, again, the expectations that people had. When we moved from indexation to taper relief, they did not disturb the indexation that had accumulated so far. For those people who had lost a great deal of past indexation, it must have come as a big shock to them.
Mr Whiting: I think it 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.
Mr Meeson: Equally, my Lord, I think it is worth pointing out that those individuals who feel hardest done by from this simplification, the 10% to 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.

Q48 ***Lord McGregor of Pulham Market:*** Could I ask one question of ATT. I think it was in your evidence that you said, "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 . . .". Would you like to comment on that further in the context of simplification?
Mr Meeson: I would, indeed, my Lord. That I think is another lost opportunity because every simplification of capital gains tax we have had over the last 20-odd

years has tended to be playing around with the rates rather than tackling the underlying complexity of the system whereby establishing what the consideration for a gain is can be horrendously complex in many cases. Establishing what is the allowable expenditure for a gain is seldom simple. The various postponements, holdovers and adjustments that go into it mean that by the time you get to establishing the rate of tax, you have already done 99.9% of the hard work, which is why we felt that simply saying "Rather than pay at your marginal rate of tax, pay at this rate" is simple but it is not a huge simplification.

Q49 ***Lord Powell of Bayswater:*** Would it not have been simplest of all to have a single short-term capital gains tax which simply tapered over ten years to zero?
Mr Meeson: There was a large constituency for that back in 1997 when we had the last major change and it is difficult not to have sympathy with it. The problem is I am not entirely sure that that would end up being simple either.
Mr Cullinane: You have seen that in other countries from time to time. The most obvious thing people would then do is set up investment vehicles so they could churn their investments in the vehicle, and then they are holding on to the shares of the vehicle for longer. They would find ways of converting short-term gains into longer-term gains and then you would need anti-avoidance around that. Fundamentally, wherever you have borderlines in the tax system between different rates and different treatments, you are going to have complexity. The only real simple answer would be to tax everything, income, capital gains, long-term or short-term, all at the same rate or rates.

Q50 ***Lord Powell of Bayswater:*** Any simplification, finally, is going to end up with clever guys like you finding a way around it for your clients.
Mr Cullinane: If you do not want to go to that level—which there are equity arguments for in the abstract—and you go on to retain some borderlines, at least you can have fewer than you have had before.

Q51 ***Chairman:*** One other aspect of this is the entrepreneurial relief. How far has this relief met with criticisms of the original proposals without compromising their simplicity?
Mr Whiting: I think it has compromised the simplicity because, of course, it has gone away from the simple, flat 18%. I am not sure it is something that has been properly thought through as to whether this is a good additional thing. It is, to my way of thinking, a compromise—and in many ways a necessary one—to recognise, going back to our previous discussions, that the entrepreneurs had a certain amount of expectation that they would have a 10% rate, so here they are, this is the mechanism where they are given that 10% rate, but it has undoubtedly pulled away from the simplicity.

Q52 ***Chairman:*** Do you think they have set about it the right way? If they had had a bit more time to think about it, would they have chosen modelling it, as I understand it, on the retirement relief. Is that necessarily the best way of doing it?
Mr Whiting: If they had had more time, they would have perhaps thought through a different way. One argument is: if you wanted this lower rate, maybe you would base it on the principles of the taper relief, because that is a slightly more modern definition of what one might term "good" assets and picked up a few more things, rather than the retirement relief, which had a slightly different model as to what qualified. A couple of our particular issues, of assets held outside and employee shareholdings, would have been better treated, would have fallen into this putative entrepreneurs' relief, using the sort of taper relief system rather than the old retirement relief.

Q53 ***Chairman:*** I think this is quite an important area. Does anybody want to comment on that?
Mr Cullinane: I think there are pros and cons but the underlying point is, given more time and proper consultation, more people would have bought into the final result.

Q54 ***Chairman:*** You think there might have been arguments about using a taper relief.
Mr Cullinane: Yes, or coming up with a different thing altogether.
Mr Meeson: I thoroughly endorse what both Johns have said. I suppose one thing is that to have carried on using a variant of the taper relief would have given an element of continuity and comfort to the taxpayer. Having had ten years to learn one set of rules, they are suddenly being told, "Relearn those we abolished ten years previously." The reason those retirement relief definitions were abolished in 19097 was because they were seen at that time to be too complex—which is somewhat ironic now.

Q55 ***Lord Paul:*** Mr Cullinane and Mr Whiting, your organisation has some concerns about the entrepreneurs' relief. How far do you think they have been met without compromising any further simplicity?
Mr Whiting: Our concerns are that two or three areas do not qualify, as I have alluded to: the assets held outside the business and employee shareholdings. As we have just been discussing, had we gone down the taper relief model, if I could term it that, rather than the retirement relief model, that would have met our concerns. Clearly, if you now cater for these two with

perhaps some adjustments, you are adding to the complexity, and we are back to the perennial issue of simplicity-and-fairness pulling against each other. We would argue that it would be fair to cater for these, but it adds to the complexity.

Q56 ***Chairman:*** We can now to move on to residence and domicile. If you have not come here burning to say something which you have not had a chance to say, let us move on. Tax policy on residence and domicile has been under review to a greater or lesser extent for many years. The present review was commenced in 2002. Why do you think concrete proposals emerged in the Pre-Budget Report of 2007? Do you welcome the fact that at least uncertainty of the review was no longer hanging over people? Do you have a view on the correctness of the policy reasons for the proposals?
Mr Cullinane: It is probably a fair guess that the proposals came out as a result of the party political situation at the time. Not much else prompted them appearing at that time. Yes and no on the uncertainty point, because I do not think many people who were affected or might have been affected thought their position was that uncertain at all. The general perception was that the prior consultation which had been announced seven years ago and did not ever seem to get any concrete form, was just there in the long grass, so I do not think anybody really felt themselves affected by the uncertainty. The proposals that were made, and even more than the proposals that were made, the way they came out of a clear blue sky, caused people a great deal of angst. There are a lot of people who will probably live with what has finally come about who were thrown into a lot of disquiet and who considered their position in the UK much more seriously than they would have done as a result of the process, or lack of it. I think the net effect is to create a kind of climate of uncertainty around policymaking which it will take a bit of rowing back to get away from. I think that was acknowledged, in effect, by the Chancellor when he kind of ruled out any further changes in this Parliament and the next. It shows that he was aware that uncertainty had been created. 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, 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.

Q57 ***Chairman:*** And you say brought in because of the political scene and for political reasons rather than necessarily—
Mr Cullinane: Without being a fly on the wall, that is the best guess you can make.
Chairman: That is the most likely explanation.

Q58 ***Lord Powell of Bayswater:*** I think it is an open secret that the Treasury have been longing to do this for a couple of decades at least. I remember it coming up once or I think twice in Lady Thatcher's time as Prime Minister and once in John Major's, and they always jumped on it and stopped it on the grounds that it would have precisely the effect that it has had. Do you think they were absolutely right to have opposed it then?
Mr Cullinane: There are certainly question marks over the domicile regime. There are probably several million non-domicile people in the country—and, by the way, not all of them by any means mega-wealthy: there are some quite poor people in this category—and, hopefully, we will have a chance to come on to that. Those numbers will grow because the world is getting more mobile. There are some very serious questions as to whether, at the very wealthy end, some people should have, if you like, an almost semi-hereditary lottery ticket of favourable fiscal status. Equally, there are competitiveness issues. It is not simply a question of treating them all the same as everybody else, because they are not the same as everybody else: they have different international connections. I think we have a very complicated problem here and a growing problem. Just to spring the problem on people and then make some hasty compromises and then say, "We won't look at it again," is not ideal—though I think you had to say, "We won't look at it again," because you had unsettled everybody and you wanted to un-unsettle them. That is not to say everything was perfect before. I can see both sides, to go back to your original question.

Q59 ***Lord Powell of Bayswater:*** I suppose if one looks at yesterday's *Sunday Times* Rich List one can conclude there is probably quite a lot of leeway before one country suffers terribly.
Mr Whiting: Of course, as John has alluded to, we are not just talking about the *Sunday Times* Rich List, we are talking about five million, there or thereabouts.
Lord Powell of Bayswater: Yes. I think we will come on to that.

Q60 ***Lord Barnett:*** One of you referred to personal allowances and the changes there that you reckon are unfair. In your earlier evidence, which unfortunately I was not here for, you spoke about "simplification can never be fair". I am not sure whether you would classify this as simplification anyway, but, on the issue of personal allowances, you feel this is really unfair the way it has been done. Is that my understanding?

Mr Meeson: My Lord, it is probably I, on behalf of the ATT, who am guilty of the comments to which you allude. Yes, we do believe that there is an element of unfairness in this. Like John, I can see both sides of the argument and I am not prepared to put myself on either side of the fence in that respect, but, the purported abuse, as it were, is that the non-domiciliaries are in some way unfairly benefiting from sheltering their offshore income and gains from UK taxation. In one sense the £30,000 levy addresses this, but then to say, "In addition, we will remove the personal allowance"—which adds an extra taxation burden to their already taxed to UK income—and to do the same with the capital gains tax annual exemption—which then puts an additional burden on their already taxed UK-based gains vis-à-vis the normal non-domiciled individual—seems to be almost, to put it callously, putting the boot in when someone is down. It is adding insult to injury.

Mr Whiting: I would also confess to a similar comment, my Lord. I have a particular interest as a member of the Low Income Tax Reform Group—so a particular interest in the unrepresented. 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—they are paying their UK taxes—but, because of the situation back home—and we could easily be talking about the half million or so foreign students who are here paying fees to our universities, as much as the people who are serving in our sandwich bars, waiting at tables, bring the agricultural produce in—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. And this is assuming they are geared to dealing with this. 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. Indeed, we are still, even today, finding that they 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.

Q61 ***Lord Barnett:*** Given the amount of money you reckon—and the Treasury have given you the figures—we benefit from non doms, are you all saying you would prefer we did nothing to change the situation?

Mr Rigg: Certainly at STEP we are guilty of making these comments in our submission. Whilst I agree with the rest of the panel that the situation needed to be looked at, certainly it could have been looked at over a much longer period of time, with adequate consultation, without rowing back on draft legislation that had already been launched and, indeed, then issuing clarifications, effectively legislating by press release, where people were trying to plan their tax payments on the basis of the latest letter that had happened to come out of a meeting or a notice from Ernst & Young or something like that. Certainly we would support the basic fundamental policy principles that the Committee cites but I think it is important to balance the sort of important abstract concept of fairness with the important but very concrete notion of competitiveness in all of this. Perhaps where we have ended up, although it has its problems, is not necessarily too bad for our competitiveness, but the way in which we have got to this position is really, really damaging to the UK potentially.

Q62 ***Chairman:*** You are concerned mainly about the people who are non domiciles but earning relatively low amounts of money over here and low amounts of money of overseas income.

Mr Whiting: That is a particular area of concern of mine. All of us would recognise different categories of people here. Within this, all of us would agree, I suspect, going back to Lord Barnett's question, that there is definitely scope and sense in reforming the residence and domicile rules. If we go back to the consultation that started in 2002, we were to have a reform, and I think many of us subscribed to the ideas and the principles that were in there. To take one particular example, it would be very welcome if we could have a good reform to the definition of residence. Certainly the CIOT is strongly in favour of a statutory residence test that can be applied mechanistically rather than by HMRC judgement. That would be a very welcome way forward, as undoubtedly there is some tightening up that is sensible on the definitions of domicile and remittance basis, but to see that we have 50 pages of legislation on the remittance basis is too much.

Q63 ***Lord Barnett:*** You have mentioned that your concern is about the less well off being hit. If they have little or no unremitted income, they can claim not to be any more non dom, can they not?

Mr Cullinane: Somebody who comes here on a seasonal basis, as a potato picker or something from Romania or somewhere like that, if they have more than £2,000 of income in Romania but they are here long enough to be resident in the UK as a year-by-year matter, then, if you follow the strict letter of the law as it is coming in, either they have to disclaim personal allowances—so they are going to have to get their PAYE code changed to effect that or they are in default—or they have to report the Romanian income they get—which may only be £2,001 by the way: it may be very small—and then they and the Revenue, if you are to follow the law properly, are going to have to work through the Romanian tax implications, the double tax implications, and so on. It is quite evident that this problem was not even thought about and that HMRC have no plans to try to enforce this. It is a way of making millions of people non compliant and putting a tax cloud over their head. As John said, we are concerned about the tax system in general as a result of the way this has been handled. The very wealthy have to some degree got what they wanted in terms of achieving reversal to the policy, whereas the problems affecting these people have only just come out. The poor and wealthy alike would have been better served by a more open, consultative approach. By all means say, "These are anomalies that need to be tackled," but allow that to be debated and get people acclimatised to the idea.

Lord Paul: I still am not convinced that the Treasury has really gained from this or lost, if you look at the next five years. I am non domicile—I am too late to change—but there are lots of people who are seriously considering that they will change their residence. Governments could not make up their minds. For the last 40 years they have been looking at it. Now, all of a sudden, as more of a political decision that makes no sense whatsoever.

Chairman: You have the question. We will have your answer when we come back.

The Committee suspended from 3.46 pm to3.54 pm for a division in the House of Lords.

Q64 ***Chairman:*** Lord Paul has been for a good long walk, having been to vote, and would like the answer to his question.

Mr Whiting: Lord Paul's question, if I might paraphrase it, was: Do we think the measures will raise any extra money in the long term? That is a very powerful question. The concern is that they will overall damage the UK's tax revenues. My personal view is that it is hard to see how they will raise significant amounts of money. Certainly, from my own firm's experience, we are seeing a number of clients considering moving—not the flood that was at one time predicted but there is the feeling that some will move, and, more subtly, some will not come here in the first place.

Mr Rigg: Certainly that is the experience of STEP and our membership. A significant number of people who were considering coming here are not now coming here. It is difficult to say how it will end up with the tax revenue position, but I think it is likely that only small amounts of revenue will be involved now.

Q65 ***Lord Powell of Bayswater:*** I think under the present practice you can arrive on day one and that does not count, be there on day two and that does count, and leave on three and that does not count; so that, in effect, you have got three days for the price of one. Now that has been reduced to two days for the price of one. Will that be a bigger disincentive, even than the idea of paying £30,000 a year tax?

Mr Cullinane: In terms of short-term residency, to the extent you are clarifying rules then it does allow people to plan, even though there is an element of tightening up in it. Our main concern about that area is that we are tightening up in the way of doing a day count but the day count is by no means the end of the story as to whether you are resident or not. You are tightening up the detail but the rest of the iceberg is still there. The Revenue rules are firm on this matter but do not exactly reflect case law and the case law is somewhat more unpredictable, as evidenced by the fact that there are still cases going through the courts. It is not so much a problem with what is being finally enacted; it is more a missed opportunity to say, "Couldn't we put this all on a statutory footing so that everybody knows where they stand?" and then I think people will know exactly how much they can come here before they become a UK taxpayer. I think we would then find more people would readily come and there would be more tax revenues. Even though some people who are coming will not be resident.

Mr Whiting: As to the result of adjusting the amount of days here, it is probably sensible.

Q66 ***Lord McGregor of Pulham Market:*** Could I come back to the £2,000 *de minimis* limit. I think you referred to the educational aspect of this. Do you mean by that that the self-employed and those not in employment will all be impossible to get at, to be made aware of the new changes, and that, therefore, it is going to be a burden on employers to do that? Is that what you mean by that? The second question is on what I might call the unintentional evasion of the tax. It seems to me that it is extremely difficult for HMRC to be able to follow through tiny sums of money. The illustrations you have given really are very, very small. Whereas there are means of checking these things in the UK, I do not see how it is going to be possible for them to do this, except at

extraordinary cost in administration and so on, to ensure compliance. The last question is: Does that lead you, therefore, to the view that it is better to confine the removal of personal allowances for capital gains tax for those who have to pay the £30,000 charge?
Mr Whiting: The education aspect is exactly as you have stated. Let us leave to one side those wealthy entrepreneurs who have advisers. Let us even leave the high-earning executive who has advisers. We are talking here about the large bulk of non doms who either are going to be in ignorance or look to other people for explanations. The Low Incomes Tax Reform Group already know that we are going to get customers looking for explanations, because we have already started to have them, but the great majority, if they look anywhere, will probably look to their employers. We just do not think the Revenue & Customs are geared up to assist, but that even assumes that these people have heard about this issue in the first place, and there we do not think the Revenue & Customs have really thought that they need to do an awareness campaign—to get Adam Hart-Davis to do another sort of jumping out of aeroplanes campaign or something on a non-dom basis perhaps The first stage is that there is a great problem about educating on the residence issue. Your question on evasion: from the low incomes tax point of view we have termed it inadvertent non-compliance.

Q67 ***Lord McGregor of Pulham Market:*** I did say unintentional.
Mr Whiting: People will just inadvertently not comply. If we go back to Lord Powell's point about low income remittances, let us bear in mind that somebody from Poland or wherever who is paying for things in the UK with his Polish credit card, is remitting funds which might or might not mess up the whole of this arrangement, so there is going to be a great deal of unwitting non-compliance. Frankly, we are assuming that the Revenue have just said, "We don't really want to bother with that. We are only interested in the £30,000," but if these people are perhaps slightly higher up the income scale, perhaps employed by the archetypal city bank, it is the bank/ the employer who is going to pick up the cost. What is the answer to this? Undoubtedly the best answer is that this loss of personal allowances only trips in, along with the £30,000, after seven years. Just to bring it right back to your first point, to education, one cadre we have continually highlighted is the student population. 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 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.

Q68 ***Chairman:*** The ATT memorandum accepts that the reason for computing the £30,000 charge in the way that the legislation does is a desire to ensure that the payment qualifies for credit against foreign taxes, particularly US tax. You state, however, that the chosen mechanism is neither simple nor clear. Do you accept that the objective is a good one? Do you have any thoughts on an alternative better mechanism?
Mr Meeson: My Lord Chairman, if one is going to do this £30,000 levy in some way, it is probably adding to the fairness (or reducing from the unfairness, whichever you chose to look at) by making it as creditable as possible against overseas taxes, but then, of course, it starts raising the question as to whether you are in fact penalising these people at all if they are getting a direct pound for pound offset somewhere else for what they are paying here, which raises our concern that effectively the levy itself is an administrative tax, rather than a financial tax, as much as anything else. That ties in also with our thoughts on the *de minimis*: that if you have this £2,000 *de minimis,* the Treasury is effectively saying, "We don't care about a certain number of people," and they are the ones for whom the tax take is £400 per annum, but that leaves a huge gap in the difference between people about whom £400 is acceptable and people about whom £30,000 is a price worth paying. It is an enormous scale and there are rather too many innocent (or more innocent) categories of people, as John has suggested, that fall within that.

Q69 ***Chairman:*** You reckon a lot of the people who are going to be paying the £30,000 are going to get tax relief against their foreign taxes anyway.
Mr Meeson: Some of them inevitably will. Some of them will not. It is certainly not going to be beyond the wit of man to arrange that one would do so, given that one has the choice of deciding which income and gains are subject to the £30,000 tax.

Q70 ***Chairman:*** Resident and domicile: are there any things you have not said that you wanted to say on that subject? You seem to have given some very comprehensive answers, but they came out in ways rather different from the way we originally thought.
Mr Whiting: We would just add one plea. Whatever the changes that have been made—and many of them have been very constructive—we do not have a complete package and one of the pleas we would strongly make is that HMRC and the Treasury,

needs to commit to keeping this under review and making further changes.

Q71 ***Lord Barnett:*** Not surprisingly, every year the Finance Bill will change it, for donkey's years ahead.
Mr Rigg: If it is kept under review, 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.
Mr Whiting: All I would be looking for is sorting out the anomalies.

Q72 ***Chairman:*** Let us go on to the third section: encouraging enterprise. Clause 28 increases the EIS investment limit from £400,000 to £500,000. Do you think this is a necessary change, given that the limit has been increased, as you know, from £200,000 to £400,000? Are you aware of any evidence suggesting that potential investors are wanting to make investments larger than £400,000?
Mr Cullinane: Not specific evidence. I can imagine there may have been. A lot of these questions revolve around the same point, which is when it comes to these special reliefs, given they complicate the tax system, and they treat some people differently from others, it seems to me you need an awful lot of evidence as to whether it is achieving something worthwhile. The general impression you get is that while a lot of good work is being done to quantify that, it does not hit you that it is making a great deal of difference.
Mr Whiting: 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.
Chairman: I think the way we asked the question indicates that we probably feel a bit like that ourselves.

Q73 ***Lord Barnett:*** I was wondering how effective all these reliefs are. Do you have any indication of how effective it is, set at the previous level or the current proposed level?
Mr Cullinane: In fairness, our members are largely tax practitioners. We are not economists or econometricians and so on, so the evidence is anecdotal. Probably, to some degree, it would hit us this way as tax practitioners: the client is already doing something or considering doing something and says, "Please do your best to get us the best tax treatment you can." We would tend to see situations where people are going to do something or they are considering doing something and the tax relief is extra. It may be that it is doing a great deal of good and it is not quite clear to us, but, again, it is not clear why the tax system should subsidise this good that is being stimulated in this way versus all the other good that might be done if it were put into generally lower tax rates. 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.
Mr Whiting: My own firm did a survey on exactly those areas on EIS. 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."

Q74 ***Lord Barnett:*** You would probably prefer, therefore, to drop it altogether.
Mr Whiting: The general evidence of the survey we did, which looked not just at this but at nine reliefs, was that the message coming back from business—and this is SMEs, the smaller businesses—was that they would prefer a lower rate of tax, a simpler system, and less reliefs.

Q75 ***Lord Barnett:*** Simple systems do not seem to be possible anyway, do they, in the tax system?
Mr Whiting: If you could get rid of some of the reliefs, many would prefer abolishing the reliefs and simplifying it that way and having a straight lower rate of tax.
Mr Meeson: The survey that John alluded to looks at the relief from the viewpoint of the company into which the investment is being made. Anecdotal evidence, looking at it from the other direction, from the point of view of the individuals making the investment into these companies, is particularly coloured by the fact that the independent financial advisory world has largely turned enterprise investment schemes, particularly venture capital trusts, into marketed commodities and the anecdotal evidence suggests here that the enterprise investment relief itself is not the driving factor. Most of the investments into the EIS and VCT are mainly ordered to retain the capital gains tax roll-over relief, and the income tax relief is, as John says, a bonus.

Q76 ***Lord McGregor of Pulham Market:*** There is a distinction between the two, is there not? I can see that the EIS is a capital gains tax roll-over relief element but the VCT is somewhat different. Mr Cullinane, I thought you were commenting from the investors' point of view—your own clients, as it were. Has not the VCT system as a whole—and in some cases it has raised quite a substantial amount of money—attracted higher rate taxpayers into using that relief in a way that they would not otherwise have done, and provided equity for companies themselves in a way they could not otherwise have got?

Mr Cullinane: I cannot claim that we as a body are getting scientific research into this. My general perception would be there are certain investors who are predisposed to a lot of ways of saving a lot of tax. Because there are so many of these types of things on the market at any one time, they will say, "Have you looked at VCT" and so on, so there is a certain amount of money that follows those opportunities around. Whether those companies could never have raised funds any other way, I frankly, if it is decent investment, rather doubt. I also have a suspicion that a great deal of the tax saving from the investors' point of view disappears to the organisers of these schemes and the tax saving effect appeals to certain investors' psychology as much as to cold assessment of their financial interest. In short, I am very, very sceptical of all of them. I do not say you could never justify any special treatment or any intervention; I am just very sceptical as to whether it either has the impact it does, or, if it does have an impact, whether it really makes sense to target those things and that other things that are therefore missing out as a result would not be equally beneficial.

Q77 ***Chairman:*** We have to face the fact that three of us here were Treasury ministers and probably at some time or other were responsible for producing some of these sorts of schemes. I do not think we are going to analyse the past, but would I be right in deducing from the tones of your replies that, if we were looking forward, whilst we would not look to you for guidance that this is likely to be a very important part of the fiscal system going forward, that is the message I am getting. I do not know if I am right. Others might but you do not.

Mr Whiting: Looking at it from a tax point of view, we acknowledge that it is there, it is a relief that we will make sure it is possible our clients, be they corporates or individuals, can claim. The acid test is: Is this raising extra money and is it getting that money for businesses that would otherwise be unable to get the funds? That is perhaps the key question, and whether the Government should subsidise that process. Maybe the people to ask are more the financiers than ourselves. Harking back to Lord MacGregor's question, there has been a lot of money generated, particularly through VCTs, that has sought and largely found investment. As the study by the University showed, it went to riskier businesses generally—and maybe that is a good thing. Whether the overall payback for the tax relief given was worthwhile is a very interesting question.

Q78 ***Lord Barnett:*** We could simplify the tax system a bit by dropping the whole damn thing.

Mr Whiting: You could indeed, my Lord.

Chairman: That really puts that particular issue to bed—for us, anyway. I am very grateful to you for coming along and, as usual, answering our questions and making comments which are highly relevant to what we are think of doing. We are very grateful to you. Thank you very much.

THURSDAY 1 MAY 2008

Present	MacGregor of Pulham Market, L	Sheppard of Didgemere, L
	Paul, L	Vallance of Tummel, L (Chairman)
	Powell of Bayswater, L	

Memorandum by the Association of Chartered Certified Accountants (ACCA)

The topics on which the Sub-Committee has chosen to focus its inquiry this year, bearing in mind its remit of considering technical issues of tax administration, clarification and simplification, rather than rates or incidence of tax, are:

Capital Gains Tax and the Entrepreneurs' Relief: Clauses 6 and 7, Schedules 2 and 3

In general we are highly supportive of tax simplification and clearly the Capital Gains Tax changes are simplification but with one eye on increasing tax revenues. In addition to this we need to keep in mind that there are two distinct and separate systems of Capital Gains Tax which not long ago amounted to a unified, single regime. We, of course, are talking about the two parallel systems for Income Tax and Corporation Tax. We do not, however, consider it appropriate to merge the two regimes if there would as a result be such a broad swathe of losers as has happened under the Income Tax Capital Gains Tax changes.

The primary concern we have is that the changes to Capital Gains Tax was announced with no consultation, hence required a subsequent rethink of the proposals. The same is true for the second topic of our meeting, on Residence and Domicile. In changing the Capital Gains Tax rules so abruptly the expectations that individuals had, for long-term tax obligations, were suddenly changed and the "allowances" they had built up over time in the form of indexation and taper relief were removed.

In addition, the message the changes sent out were also, perhaps, inappropriate and certainly contrary to what the Government message was previously, in that it seemed to signal that business activity was no longer held in such high esteem. While the change of heart in introducing the entrepreneurs' relief may go some way to offering reassurance to small businesses it only happened after significant business pressure.

The entrepreneurs' relief is welcome as a means by which to redress the tax expectations of businesses, and it goes some way in redressing the perception they may have had from the initial proposals of not being considered as important as they were under the previous Capital Gains Tax rules. However, the down side is that it has already re-introduced complexity to the original simplification proposals.

Residence & Domicile: Clause 22, Clause 23 and Schedule 7

Comment on Clauses 22 and 23 of the Finance Bill 2008 (as at 21.4.08)

Clause 22 changes the proposals on day counting for residence purposes. Instead of including both the dates of arrival and departure, clause 22 now only includes days when the taxpayer is present at midnight.

This substantially "frees up" the position in relation to transit passengers, so that it will now be possible for passengers to change airports or other terminals and to switch modes of transport without being regarded as resident for a day.

This is generally helpful (although the drafting could be better).

Clause 23 makes a few relatively useful changes in relation to the remittance basis as follows:

> The annual de minimus amount which will be dealt with on remittance basis without election has been increased to £2,000. How will this be audited.
>
> The much narrower definition of a relevant person given in Schedule 7 part 1 by the new section 809L now only refers to an individual's partner, child or grandchild under 18 and certain trusts and close companies. This takes remittances by other relatives outside the scope of the remittance provisions.
>
> The remittance basis charge of £30,000 is set out in section 809H. There is a change in the way that this is dealt with in that it will be treated as tax paid on nominated income and gains not remitted to the UK in that year. This is available for credit if the nominated income or gains is remitted in a later year,

although the ordering rules apply in such a way that the nominated amount cannot be treated as remitted whilst other untaxed income and gains remain unremitted. Perhaps there should be a change in the ordering rules.

The general identification rules should also be given more thought in relation to mixed funds. It is worth noting that section 809M provides that the identification should be carried out on a just and reasonable basis, but it should also be noted that the provisions in the bill are not final and will be subject to Government amendment. As things stand the overall effect is to treat taxable income as remitted sooner than previously.

Anti-Avoidance Measures

I do not think we can reasonably complain about the ending of source ceasing, but the abolition of the cash only rule may well lead to substantial time consuming arguments over value and whilst the exemption from charge on assets held at 11 March 2008 looks reasonable at first sight, it is probably going to lead to a good deal of work and confusion in practice.

One point which is unhelpful and in my view unreasonable is the denial of personal allowances and various other reliefs to a non domiciliary who opts for the remittance basis in respect of overseas income, but who has substantial UK income and gains on which UK tax is paid.

Clause 28, Clause 29 and schedule 11

Encouraging enterprise: Clause 28, Clause 29 and schedule 11, taking into account three documents published on Budget Day by HM Treasury and HM Revenue & Customs:

Enterprise: unlocking the UK's talent;

The Enterprise Investment Scheme: a consultative document; and

A Study on the Impact of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) on Company Performance (HMRC Research Report 44).

Encouraging enterprise: Response re Budget 2008

Taking into account three documents published by HMT and HMRC:

- Enterprise: unlocking the UK's talent.
- The Enterprise Investment Scheme: a consultative document.
- A Study on the Impact of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) on Company Performance, HMRC Research Report 44.

Enterprise: unlocking the UK's talent

This is a modest document that, in our opinion, reflects the Government's observed disenchantment with small businesses and offers nothing substantive to ameliorate the impact of tax increases introduced for SMEs eg abolition of the CGT taper, raising the small company's rate of Corporation Tax and the attack on income shifting. As such, the purpose of the document is political, ie to provide a platform for reassuring announcements whilst leaving government policy, as evidenced by behaviour, largely unchanged. Topics included are summarized below under "five enablers of enterprise" (their classification):

Culture

- Government policy will have three main streams of activity:
  - Reduce the stigma of bankruptcy by offering discretion to waive advertisements in the local press.
  - Inspiring young people around enterprise (eg through football clubs).
  - A high level media campaign around women's enterprise.

Knowledge and skills

— £30 million to extend enterprise education from secondary schools into primary and tertiary education.
— Peter Jones' National Enterprise Academy (NEA) as a first in a planned network.
— Enterprise among women, Regional Development Agencies (RDAs) to pilot Women's Business Centres (WBC).
— A Leadership and Management Programme with the RDAs.

Access to Finance

— Small Firms Loan Guarantee scheme strengthened by: a 20% uplift in lender allocations for one year; and extension to the eligibility for businesses with growth that are more than five years old.
— Supporting Community Development Finance Institutions.
— Improvements to the operation of Community Investment Tax Relief.

Regulation

— Consultation on introducing regulatory budgets for Departments (to exclude HMRC).
— HMRC to extend tax simplification by increasing a range of income tax self-assessment thresholds for reporting and payment arrangements for the smallest businesses.

Innovation

— Since 2000 R&D tax credits have delivered more than £2.3 billion through 30,000 claims.
— Budget 2007 announced increased rates of relief, from April 2008, from 150% to 175% for SMEs and from 125% to 130% for large companies.
— Under the SBRI programme Government must purchase at least 2.5% of their R&D from SMEs. In 2006–07 this figure was 6%, mainly accounted for by MoD.
— New Technology Strategy Board (TSB) created in 2007. TSB funds innovation through Collaborative R&D programmes, Knowledge Transfer Partnerships, Knowledge Transfer Networks and Innovation Platforms. During 2008–11, the TSB will invest over £720 million in innovation.

Consultation on the Enterprise Investment Scheme (EIS)/Venture Capital Trusts (VCTs)

According to the Budget Report, since inception, the Enterprise Investment Scheme (EIS) has raised over £6.1 billion, invested in over 14,000 small, high-risk companies, while Venture Capital Trusts (VCTs) have invested over £3.2 billion in over 1,500 companies.

There have been two evaluation studies:

1. Study of the Impact of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) on company performance, HMRC Research report 44, 2008.
2. Research into the Enterprise Investment Scheme and Venture Capital Trusts, A report prepared for Inland Revenue by PACEC, 2003.

Both report positive outcomes, but the former notes that the added value of the schemes is currently small and that they should be judged over a longer period of time for the true effects to be known.

ACCA support the continuation of the schemes, especially as it has recently become even more difficult to obtain conventional bank finance.

29 April 2008

Memorandum by the Institute of Chartered Accountants in England and Wales (ICAEW)

Introduction

The Tax Faculty of the ICAEW welcomes the opportunity to submit evidence in response to the Sub-Committee's 2008 inquiry.

Details about the Institute of Chartered Accountants in England and Wales are set out in Annex 1.

Overall, the Institute is most concerned about the absence of sound tax policy formulation in the months preceding the 2008 Budget. Both the Capital Gains Tax (CGT) and residence and domicile proposals in particular inadequately preserved the reasonable expectations of taxpayers, did not benefit from the proper consultation, and did not achieve an effective balance against fairness concerns. The Institute also believes that the intended revenue raising product of measures proposed as within a "simplification programme" undermines public and stakeholder support for the simplification agenda.

The Institute believes that several measures can be taken at this stage, detailed below, to ensure more effective tax policy outcomes.

Executive Summary

- We are concerned about the way in which the CGT flat-rate was introduced and believe that tax policy formulation needs to be improved, incorporating a balance against fairness and the need for consultation and preserving the reasonable expectations of taxpayers. The policy formulation of the CGT flat-rate failed these requirements.
- CGTis designed to increase revenue yield. The ICAEW believes that a tax simplification programme should be broadly revenue neutral.
- The ICAEW believes that the "Entrepreneurs' relief" limit should be indexed in line with inflation and would benefit from alignment with the pensions lifetime limit. The limit should in any event be kept under review to see whether it discourages investment by serial entrepreneurs.
- Residence & domicile proposals now place a fundamental importance on establishing whether a person is resident in the UK for tax purposes. This highlights the fact that the existing residence test, which is based primarily on old case law and HMRC practice, no longer provides a satisfactory basis for establishing liability to UK tax and introduces a level of uncertainty that places the UK at a disadvantage as compared to our international competitors.
- The domicile and remittance rules announced in the 2007 Pre Budget Report demonstrate further lack of adequate tax policy formulation and consultation.
- We continue to have concerns about the draft clauses of residence and domicile proposals. The legislation is highly complicated, much of it is incomprehensible and we think that taxpayers will find it hard to comply with these rules, thus undermining the culture of good tax compliance that is fundamental to the UK system.
- ICAEW believes that the overall changes, as opposed to the Budget Red Book projections, will result in a net loss of revenue to the UK due to unforeseen and unanalysed behavioural impacts.
- Many non-domiciles affected by the changes will not be particularly well off and may not even realise that they face an increased tax bill in the UK. The ICAEW remain of the view that the de minimis should be set at a higher level.
- We remain concerned that HMRC will also need extra resources to implement and monitor the proposed changes at a time when HMRC's budget is being cut in real terms over a three-year period.
    - a detailed review of the various schemes in existence and whether they are cost-effective in generating successful investment in growing businesses that would not otherwise have been made;
    - that there should be a survey of EIS investment levels pre and post the FA 2006 changes; and
    - there should be a more general review of investment tax incentives including details of the schemes and their success in increasing investment, their costs to the Exchequer, how EU state aid rules are likely to impact on them and whether there is a principled ease for change.

Capital Gains Tax and Entrepreneurs' Relief: Clauses 6 and 7, Schedules 2 and 3

CGT simplification

The move to a flat-rate CGT is a potentially welcome simplification, but we are concerned about the way in which the flat-rate was introduced and believe that tax policy formulation needs to be improved. Tax simplification is not a principle that can be considered in isolation: it needs to be considered within a broader framework of principles which we have identified as the ten tenets (set out in the Annex 2). In particular, tax simplification needs to be balanced against fairness and the need for consultation.

The rate of CGT is ultimately a political question for the Government. Whilst any tax simplification is likely to 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.

The change will create a considerable number of business losers. In particular, many businesses and employee shareholders who previously would have qualified for the 10% CGT rate will not qualify for entrepreneurs' relief and will therefore face an 18% CGT rate rather than a 10% rate.

Preserving reasonable expectations

We think it is important for the integrity of the tax system that it should respect taxpayers' reasonable expectations. When taper relief was introduced in 1998, the existing entitlement to indexation was preserved, which was a measured and reasonable transition to the new taper relief system. The blanket withdrawal of indexation and taper relief fails to respect this need.

The need for wide consultation

In view of the fundamental change which is proposed, this measure should have been first subject to wide consultation. This principle of full consultation on all proposed policy changes is reflected in the Code of Practice for consultation for the Revenue departments, which states that *The Govemment intends to consult on tax policy matters wherever it is reasonable to do so*.

The Code sets out four benefits arising from consultation, namely that it:

- allows a national debate to take place on the major tax policy decisions that affect all taxpayers;
- enables everyone to have a better understanding of the likely impact of proposals on businesses and individuals;
- enables Ministers and officials to consider the merits of alternative suggestions, or whether the Government's proposals can be improved in the light of comments made; and
- improves the quality of any resulting draft legislation, in particular by ensuring that it works in the real world.

We believe that the proposed CGT reforms clearly met the criteria for consultation and that a full public consultation would have provided all four of the benefits set out above. We accept that there may be some times when consultation is not appropriate, and the Code sets out four possible areas:

- where there is a significant risk of forestalling;
- which are market sensitive and could lead to significant temporary distortions in taxpayers' and market behaviours;
- where it is necessary to act swiftly (eg to take anti-avoidance measures); and
- where policy develops significantly in the period between the pre-Budget Report and the Budget proper.

We appreciate that a major reform CGT is market sensitive and is likely to lead to significant distortions, but we do not think that these concerns were sufficient to outweigh the benefits that would have arisen if there had been proper consultation beforehand.

Clause 7 and Schedule 3

These enact the new "entrepreneurs' relief", which was announced on 24 January 2008. This relief, which is based upon the Capital Gains Tax (CGT) retirement relief rules which were phased out beginning in 1999, provides that gains of up to £1 million on the disposal of all or part of business are taxed at an effective rate of 10% rather than 18%. We recognise that the £1 million limit is a policy decision and understand the rationale for it. However, given that the new relief is aimed at entrepreneurs rather than business people looking to retire, we are concerned that the £1 million limit will not necessarily encourage "serial" entrepreneurs to reinvest in new businesses. We think that the limit should be indexed in line with inflation and to simplify matters there would be some logic in aligning it with the pensions lifetime limit. The limit should in any event be kept under review to see whether it discourages investment by serial entrepreneurs.

We appreciate that this new relief includes a number of welcome simplifications as compared to the old retirement relief rules, but those rules were not without problems and many of these are re-enacted in the new relief. The rules for partnerships and companies are not identical, with the latter being generally more restrictive in that the shareholder must be an officer or employee and own 5% or more of the voting rights. We question whether the old retirement relief restrictions on personal holding companies are still appropriate, particularly given the advent of LLPs as an alternative business structure.

The legislation reintroduces the "whole or part of the business" test that was such a problem for retirement relief for unincorporated businesses. This contrasts with the position for shares and securities where it seems that any disposal, however small, can qualify.

The 12 month ownership compares favourably with the ten year ownership period for retirement relief. Nevertheless, it would have been simpler if the definition had been aligned with the substantial shareholding exemption. This allows for any 12 month period within the previous 24 months. This change would mean that there was one common definition and would allow slightly more flexibility to a taxpayer who is in the process of extracting himself from a business.

Restriction on let property (section 169P)

The rules will operate to deny relief for associated disposals in circumstances where we think it should be available. The point is best illustrated by using an example which was set out in a document which was published on Budget Day providing examples of how the new relief would work in practice.

Example

Mr R has been a member of a trading partnership for several years. He leaves the partnership and disposes of his interest in partnership assets to the other partners, realising gains of £125,000, all of which qualify for entrepreneurs' relief. He also sells the partnership office building which he owned outright, but let to the partnership, realising a gain of £37,000. The disposal of the office building is "associated" with Mr R's withdrawal from the partnership business, and the £37,000 gain therefore also qualifies for entrepreneurs' relief (assuming there is no restriction on the amount of the gain qualifying for relief as a result of non-qualifying use).

Our understanding is that entrepreneurs' relief will only be available in relation to the office building if it was let "rent-free" to the partnership for the whole of the period of ownership. The problem is that even if rental arrangements are changed from 6 April 2008 and any property is let rent-free, the test of whether the asset was an investment is by reference to the complete period of ownership, which will include any period of ownership prior to 6 April 2008. It therefore seems to us that the requirement to include the period of ownership prior to 6 April 2008 will restrict the availability of relief even if the taxpayer seeks to amend the position for the future. We appreciate that this provision is subject to a "just and reasonable" test but we believe that the period of ownership prior to 6 April 2008 should not be taken into account for these purposes.

Disposals by trustees—section 1.69J

In relation to disposals by trustees, it is necessary for the company to be the qualifying beneficiary's personal company, ie the beneficiary needs to own 5% or more of the company. This seems unduly restrictive given that the beneficiary may not own shares personally in the company and we think that the provision should be amended and that the condition is by reference to the shares owned by the trustees.

Residence & Domicile: Clause 22, Clause 23 and Schedule 7

Clause 22, Periods of residence

The clause amends the way in which days of presence are counted for determining the amount of time spent in the UK. Given the fundamental importance of establishing whether a person is resident in the UK for tax purposes, this change highlights the fact that the existing residence test, which is based primarily on old case law and HMRC practice, no longer provides a satisfactory basis for establishing liability to UK tax. Current HMRC practice in this area is unclear, often ambiguous and highly uncertain in application. The result is that individuals can be present In the UK without knowing if they are or are not tax resident. The lack of certainty puts the UK at a disadvantage as compared to our competitors.

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 (subsequently consolidated in 1997) 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.

Clause 23 and Schedule 7, Remittance Basis

The drafting of the legislation

The reform of the domicile and remittance rules was announced in the 2007 Pre Budget Report (PBR). Whilst reform of these rules was expected, as with the CGT changes described above we are concerned at the approach adopted to tax policy formulation and think that it needs to be improved in consultation with stakeholders. More time should have been given to consult on any proposed policy changes and then an adequate transitional period given so as to ensure that taxpayers' legitimate expectations are respected.

In addition to the increase in tax charges on non-domiciles, the proposals impose potentially onerous new compliance requirements on many non-domiciles. Many of the original proposals.also imposed tax charges which went against the legitimate expectations of taxpayers, although we recognise that many (although by no means all) of these concerns have been addressed in the draft legislation. However, a significant part of the legislation remains unfinished even though it comes into effect on 6 April 2008. We do not think that this is a satisfactory situation and it certainly does not provide certainty. We remain of the view that it is unfair to taxpayers not to have deferred the implementation of these aspects of the legislation until 5 April 2009.

We continue to have concerns about the draft clauses. The legislation is highly complicated, much of it is incomprehensible and we think that taxpayers will find it hard to comply with these rules, thus undermining the culture of good tax compliance that is fundamental to the UK system.

The economic justification for change

We remain concerned that the changes will result in a net loss of revenue to the UK. Whilst the Budget Red Book predicts that the changes will increase revenue, we remain concerned that no economic and sensitivity analyses have been prepared to support the change and that behavioural impacts will result in the opposite effect to that intended.

The impact of the changes on "ordinary" non-domiciles

The focus of these changes is on extracting more tax from the "super rich" but the need to formally claim the remittance basis and the loss of personal allowances and the CGT annual exemption will increase the tax rate on all non domiciles, many of whom will not be particularly well off and who may not even realise that they face an increased tax bill in the UK.

The increased administration burdens

In addition to the increased tax charges, the changes will also impose significantly higher administrative burdens and associated costs on many non-domiciles. This is because they will now need to take advice on their UK tax position and they may now need to complete a UK tax return whereas currently many non-domiciles do not need to do so. The raising of the *de minimis* limit from £1,000 to £2,000 announced in the

Budget was a welcome announcement and this will help to alleviate some of the compliance burdens, but we remain of the view that the *de minimis* should be set at a higher level.

We remain concerned that HMRC will also need extra resources to implement and monitor these changes and that the strains that will be imposed could be considerable at a time when HMRC's budget is being cut in real terms over a three-year period.

Encouraging Enterprise: Clause 28, Clause 29 and Schedule 11

These schemes are aimed at encouraging investment but we are not convinced that taken as a whole they are as effective as they once were and that the changes in this Finance Bill are unlikely to improve the attractiveness of the schemes.

We also note that EU state aid approvals for EIS and VCTs are still being sought and there must be some doubt as to whether these will be forthcoming or whether further changes might still need to be made to make the schemes acceptable (or indeed whether state aid approval is refused).

We believe that the halving of the gross assets limits in 2006 so as to comply with EU state aid rules have generally rendered these schemes much less attractive than hitherto. Anecdotal evidence suggests that few investments are made using EIS and we suspect that the increase in the limit from £400,000 to £500,000 will have little practical effect. It would be useful if the Government made a survey of EIS investments before and after the 2006 changes as we believe that this would identify more clearly the reduction in the number of EIS investments.

The list of excluded activities is also extensive and again EU state aid rules are merely likely to restrict further the activities that qualify. In this context we note that shipbuilding, coal and steel production are now also excluded activities for the purposes of the EMI scheme (see clause 30). Our conclusion is that investment reliefs such as these are likely to remain under pressure at the EU level and that the continued attractiveness of these schemes in encouraging general investment is likely to be limited.

More generally we are concerned that:.

- there are too many investment schemes, leading to confusion;
- they are too restricted in terms of investment limits and activities;
- the detailed rules are too complicated, thus adding to the complexity of the tax system at a time when the government is committed to simplifying the tax system; and
- they are too vulnerable to challenges under the EU state aid rules which are likely to preclude addressing the above issues.

The studies and consultation documents are useful but we think that the time has come for a more general review of tax incentives for investment and, in particular:

- a detailed review of the various schemes in existence and whether they are cost-effective in generating successful investment in growing businesses that would not otherwise have been made;
- what are their costs to the Exchequer;
- how the EU state aid rules are likely to restrict any schemes;
- whether there are other more cost effective ways of encouraging investment that do not fall foul of state aid rules; and
- whether there is a principled case for simplifying or even abolishing these schemes whilst improving the general climate for business investment.

April 2008

Memorandum by the Institute of Chartered Accountants of Scotland (ICAS)

The Institute of Chartered Accountants of Scotland welcomes the opportunity to give evidence to the House of Lords Committee considering aspects of the Finance Bill 2008 and related consultation documents. In this draft response we have followed the order of the questions issues in the March 2008 consultation document published by HM Revenue & Customs and HM Treasury.

The Enterprise Investment Scheme

Before Investment—The Investee Company

Q1 *In October 2007 PricewaterhouseCoopers Ltd published the survey "Enterprise in the UK: Impact of the UY tax regime for private companies", which showed 65% of respondents were aware of the EIS—up from 52% in 2006. What more can be done to continue this trend of increasing awareness of the scheme?*

A1 Given the restrictions regarding connection with the company prior to the raising of capital through EIS, it is of extreme importance that any potential investors in a business are aware of EIS as early in the process as possible. We do not think, however, that any amount of publicity will ever mean that awareness is at an acceptable level. There does not seem to be a problem with this in the EC state aid rules.

Although this may increase compliance costs and discourage some investee companies from proceeding (see our comments at Q3 below), if HMRC think that avoidance is the issue here, further debate and consideration of a GAAR restricted to VCT/CVS/EIS might enable some of the restrictions to be removed.

Q2 *Is there anything in the broader regulatory regime that hampers investee companies seeking external investors under the scheme? If so, how could this be addressed?*

A2 The problem with EIS is that the legislation is so complex and subject to differing interpretations. What is needed here is a lighter regulatory touch and a set of unambiguous rules so that the costs of setting up the scheme are not prohibitive to the investee company. In our opinion that can only be possible where you have acceptance by Government that there will be some tax lost through simplification. In practice, many professionals find the EIS intimidating and fear of making a mistake deters many from starting the process.

Q3 *How well do advance assurances serve their purpose? Are there any ways in which the process of gaining an advance assurance could be simplified?*

A3 It remains the case that very few investee companies could complete an application to HMRC for advance clearance without knowing the rules; otherwise how do you know what is important to disclose? One answer is that you disclose everything but that could be a prohibitively long and costly process. The most usual answer is that you engage a professional advisor to do it for you if you can find one sufficiently skilled to feel able to take on the work.

The answer of course, is to simplify the system as a whole and expect to lose some tax at the margins. As suggestions, the losses could be kept to a minimum by setting a two-tier system, one for small companies and another for medium sized companies. The smaller companies regime would be very light touch and simple to follow. The other could be more regulated.

Q4 *The list of excluded activities (see Box 2.1) has remained largely unchanged since the inception of the scheme. Do respondents feel it has kept up with commercial and technological developments? Are there any anomalies affecting particular industries or sectors?*

A4 We think that the list system is preferable to any other. However, some sales are qualified by the number of times the product is used and this can give the appearance of a leasing arrangement. Any disputes or uncertainty adds to cost, absorbs management time and detracts from making an EIS attractive to raising finance.

Q5 *How well does the current control test achieve its objective of focusing relief on financially independent enterprises that have most difficulty in raising capital?*

A5 We do not have objections to the independence test. We cannot think if any reason why you would disadvantage any small businesses as a group structure is probably not appropriate for most at the seed capital stage.

Q6 *The Sainsbury Review of Science and Innovation recommended that "The conditions of the EIS concerning the time constraints for the start of trading and the expenditure of money raised should be reviewed". While the Government believes that it is necessary to preserve rules requiring the investment to be put to good use promptly, views are welcome about how the requirements might be refined in practice, especially whether there are particular industries that they do not fit well (for example, those whose ability to commence trade is dependent on potentially long regulatory approval procedures)?*

A6 We think what needs to happen here is that there is some "wriggle room" is built into the rules whereby companies can obtain an extension to the limit in certain circumstances such as factors beyond their control eg difficulty in obtaining loan finance makes it hard to complete the funding package in time. In addition, there should be no time limit on say 20% of the funds. It is known that certain trading activities are frustrated by the time constraints especially where planning approval is required. By "wriggle room" we suggest an amendment to Section 175 ITA 2007 to add at the end of (3) the words (c) or such later time as the Board may by notice allow.

It is commercially unrealistic to expect companies raising funds to know exactly when and how much funds are needed and a relaxation on the 20% would allow companies to err on the side of caution. Raising too little equity is a serious mistake.

Section 179 ITA 2007 defines a qualifying business activity to be a qualifying trade carried on wholly or mainly in the UK. This can cause difficulties for high tech companies wishing to export and needing to set up a foreign sales force.

Before Investment—The Investor

Q7 *Is there an adequate level of awareness among potential investors of the existence of the EIS? If not, do you have specific proposals regarding how investor awareness could be increased?*

A7 There is not an adequate awareness. HMRC should consider TV advertising or simplify the rules to make advertising the scheme unnecessary. It might be worth considering whether information held on HMRC's database might be used to identify taxpayers who should consider EIS investment and targeting better a campaign of awareness.

Q8 *Is there anything in the broader regulatory regime that hampers external investors seeking potential investee companies under the scheme? How could this be addressed?*

A8 We think the main thing hampering investors seeking individual companies is the fact that EIS funds exist. If we were investing through EIS we would always go to a fund to take away the risk that procedures had not been followed correctly leading to the loss of relief. This will be exacerbated through the new penalties regime which puts the emphasis on the individual taking reasonable care. Presumably HMRC will consider anyone with an EIS investor to be a relatively experienced investor who should know the rules of the scheme. EIS investment is notoriously complex and many external investors are deterred from further consideration because of the fear of getting it wrong.

Q9 *Could any added value be gained from adapting the carry back provisions to all carry back or carry forward for one year either side of investment?*

A9 That would be welcome but it does not help with the fundamental difficulty of EIS—complexity. There is a fear that the complexity can have unforeseen and unpredictable consequences. For example a loss claim made under Section 381 ICTA 1988 (Sections 23, 24 and 72 ITA 2007) could eliminate taxable income for earlier years.

Q10 *Are there examples where the rules surrounding connected parties work in a way that seems anomalous to, or at odds with, the purpose of the scheme?*

A10 At is most fundamental level the scheme is there to provide growing companies with seed capital because loan capital funding is inappropriate due to the riskiness of the business. As most businesses start as family affairs to some extent at least with mother/father/grandparents funding the start-up, it seems anomalous to us that these are the very persons excluded by the connected persons rules. By removing those rules you would allow the business to start, concentrate on producing a product the then attract further EIS funding from funds or individuals.

We would also point out that the founder directors/employees behind setting up the business should always be allowed to own EIS shares and that they should be able to own more than 30% and that it need not be ordinary share capital. The EC state aid rules talk about quasi share capital (eg asset backed loan stock) and do not talk about connection being an issue. It is recommended that some revision of the rules on connected parties might encourage better corporate governance by encouraging non executive directors. A compromise might allow a cap on pay for the right non executive directors to be recruited and encouraged to invest.

Before Investment—HMRC

Q11 *Are HMRC or other Government departments missing any opportunities to raise awareness of the scheme among potential investors and/or companies? Is there anything that HMRC or other Government departments are doing that impedes the links between potential investors and companies?*

A11 See previous comments.

Making the Investment

Q12 *Are there any ways in which the process of obtaining EIS relief (or the forms themselves) could be simplified?*

A12 The forms are not the problem, it is getting to the point of completing the forms that is the problem ie is it qualifying and does the investor qualify?

The Three-Year Qualifying Period

Q13 *Is three years a sensible time period for the company to have to continue meeting the qualifying conditions to ensure that the funds raised under the EIS are being used according to the policy objectives of the scheme?*

A13 We think it is probably not necessary because there will be a limited secondary market for the shares anyway unless someone creates one. In that circumstance you could have avoidance and early withdrawal of capital but we do not see that as a realistic possibility when there is already a GAAR for financial products that could be extended to cover here.

Q14 *What more could be done to ensure that companies meet their obligations and avoid accidental breaches?*

A14 Simplify the system and accept some limited tax leakage.

Q15 *Are there alternative ways of treating breaches of the requirements that still support the scheme's objectives and deter misuse, but apply more proportionately?*

A15 Rather than have an "all or nothing" approach why not use a sliding scale that distinguishes between deliberate and non-deliberate breaches. Proportionality seems sensible.

EIS Funds

Q16 *Are there any procedural or administrative aspects of the processes concerning EIS funds that you feel could be simplified. If so, how?*

A16 Not that we can think of.

Other

Q17 *Do you have any other suggestions on how the administration of the EIS could be simplified and/or improved?*

A17 See above.

Residence and Domicile: Clause 22, 23 and Schedule 7

Introduction

Since the announcement in the Pre-Budget Report (PBR) on 9 October 2007, that major changes to UK tax law and practice in this area were to be made there has been significant uncertainty as the proposals have changed on many occasions. The draft legislation and full details of the changes had been promised for publication before Christmas 2007 (itself some 2½ months after the PBR. However, it was not until 18 January 2008 that these were published.

Whilst there has been consultation by HM Revenue & Customs (HMRC) (who are to be congratulated for taking account of the concerns raised by this Institute and the other Professional Bodies), the frequency of change in the run up to commencement on 6 April 2008 when affected individuals, companies and trustees were seeking to understand the impact of the changes and determine what action to take made it extremely difficult for them to do so.

The problem is compounded by the fact that the Finance Bill provisions are not final as stated in the Explanatory Notes by HM Treasury. The HMRC website has sought, with some success but also with some problems, to set out the updated version of what is proposed. It cannot be sensible for the proposed legislation as published in the Finance Bill to require so much revision. Indeed, before the Bill was available to the public, the detail was already out of date in many aspects. Some of the proposed revisions are as a result of representations made in the consultation and others as an apparent result of threats from many non-domiciled individuals to leave the UK taking wealth and business interests (many providing UK jobs) with them.

In our view, all of this demonstrates the need for effective consultation to take place with sufficient time being given for proper discussion of the concepts as well as draft legislation so that the conclusions of that process are then presented in the Budget with the Finance Bill containing the final legislation (subject to any amendment made in the Parliamentary process) but without it requiring significant amendment from the consultation process.

Whilst it is for Ministers to determine policy, the outcome has to be capable of being operated by both taxpayers (and their advisers) and HMRC with sufficient certainty that once the legislation is seen in the Finance Bill that will be the final form subject only to minor change rather than wholesale surgery.

We now deal with some of our specific concerns.

Test of "Residence in the UK"

Despite the change to count any day in which an individual is in the UK at midnight, we take the view that there will still be substantial uncertainty as the test will still be heavily dependent on existing case law and HMRC practice. We would prefer a clear statutory test as is the case in many other countries and which is consistent with the approach taken elsewhere.

We welcome the exception to the "in the UK at midnight" test for transit passengers. There will inevitably be potential for litigation as to when the new Section 831 (1B) ITA 2007 will apply.

Personal Allowances and the Remittance Basis

There are significant numbers of migrant workers in Scotland and other parts of the UK—with large numbers from Eastern Europe and the Indian Sub-Continent. The vast majority of these workers will retain their domicile outside the UK and will, therefore, be "non-domiciled" within the terms of the proposed new legislation despite having been in the UK for many years. These workers are likely to have income arising in their home country especially where they spend part of the year in the UK and part in their home country. Whilst the amount of this income may well be within the £2,000 *de minimis* amount (the doubling of which from the original proposal is welcomed) in some cases, the effect of the new legislation will be that such individuals will have to file UK Self Assessment Tax Returns to disclose that income and to deal with any potential double taxation. Failure to do so will mean that such individuals will be non-compliant in respect of their UK tax obligations despite their UK income being dealt with, commonly, under PAYE. It is unreasonable, and arguably contrary to Human Rights legislation, that new UK tax rules should be introduced with this effect without adequate time having been given to allow such individuals to be made aware of these new obligations. In general, such individuals will not have Tax Advisers and many do not have adequate skills in English to be able to ascertain the full extent of their UK tax obligations. Time will also be required for HMRC staff (in Contact Centres) to be trained in the new rules as applicable to this group in the population. The necessary language skills for HMRC staff will also need to be adequately resourced.

We would have preferred the *de minimis* limit for unremitted overseas income to have been set at a more reasonable figure to take these individuals out of UK tax in respect of the overseas income (where it will normally be subjected to tax in the source country)—especially where, in terms of the new rules, such individuals may lose their right to the UK personal allowance for income tax purposes and the CGT annual exemption (although this is likely to be of much less concern in such cases). We recommended, and still do, that a level of £5,000 (approximating to the personal allowance) would be fairer in such circumstances. In addition, we do not think that it is reasonable to require that individuals with small levels of unremitted overseas income should lose their UK personal allowance as this will impact on low paid migrant workers against whom the policy does not appear to be directed.

It cannot be the Government's intention to create a system which inherently puts a large number of low-paid migrant workers (who are essential to the UK economy) in a state of non-compliance with their UK tax obligations.

Meaning of "Remittance"

The new Section 809K defines a "remittance" to the UK (of overseas income and gains) to include "property" being brought into the UK.

In the case of migrant workers, as described above, we are concerned that, for example, the bringing to the UK of a vehicle or the tools of the trade for, say, a Polish plumber where these items had been purchased out of non-UK funds—perhaps several years before there was any intention of coming to the UK, will amount to a remittance of a sum equal to the original cost of such items.

Relevant Persons

The new legislation defines "relevant persons" for the purposes of Sections 809K to 809N. Section 809L (3)(a) provides that a man and woman (who are not married to each other) living together as husband and wife are treated as if they were husband and wife. This is in essence a "common law spouse" (or civil partner as there is a similar provision for same sex couples). This is inappropriate as such a concept is no longer found in Scots Law having been abolished by the Family Law (Scotland) Act 2006 as we understand it. We also believe that such a status is not available elsewhere in the UK. It seems to fly in the face of Human Rights legislation that such status might be introduced for certain individuals from overseas but is not applied for taxation purposes to the UK population at large.

Conclusions

We are of the view that there are many lessons which ought to be learned from what has happened since the PBR in relation to these changes. Among these are the need to consult at an early stage with the Professional Bodies and others to ensure that a policy decision can be implemented fairly and effectively. There can be little doubt that the early version of the proposals gave an impression that non-domiciled individuals were not welcome in the UK.

We consider that too much concern was expressed about how to tax wealthy non-domiciled individuals without adequate recognition of the impact that the proposals would have on much less wealthy individuals to whom the provisions would also be applicable (as discussed above).

28 April 2008

Examination of Witnesses

Witnesses: Mr Frank Haskew, Head of the Tax Faculty, and Ms Francesca Lagerberg, Chairman of the Tax Faculty's Technical Committee, Institute of Chartered Accountants of England and Wales; Mr Derek Allen, Director of Taxation, and Mr Alex McDougall, Institute of Chartered Accountants for Scotland; and Mr Chas Roy-Chowdhury, Association of Chartered Certified Accountants, examined.

Q79 *Chairman:* Welcome to some old friends and the occasional new face. We are delighted to have you along this afternoon. As you know, the Committee this year is going to be focusing on three aspects of the Finance Bill, namely, capital gains tax, residence and domicile and encouraging enterprise. You have all let us have some very useful written evidence, which I am sure the Committee has read with care. If you have initial statements to make then by all means make them. If not, we will launch straight into questions. Do you want to make any opening statements or shall we take your written ones as read?
Ms Lagerberg: We are happy to go with the written statement.

Q80 *Chairman:* Thank you very much. What we would like to start with, before we look specifically at each of the three items in turn, is to spend a few minutes on the general issue of consultation because I think most witnesses, not just yourselves, have said this could have been a good deal better process had there been better and earlier consultation. That could be read as a bit of motherhood and apple pie because it is very easy to say consultation helps things. I wondered if you could tell us a little bit more about what kind of improved consultative process there might have been on these two issues of capital gains tax and domicile and residence.
Ms Lagerberg: Opening up from the ICAEW's perspective, consultation is a tricky beast because sometimes you cannot build in the time that you might want on consultation because things move very quickly. 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. From a capital gains tax perspective we knew there was going to be a relief, we just did not know what. From the residence and domicile point of view we knew that the proposals announced in October were very ill-defined because the detail was not available at that stage. Again, people knew something was going to happen, but there was a lot of uncertainty about what that something would be and what people were desperately trying to find out was, "What does it really mean for me?" They 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. This was not about forestalling or having to bring in legislation to stop avoidance, this was about sensible tax change, but it was done in such a way that it raised a lot of concerns and very little information was provided until, to be honest, they had four to five weeks to make sensible decisions that were life changing if it involved not being based in the UK.
Mr Roy-Chowdhury: Just to add to what Francesca has said, I fully agree with everything that was said but 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. We knew that there were changes afoot, that discussions had been had, but at no time was there a proper consultation going on, no document produced. For example, I sent two emails in to the Treasury to try and participate in the consultation but there did not seem to be any mechanism by which you could actually enter it. To give an example where consultation has been very good, which is digressing slightly from the two areas that you mentioned at the beginning, 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.

Q81 *Chairman:* Is not the Government a bit between the devil and the deep blue sea here, certainly in terms of the degree of definition that it comes out with as a start. If it is relatively open in terms of what it is looking for then there is a great deal of scope potentially for consultation, but I think from listening to what you were saying you would have preferred something more definite.
Ms Lagerberg: I think with these particular proposals, when the decision had been taken that there would be a change to a flat rate system of CGT that was not a proposal that was open for discussion, that was given very much as, "We have made this decision, this is going to happen" because the consultation there was all about would there be any relief. In fact, we had 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, whereas 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. They were two very good examples of how not to do consultation because they raised expectations without delivering clear messages and they also did not build on some of the previous work that had taken place.
Mr Haskew: Just building on that. We have obviously had these evidence sessions with your Committee now for a number of years and consultation has been an issue at almost every single one of them. A couple of years ago, for instance, we gave evidence in relation to all the IHT changes where the same points were being made again, and here we are this year making exactly the same points. There is a trend here 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.

Q82 ***Chairman:*** If you do have open consultation early on, I think one of your colleagues said you listen to the ones who shout the loudest. Does that not give an opportunity for those who shout loudly to change or derail the proposals almost before they start?
Mr Allen: If I could chip in here. I think that consultation is an essential element, but everybody recognises that there cannot be consultation when there is a need to forestall or to close an avoidance loop. In principle, we support any move to simplify our regime because it is a self-assessment regime and certainly there are areas now which have got beyond the ability of the average, or even the way above average, taxpayer to self-assess. In principle, we would be fully supportive of any move which was going to simplify the tax regime and, therefore, bringing in a flat rate of 18% would have our full support, but the process was not really intended to be a revenue raising exercise and, therefore, there could have been consultation in an attempt to ensure there was a degree of equity and that people then had confidence that the system itself was not going to change, basically making investment decisions that they had made many years ago punitive or negative. We would accept that consultation is not possible where there are avoidance loopholes to be closed, but where it is a reform of the system, particularly with a view to simplification, we would have hoped that you do not need to do it in the timetable of a Finance Bill process and, therefore, you could do it better.

Q83 ***Chairman:*** Setting aside the issue of forestalling and avoidance, I think we understand that. When there is a system change of this kind could you set out quite clearly what you think the real desiderata are of a consultative process under those circumstances?
Mr McDougall: It might be worth thinking about that by reference to the capital gains changes this year. The announcement was made on 9 October in the Pre-Budget Report. Within a fortnight or so of that there were reports in the press, coming allegedly from the Treasury, that there was going to be some form of relief. 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. At that point we were also told that the reason the PBR was early compared to previous years was that given the change it was to allow taxpayers to make an informed decision as to whether they wanted to make a disposal within the old regime or within the new regime, yet it was not until February that we actually got the details of the entrepreneurs' relief even though on several occasions we had been promised it before Christmas, early in January and it did not actually arrive until February. One of the desiderata really is if time is given where a change to the regime has been announced, it really is necessary for sufficient detail to be available early so that where we had effectively six months in that case, not only could people make informed decisions but actually the professional bodies and others could work with HMRC and the Government to try and get the thing in a workable position so that some of the difficulties that have arisen did not actually happen.

Q84 ***Chairman:*** I do not know whether any of my colleagues want to follow up on that issue, but I wonder whether you might consider helping us by not just saying what you think of the criticisms of the consultative process but perhaps a little supplementary note which sets out what would be your ideal form of consultation in circumstances of this kind where we are not talking about avoidance.
Mr Roy-Chowdhury: Would you like a roadmap now?

Q85 ***Chairman:*** No, if you can do that for the clerk later that would be great.
Ms Lagerberg: We would be happy to do that.

Q86 ***Lord MacGregor of Pulham Market:*** Can I ask you a question about consultation now, and I would like to take as my peg two of the comments that you have made to us. The ICAEW said: "We continue to have concerns about the draft clauses of residence and domicile proposals. The legislation is highly complicated, much of it is incomprehensible and we think that taxpayers will find it hard to comply with these rules . . . " That is one. I think the other is the Scottish Institute which said: "The problem is compounded by the fact that the Finance Bill

provisions are not final as stated in the Explanatory Notes by HM Treasury. The HMRC website has sought, with some success but also with some problems, to set out the updated version of what is proposed. It cannot be sensible for the proposed legislation as published in the Finance Bill to require so much revision. Indeed, before the Bill was available to the public, the detail was already out of date in many aspects." I have taken some Finance Bills through Parliament and I have a great deal of sympathy with both comments. Can I ask you, what consultation is actually taking place now on those areas that you are criticising?
Ms Lagerberg: When the residence and domicile rules were announced in the Finance Bill, it said in the Explanatory Notes to the Bill that a number of items would be brought as amendments because they were not ready for the Finance Bill. We know the explanatory clauses to the Bill are meant to be quite succinct and intended to be helpful, but there are over 550 paragraphs explaining just one clause. To be honest, if you are having trouble sleeping at night you might want to read some of it. It is utterly turgid and actually does not make sense when you read it through because it has clearly been written either very early in the morning or very late at night. That is incredibly difficult because clearly they were under huge pressure to bring something for the timetable that they had and we understand that the residence and domicile provisions are now being debated at the end of the Public Bill Committee hearings because they will not be ready in time to be looked at in chronological order. That shows you just the sheer complexity of what has been undertaken. These rules were announced in January, they changed very significantly in time for the March Budget and are still not ready yet and that clearly cannot be a sensible way to bring forward change that has already taken effect. It took effect on 6 April.

Q87 ***Lord MacGregor of Pulham Market:*** Now that a lot of this is out in the public, as it were, are you actually being consulted on some of your criticisms and some of the changes that are still to come?
Ms Lagerberg: We went to see HMRC yesterday about the possibility of one particular element of the provisions. We have put in a lot of points that we think need to be considered but everyone is so busy still drafting it is very difficult for people to take the time back and consult in the way that these provisions deserve.
Lord Paul: My Lord Chairman has requested that you do a note on the consultation process that you would like, but can I also request whether a page can be done on what would have been a better way of consultation than what has been done already so we know that is how it could have been done better.

Q88 ***Chairman:*** In other words, not just a general note but one which also pins back specifically to if you had been able to wind back the watch and start on these two issues, how would it best be done?
Mr Roy-Chowdhury: On capital gains tax, as I mentioned before, most of us were actually excluded from the process. I think it would have been very useful, first of all, to go through the usual process of a document being published and then we could have been called into the process to discuss how it could have worked. There would not have had to be changes which were ongoing as and when people decided to tell the outside world that something was happening, like entrepreneurs' relief, although we had some inkling. The people out there who have to make the tax work were not called in. I think what needed to have happened was that we should all have been brought in within the tent to discuss exactly how the new changes would come into effect, what would have happened about taper relief and indexation. If the whole thing was meant to be non-tax raising then there should not have been any reason why we could not have discussed all this, including the rate and exactly who was in and who was out of the entrepreneurs' relief if that was the way they wanted to go or if that was appropriate.

Q89 ***Lord Paul:*** Is it normal that they announce something and they keep drafting as it comes along instead of just starting with a full draft on one day and then going for consultation?
Ms Lagerberg: I think the residence and domicile rules are much more unusual in the way that has happened. I think probably the Finance Act 2006 is the closest we have got in recent times where you had the trust changes and particularly the inheritance tax provisions and there was quite a lot of radical change reining back some of the more difficult and complex areas of revision provisions to make them more workable. That is the nearest I have seen in the last few Finance Bills. Adding to Chas' points, the key problem here was certainty for businesses; there was no certainty. We knew things were coming, we did not know what they were and should you take action. To be honest, you really could not have taken any sensible decisions until a few weeks before the end of the tax year.
Mr Roy-Chowdhury: On the residence and domicile, the consultation process was started in 2002 and I participated in the committee and I think it did finish basically. I do not think it has been ongoing. Then clearly the climate was judged to be right for measures to be introduced now, which they have been. Within that consultation we were talking about statutory rules for residence, other rules about domicile, and none of this seems to have been brought into what is currently on the table.

Q90 ***Lord Powell of Bayswater:*** One last point on this. HMRC have taken a pretty good kicking so far in this session. Is it not really the fact that many of the complications arose because the broad proposals were announced in advance, there was then an outcry from those who were going to be the losers and the Government then tried to amend its proposals in a way which would minimise the concerns of the losers? You could say that in a way some consultation has taken place and some remedies have been attempted. I quite see it is not the consultation that you like, which is professional consultation on how to do these things in detail and how to draft the resolutions so you can better advise your clients, but I think one would have to say the Government could have reasonably argued that it has been trying to help alleviate concerns and that has given rise to some complications.

Mr McDougall: There certainly is a degree of truth in that. I think one has to say well done to the system. We have much more consultation now than was once the case. I remember many years ago you would hear a measure on Budget Day and the first time you saw any detail was after the Budget. A lot of areas have improved. Therefore, as a result of bringing forward the idea of consultation I suppose what we all want is for that process to actually produce at the right time legislation which is workable, understandable and which does allow people to make a choice given that it is apparently part of government policy to give people sufficient information to make a choice. Certainly that was what was said on capital gains. I think the difficulty on the residence and domicile provisions was we had the announcement in the PBR and then there was a period of silence. The Finance Bill was published on, I think it was, 27 March and I attended a meeting with HMRC at which we were told, "Don't worry about what's in the Finance Bill, it is all going to be changed". That was able to be seen from the Explanatory Notes where, as has been said already, there were a number of areas where, in essence, the explanation was, "This is going to be changed". That meant that having effectively said those to whom this stuff would apply could make decisions ahead of the new tax year, they actually were not in a position to do so. Yes, I would accept and congratulate all those concerned on the advances that have been made, I think the difficulty is that having moved a number of steps forward we would actually like to see the process move more logically to fuller and more effective consultation.

Mr Roy-Chowdhury: May I just put the record straight on one point. 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.

Chairman: Let us draw a line now under consultation. We look forward, if you are prepared to do it, to a further note along the lines we have discussed, in other words where there is not tax avoidance or forestalling to worry about, but how you would have thought in these two contexts of capital gains tax and residence and domicile it could have been properly done and how it could have been sculpted. We will come back to looking at each of the three topics in order, starting with capital gains tax and entrepreneurs' relief.

Q91 ***Lord Sheppard of Didgemere:*** Last October when the PBR came out the Government stated that their double aim was really to have the whole of the CGT regime on a more sustainable footing and to help investors be able to think and act long-term. I will ask you one question on that and one other allied question. How successful do you think the Government have been in those aims on what they have actually come forward with? Insofar as it is not either on a sustainable footing or helping investors to plan long-term investment, where do you think in particular it has fallen down? A different but allied point is they also said that their aim was to simplify tax. Some of you, certainly the ICAEW, have said that in simplifying tax one should aim to be broadly revenue neutral. Do you think that always has to be true? Perhaps they should have pointed out more clearly that they were doing two things, trying to increase revenue and also to simplify it. I agree with that, but simplification is one thing and it does not necessarily mean that they have to be tied too tightly to that in what tax rates they come up with.

Mr Haskew: If I could pick up on some of those points. Obviously it is open to the Government to increase revenue, and that was what they did, but look at the results of what actually happened. We have had six months of anger, complete changes in some of the underlying rules, badly drafted legislation, ill thought through legislation. We do not really feel that is the right way to proceed. Let us not also forget that ten years ago we had a system introduced of taper relief which encourage to long-term holdings of both business and non-business assets, but also encouraged the holding of business assets. That was a clear policy to encourage the long-term which most people thought was a not unreasonable approach. Then suddenly it is all about-turn, we have a flat rate of CGT, and all the previous rules swept away from 6 April with no real justification for those changes. From a very clear policy we had a complete sea change. 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 probably going to encourage short-term investment and speculation. It is difficult to reconcile those comments with what has actually happened on the ground.

Mr Allen: If I could add a point there. Encouraging long-term investment requires people to have confidence in the system and a system that is stable and an outcome that is as certain as it can be. We would never comment on any decision of the Government to impose a rate or whether it should be tax neutral or tax raising, that is for the Government to do. Our concern is that these changes actually undermine confidence in the system because people who have made a long-term investment on their understanding find a very significant and apparently arbitrary change and the changes do not seem to be related to past policy announcements. Most people would say if you understand the policy you should not have too many surprises, but in this particular instance the policy is producing a lot of surprises. If I can just talk about the principle. The internal manual of the Inland Revenue on capital gains, paragraph 10243, says: "Capital gains tax is charged on real gains", so to attempt to tax charge on what was inflation from 1982-98 is in principle reducing people's confidence that they understand the principles of the system. There are lots of other detailed anomalies that have been produced by this change.

Mr Roy-Chowdhury: I think in terms of sustainability of the system, clearly the old system was getting more and more complex and hence something had to be done, and I guess that is where the Government decided to make an 18% flat rate. The problem that we have is we have this simplification, which clearly it is, there can be no denying it is, but it goes against the expectations people have and we already have a system where entrepreneurs' relief has been introduced, so it has complicated it, and in the future we will perhaps have inflation picking up so there could be a form of indexation reintroduced, we could have a form of taper relief reintroduced, there could be uplift exemptions. Clearly while this is ground zero, if you like, 18% to start with, it could again go back to the old system. It depends whether the changes were meant to be revenue raising as well as simplification or it is simplification going forward for the future, and I suspect we are kind of in the middle ground really, it is meant to be revenue raising as well as simplification for the time being which will gradually get more complex.

Q92 ***Lord Paul:*** Both of your organisations have commented that the reasonable expectations of the CGT system in place up to 6 April 2008 should have been preserved within the new regime. Potentially this would have meant having two systems operating in parallel which would have led to complexity for a substantial number of years. Perhaps you could expand on that. Why should the principle that the taxing of a gain be determined by the law in force at the date of disposal not be preserved within these changes?

Mr Roy-Chowdhury: Both organisations would see eye-to-eye, I imagine. Really what Frank said earlier was there was an expectation people had that they would get indexation, taper relief, that they would get relief for inflation, and there was a long-term project, especially in terms of enterprises, where they were going to expect to pay an effective 10% rate. That went very suddenly, very abruptly, without any consultation or any process of actually getting the feed through from businesses before the announcement happened. I think where we are coming from is we are not sure what the new system should have been, but the old system should have been maintained until a proper set of reliefs were put in place for that indexation and taper relief so that people did not feel hard done by, they did not feel that they were taking a long-term view totally pointlessly.

Mr Haskew: Just to support what Chas said, I think capital gains tax is generally looking at long-term decisions and long-term holdings of assets, so people need certainty and with things like indexation people did have certainty for a long period of time. I think it would have been difficult to have two systems running in parallel, but what we would have probably preferred was some sort of better transitional arrangements so that we had an orderly transition to the new system that effectively gave people time to reorganise their affairs in a reasonable way.

Q93 ***Lord Paul:*** Does the removal of indexation to April 1998 seem justified in the context of the overall package?

Mr Haskew: When the taper relief rules were introduced in 1998, and indexation was obviously frozen up to that point, I think most people at the time thought that was a reasonable transition into the new system, given that things like farmland, for instance, had effectively only been increasing at RPI since about 1982. For quite a number of assets it would still have been helpful if they could have kept indexation which was a proxy effectively, as Chas said, for recognising the real gain.

Q94 ***Chairman:*** Mr Allen, I think you were on the point of saying something

Mr Allen: I wanted to comment about denying people what I would describe as their legitimate expectations. Putting capital gains tax into context, it is actually payable by a relatively small community on an annual basis and, therefore, it does not affect all of the taxpayers in the country. It seems to me that there are times when simplification should be the guiding light and you have to accept that there are going to be losers who shout and there are times when you can say you could accept a complexity, particularly if that resulted in a degree of equity but also gave people confidence in the system. In something like this I would have thought that elsewhere in the capital gains tax law it recognises, for example, selling property takes time and there are statutory provisions that allow a three year period in which to realise property, and it would have been quite reasonable and quite appropriate, given the relatively small community that is affected here, to have introduced a transitional provision that allowed people to have their legitimate expectations realised.
Mr McDougall: Over the period of taper relief, which was with us for ten years, many people made investment decisions, and I am not thinking about Stock Exchange investment decisions but business investment decisions, how they might hold, for example, the land and buildings from which a company or a partnership operates with the taper relief rules in mind and in particular that under taper relief the fact that a lease may have been granted for full value between the landowner and the company that he or she also had shares in, and that was fine. But then we find when we look at the detail of the new system of the entrepreneurs' relief that having done that in a period when there was no expectation that capital gains tax was going to change, and change radically, and entrepreneurs' relief replaced business asset taper relief, but not as a direct replacement, the decision to rent the property is actually going to mean that entrepreneurs' relief is denied, and that is the effect of the new Section 169P.

Q95 ***Lord Powell of Bayswater:*** Would you not agree that if simplification is the real goal then a general short-term capital gains tax which everyone pays but with a general taper over, say, ten years, is the simplest method of all and encourages people to save and make long-term investments?
Mr McDougall: Yes. The distinction between short-term gains and longer term gains recognised in the tax system rules would be preferable because in a way, especially for Stock Exchange investments, the new system effectively encourages short-termism and speculation.

Q96 ***Lord Powell of Bayswater:*** My other question was with the capital gains tax rate of 18% for all gains, is there not going to be an incentive to turn income taxed at 40% into capital gains taxed at a lower rate? Are not lots of clever chaps like you going to help them do that?
Mr Roy-Chowdhury: I think we have said in the past that may have been the case to try and shift income to gains, but clearly there is the disclosure regime which is in place, a much more principles-based system in some ways in terms of what you do in terms of tax planning, so there is a lot of mitigation within the system which may not have existed some years ago. While clearly there will be an incentive with a big differential between the top rate of income tax and the rate of capital gains tax, if you like, there are provisions in place which may prevent people from trying to do that.

Q97 ***Lord Powell of Bayswater:*** You really think there is sufficient protection in the legislation to prevent this?
Mr Haskew: I would not have thought there is probably sufficient in the legislation to prevent people doing it. We all know what is going to happen. There will be lots of minds put to how they can reduce or convert income into capital. We have had all this ever since capital gains tax was introduced. The changes that we have had down the years, there was some logic to them in excluding inflation and taxing it at a tax payer's marginal rate. We have actually moved very much back to capital gains tax as it was when it was introduced in 1965. We will see a lot of this happening. As at this moment we do not quite know what will be needed, but I suspect there will be more measures needed.
Mr Roy-Chowdhury: I suspect there will probably be some complexity later on, we will introduce rafts of anti-avoidance legislation just to combat some of this simplicity at the moment.

Q98 ***Lord Powell of Bayswater:*** It sounds as though in the future most of the Budget will be concerned with anti-avoidance.
Ms Lagerberg: Even more so.

Q99 ***Lord MacGregor of Pulham Market:*** Just to finish on that point. Obviously a lot of the firms you represent will be working out schemes and presumably intending to promote the schemes to high net worth individuals and so on, but they will have to run that scheme through the clearance of HMRC, will they not?
Mr Roy-Chowdhury: Yes.

Q100 ***Lord MacGregor of Pulham Market:*** How much of that do you think will really deal with the problem?

Ms Lagerberg: There is a very effective disclosure regime in the UK. I think the disclosure of tax avoidance scheme rules have changed the way that these schemes are undertaken. Also, there is quite a strong recognition about the way HMRC risk assess that area. I do not think that is really the problem here, 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 very some 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, which is what it is trying to help, trying to get an effective rate of 10% and will they be able to use the relief and is it good enough for what it is intended to do. I think that is going to be the bigger concern for the majority of people, will that work effectively, and have we not just reintroduced some of the problems we removed in 1998.

Q101 ***Lord MacGregor of Pulham Market:*** But that is a different issue from the issue of people trying to move income into capital gains for the obvious reason of the lower tax rate. Although you have raised that point, just to confirm, you do also agree with your colleagues that the requirement to disclose schemes now to HMRC will effectively deal with the problem that did exist previously?

Ms Lagerberg: To be honest, I think it will. I think the disclosure of tax avoidance scheme rules means that if someone is trying something very aggressive, very out there, it would have to be disclosed and it would be shut down incredibly quickly if the previous two years are anything to go by. The ground rules that people operate under have changed, so they would be far more wary about trying to implement a scheme which would have a very short shelf life indeed.

Q102 ***Lord MacGregor of Pulham Market:*** Could I just go back to the indexation point of April 1998. We have already discussed it a bit, but it seems to me in a way there is an element of what you might almost describe as retrospection in what is coming in now. In 1998 the Government did agree to a 1982 fixed point for devaluation to take place. Is there any reason why they could not just have drawn the line at 1998 and taper relief, of course, would have gone but at least the indexation up to that period would have remained?

Ms Lagerberg: That is a very good point and it is one that I think was not really thought through properly. There is a lot of expectation there, particularly for certain sectors, where indexation was a very significant item and the reason the rule changes were brought in in the way they were in 1998 was to preserve people's expectations. It very badly affects a number of people for whom that was their nest egg on retirement, they thought they knew what was going to happen to them and the rules completely changed for them. When you run some of the computations through it is a pretty dramatic effect. Taper relief is a dramatic change but actually it is the loss of indexation, and the hike from an effective 10% to 18% is an 80% increase, and if you add on indexation some people are well over 100% worse off because of those changes.

Q103 ***Lord MacGregor of Pulham Market:*** If they had held the asset for some considerable time.

Ms Lagerberg: If they had held the asset for some time.

Q104 ***Lord MacGregor of Pulham Market:*** And during a period of what was quite high inflation which indexation dealt with.

Mr McDougall: That is right. That was particularly true of farmland where the problem was quite acute. The indexation allowance for an asset held on 31 March 1982 up to 1998 was a multiple of 1.047, so it more than doubles the base value. If it was felt that it was right that an 18% rate applied to the gain from the market value at March 1982, in essence what is happening is you are taxing them at 36%.

Q105 ***Lord MacGregor of Pulham Market:*** How much?

Mr McDougall: You are really doubling the effective rate because you are losing this 1.047 multiple purely as a result of not necessarily land price inflation but RPI, but it is as close as the system allowed for the real rate of inflation over agricultural land. In essence, the rate that has been charged is on a gain which is twice what the real gain is if you take inflation to 1998 into account.

Q106 ***Lord MacGregor of Pulham Market:*** So for long-term holders, if they come to sell the assets, they will actually be facing a higher rate of tax now—

Mr McDougall: In essence, yes.

Q107 ***Lord MacGregor of Pulham Market:*** —even with the 18%.
Mr McDougall: Yes.
Mr Roy-Chowdhury: In some ways that allowance could have been taken forward like a capital gains tax exemption as being a parcel on its own if there had been proper consultation at the time.

Q108 ***Lord MacGregor of Pulham Market:*** Can I ask one last question. You have recommended that there would be some logic in aligning the index limit in line with the pension lifetime limit. I could not quite see the logic of linking it with the lifetime pension limit.
Mr Haskew: 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. Instead of having two separate limits for two separate things, it was just having one limit that would do both.

Q109 ***Lord MacGregor of Pulham Market:*** They are two separate issues really, are they not?
Mr Haskew: They are, yes. It is really another possible way of simplifying the system.

Q110 ***Lord MacGregor of Pulham Market:*** Or raising the limit?
Mr Haskew: The point is it is not obvious that the current limit is going to be increased whereas there is a mechanism for the pension limit to be increased annually, if you like, so it was really a question of shoehorning it into that.

Q111 ***Lord MacGregor of Pulham Market:*** It is as much a question of indexing the limit.
Mr Haskew: Yes, that is it.

Q112 ***Lord Sheppard of Didgemere:*** Can I ask one question on what has been said on avoidance. I cannot remember whether it was three or four years ago, but it was at least three years ago, when I remember saying to the Inland Revenue when they came to this sub-committee why was it the legal profession and the accounting profession had been able to out-run them for decades. That is from my experience in business and so on. I said do not take that badly and they said they wanted more powers and since then they have got more powers. From what you have just said the position on avoidance would be quite different and the 20 versus 18 will not be the same position as it was for many years when that existed in the late 1970s and into the 1980s. Does that mean that you think the Inland Revenue have, I had better not insult them by saying woken up, but do you think they are now in a much better position? Are they asking the legal and accounting professions much sharper questions than they used to?
Mr Roy-Chowdhury: It is really a principles-based solution where it is self-assessment and it is for the accountancy profession and legal profession to actually disclose schemes which are, for want of a better word, considered to be in certain categories of tax avoidance. Therefore, the Revenue are getting a heads-up before those potential planning opportunities are put in place to actually issue a press release saying, "We are going to stop this now, from today, and legislation will come in the next Finance Bill". It is a very smart tool that they now have which they did not have four years ago. Clearly that has given them the opportunity of being able to stop shifting from income to gains and stop a lot of what otherwise may have gone on with the differential in the rates.

Q113 ***Chairman:*** I think we have given capital gains tax quite a good run for its money, but just before we move on to residence and domicile can I just ask, in some ways the scope of the entrepreneurs' relief is narrower than for business assets taper relief and may be more complex as well. Do you think that is justified?
Mr Roy-Chowdhury: It is difficult to understand why, if it is there to give some measure of relief in the same way that taper relief gave relief for certain classes of assets in a certain way and other classes in other ways, the rules should be based on the taper relief rules for entrepreneurs. It would have been broader, it would have been fairer and, again, going back to what we were talking about on expectations, where certain entrepreneurs were expecting to get relief and pay tax at 10%, they would have been brought within that 10% rate which under the current entrepreneurs' relief they are not. Again, it is failing legitimate expectations that these business people had.
Ms Lagerberg: I would rather we have some relief than none at all, so we should be grateful for small mercies. It is very targeted, it is only aimed at small businesses, it is capped, a person with a large gain gets some benefit from it but it will be a drop in the ocean for some people's gains. It will not help employee shareholders who do not have a sufficient shareholding, so it will not help the Tesco cashier who has got shares in the business, so that is not good to encourage people in their ownership of the business that they are in. It is quite limiting. Also, in some ways it is a shame that it has not been linked to competitiveness for the UK because the serial entrepreneur will be through that million pound cap and wondering whether the UK is a place for them to take their gains. They are internationally mobile, why would they stay in the UK to make the gain

for their next venture. I think it 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.

Lord Sheppard of Didgemere: There has been concern that insurance bonds may be put at a disadvantage by these changes. I am not certain that I am qualified to understand your answer on that but perhaps you would like to give it to me and I will tell you if I understand it.

Q114 ***Chairman:*** The question is on insurance bonds, that they may be put to some disadvantage by these measures. Do you share those concerns?

Mr McDougall: I think it is because they come under a totally different regime, the effect of which is that it is not on a level playing field with the investments which are subject to capital gains tax, largely because in the hands of many policyholders where you are looking at the gains they are not capital gains, albeit that quite a lot of the growth has arisen from capital gains in the life fund. It is because tax has been paid at the level of the fund that there is no basic rate tax on policyholder gains, but the effect is that if you have got a higher rate taxpayer who makes a policyholder gain he or she will pay tax at 20% on the gain because there is an inbuilt basic rate credit, whereas if it were capital gains it would be taxed at 18. That is my understanding of it. I used to do a lot of life company tax but that was a long time ago and the regime has changed somewhat. That is how I would see it.

Q115 ***Chairman:*** Thank you very much. Let us move on to residence and domicile and perhaps I can start by asking one or two general questions. It is an area that has been under review for many years, indeed I think the present review was started in 2002. Why do you think concrete proposals then emerged in PBR 2007? Do you welcome the fact that at least the uncertainty of the review is no longer hanging over people? Do you have a view on the correctness of the policy reasons for the proposal? I think for the ICAEW you thought that the changes might result in a net loss of revenue because of the behavioural changes and the reactions to it, which means you are casting doubt on the figures that went into the Budget arithmetic. Perhaps you would like to expand a bit on that.

Ms Lagerberg: If I could pick up on the first point on whether concrete proposals emerged and why they emerged in the PBR in the way that they did. Politics is a funny old game, is it not, and we are not really the right people to judge on politics. Obviously the political climate had changed and it was time for the Government to put forward some proposals on this. What is really disappointing about this is there has been a consultation. If you go back to 1988 we were talking about reviewing residence and domicile and there was actually a very strong belief that the rules needed to be changed. The residence rules are based on the age of steamships and on cases that involved lunar months as the grounding on which they were based. There is no doubt that change was needed. The domicile rules have been looked at many, many times and consistently put on the too difficult pile, but there is a need for change. There was a huge amount of response to the consultation that began in 2002. The ICAEW put in at least two responses, if not three from memory, and many other people did too. What we got in the PBR was not bad. It was not a response to that consultation, it was a much more short, snappy comment based around having a £30,000 annual charge with more details to follow. The details that came out in January were not based on the back of a detailed consultation, they were a raft of measures that had been thought about but were not part of the consultation process that we recognise. Of course, the January changes have been significantly altered thereafter. Do we feel it has got rid of the uncertainty? Well, if I knew what the rules were I would probably be able to tell you. I am still not sure what they are doing because we have not seen the proposals yet. I am looking forward to seeing the Finance Bill proposals because they are not there yet. Do we think they have got the policy right? Again, policy is difficult for us to comment on, but if you are looking to improve the residence and domicile rules in a way that gives people certainty we are not there yet. Fairness, I am not convinced they have quite got that right but it is an awful lot better in the Finance Bill than it was in the January proposals. I am very concerned about the competitive elements of it. Again, the January proposals were far worse than the proposals we have got in the Finance Bill so there has been some sensible discussion there but there are a lot of issues around this. This is a really complex area. It is a law of unintended consequence area where you make one minor change here and you unravel a whole host of complex legislation somewhere else. This should not have happened this way, this was a very poor consultative process.

Q116 ***Chairman:*** Do you still think there will be a net loss to Revenue even after the changes have been made?

Mr Haskew: If I can pick up on that point. I think we said “might”, we did not say “would”. 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. To be perfectly honest, we do not feel we have had that at all. There has been no real attempt to justify the figures and the amounts of revenue being raised from this. Our concern is that we have no idea where the figures have come from to support this and certainly our evidence is that a lot of people would just leave the UK. I think it would be true to say that the changes that we have seen in the draft legislation on areas like remittances, have potentially dampened down the worries considerably for a lot of people, so perhaps the initial concerns we had back in October are less than they were, but the fact is we have not had any figures to justify what is a fundamental change in policy.

Q117 ***Lord Sheppard of Didgemere:*** Against the background of it being a complex topic of conversation or fear, if you want, certainly in the City for six or seven years, if not longer, was it rather surprising that it became so controversial when it did actually happen? Was it because it became highly political with both parties trying to pinch each other's ideas, or was it because we still do not know exactly what the results of this will be and we probably will not know for ten years whether people do come here and whether we do lose inward investment and so on? Why do you think it has been so controversial?
Ms Lagerberg: I think the January proposals which were far more extreme than what is actually in the Finance Bill did raise a lot of concerns in the City because certainly the UK looked very unattractive with the potential to be taxed on your income in different parts of the globe in a way that had never happened before. It was such a dramatic change with such little time for people to reorganise their affairs. 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. From the PBR proposal, which was quite short, to the detail that came out in January, those were really quite sweeping ideas and thoughts that had a very, very negative effect on the UK. If you are internationally mobile the UK did not look very attractive in January. I work for a large accounting firm, Grant Thornton, and we have a lot of high net worth individuals and you always wonder about whether people are genuinely going to leave the UK, but we had clients who were very, very concerned about whether they should remain based in the UK in a way that I have never seen before.
Mr Roy-Chowdhury: I fully agree with Francesca and Frank but, like capital gains tax, it was the abruptness with which the announcement happened. The 2002 consultation which we were very much a part of, ACCA participated in, was nothing like what has come out. What seems to be totally lacking is if there is a need to rein back the tax regime for non-doms to create a fairer tax regime for them, as the announcement says, then where is the research. Is it actually beneficial for the UK to not have this regime at all? Is it going to mean more job creation, more wealth creation, more tax revenues for the UK? In terms of cost benefit, is it better for the UK not to have this at all or to have it? If it is better for the UK to have it then let us not fetter the regime with a levy, let us not fetter the regime with other consequences for those who are staying here. If it is best that the UK does not have it then let us sweep it aside and have the same regime for everyone, which is what most of the rest of the world does. The research has not been done but the measures were announced and the proposals had to still be formulated in a concrete fashion for legislation. That is where we are coming from, that there should have been a more formed judgment 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 rising bases and the remittance bases at the same time, which is not the way to attract talent and keep talent in the UK.

Q118 ***Chairman:*** There is a Scottish view coming.
Mr McDougall: I have a couple of comments to add to that if I may. The first one is what we got in October and subsequently was not really the result of a review of residence and domicile. Whilst there was a little bit of adjustment to the meaning of resident, particularly in terms of how you count days, actually what it is really about is how the UK tax applies to resident but not domiciled individuals, which is a very different matter. We are still somewhat out of step with many other countries on how we look particularly at this issue of domicile where we have a number of significant anomalies because of what the word means. That was the first thing. The second thing was, in support of what Chas has just said, when the first consultation document came out after the PBR most of what it was saying was that we really did not have very much in the way of concrete information because the only statistical information which was available was the number of people who submitted non-resident pages to their self-assessment tax return claiming to be not domiciled, but you only had to submit these pages where that status had an impact on UK tax, so we do not actually know how many non-domiciled individuals there are. Because it only applied to people who remitted income to the UK we do not know the extent of the potential wealth

which is arising to people who are not domiciled but had not previously been remitted. There was a huge amount of information not there. There was a huge perception among those who are not domiciled in the UK that, in fact, this was a political attack on them and somehow they were not welcome. There have been elements of an attack raised over the years. I say it is a perception, I do not think that is the reality, but, nonetheless, in these things perception is what matters more because that is what people take as the basis for some of their behaviour.

Q119 ***Lord Paul:*** If there is any case where consultation had been long enough, it is the non-domicile case. As has been discussed, it has been going on for the last 30 years and very much hyped up over the last ten years. The press criticised it and there have been attacks on a few non-domiciles, including me. I declare that I am a non-domicile because it suited me because I belong to one party. Why is it that the profession did not speak up during those years and give some facts and figures? It was announced, I am sure it was a reaction to a very half-hearted type of policy which was announced by one party and the other party jumped on the bandwagon with absolutely no thought, and even at that time the press went on until they realised that the truth was very different. There is no doubt that a lot of people who want to come in certainly have no intention to come in and stay here to invest. They might invest, but you do not have to be here to invest. The damage has been done which is very significant. There has been 30 years of work by both parties to make Britain an attractive place and the damage has been done, I do not think there is any doubt about it, people are talking. I know a lot of people, and I am sure you do, who are looking at it and asking whether they want to stay. There are people like me who may not want to stay. I will not go but younger people are thinking of it. Was it not possible for the profession to speak up more for 30 years instead of discovering all of a sudden in January when all hell broke loose?
Mr Roy-Chowdhury: In terms of the consultation process, we considered it had actually finished in 2002-03 when no more was heard, no more meetings were held, so as far as we were concerned that was the end of the issue. As you said, very rightly, there was a decision made when it was a right and opportune moment to re-announce this but what came out, as we said, was not anything to do with consultation. I have been preparing a presentation which I am giving in a couple of weeks' time and looking at *The Sunday Times* Rich List published last Sunday, 27 April, if you look at the top ten more than 50% are non-doms, and that is anecdotal evidence as to how powerful the non-dom regime is in the UK in attracting those kind of people. Below that, there is a whole raft of others who are operating in much more ordinary jobs. I think the research needs to be done, or should have been done before the announcement was made and before legislation happens. That is what it is about, is it good for UK plc to maintain this regime or not. Let us do the research before passing judgment and passing legislation.
Ms Lagerberg: From an ICAEW perspective, over many, many consultations that have taken place over, you are right, 30 years, that has been going on for quite a while, the point that has always been made is do not bring in something quickly without really thinking it through and looking at the consequences. As with any change you are going to get winners and losers, and we all know that there will be winners and losers from any change of this nature. Take your time, do it properly, look at the research, think it through. That is not what has happened. To stand up for the profession, I think that point has been made over and over again. Looking back to the 2002–03 review, one of the things we asked for was a commitment that there would be a proper consultation process if this was ever decided and I am afraid to say that simply has not happened.

Q120 ***Lord Powell of Bayswater:*** Could we come on to the question of residence. I read in your memoranda that most of you agree there ought to be legislation to determine when someone is UK resident rather than just relying on the case law in current practice. Have you put this point to the Treasury and the Revenue?
Mr Haskew: Yes, we have.

Q121 ***Lord Powell of Bayswater:*** What have they said?
Ms Lagerberg: We have had discussions with HMRC and Treasury on this point and we have raised the issue with ministers. I think it has been looked at. One of the difficulties of the lack of thorough consultation on these proposals means that we have got a Finance Bill already there and bringing in something at this stage is a political decision, is there the time to draft it, to think it through. From the ICAEW's perspective we think it is a very helpful thing to have a statutory residency test. Ireland has one, the US has one, many other developed countries have one and they have worked very effectively for a long period of time. If you had the opportunity to look at this particular consultation and where you would start from, you would have put that in the original proposals and we think it would have been a very worthwhile addition.

Q122 ***Lord Powell of Bayswater:*** You think it is just a question of parliamentary timing and difficulty of changing things after the Bill is published?
Ms Lagerberg: It remains to be seen whether they find an opportunity to do it and whether there is the political will to support it. I do not know where that is going to go.

Q123 ***Lord Powell of Bayswater:*** They have not put any counter-argument of substance.
Ms Lagerberg: I think there are a lot of things you have to think through with any of those tests because you have such a complex matrix of laws. It is not a case of drafting it in an afternoon and being able to put it forward. You have to think through the ramifications from it. The timetable is tight to enable them to do it but we think it should be part of the proposals.
Mr Roy-Chowdhury: Certainly in 2002-03 we did go the route where we came pretty close to drafting or having statutory rules for residence, so that work is within the Inland Revenue, as it was then. We have actually prepared the ground work already, so there is much material available which a number of us here worked on at that time.

Q124 ***Lord Powell of Bayswater:*** Can I just ask a supplementary? Do you think there will be uncertainty as to whether the new day-counting rules will apply to the extra statutory guidelines still surrounding the residence status of individuals?
Mr McDougall: Yes, I am afraid I think there will be, in particular on the in-transit people, because the legislation has a particular phrase, which is not defined. The definition is then by statement. There are a number of examples in the explanatory notes explaining complex travel arrangements from outside the UK to different bits of the UK, going on elsewhere, having dinner or going to the theatre just before an overnight stay, and depending on who you happen to dine with and whether it was prearranged or not prearranged can affect whether that day counts or not. There will always be uncertainty about whether or not issues were predetermined or not predetermined. When do you make that determination? Do you find, for example, that if you were flying into Heathrow and out again, but your inbound flight was running late and, as a result of that, you were going to have to overnight in London, then sitting in the airport somewhere else you say, "Well, in that case, I might as well make it productive rather than just an extra chore," is that preordained because it has been arranged, or I think it will be preordained because it was fixed before you arrived in the UK. So if you fixed it sitting in the terminal in JFK rather than waiting until you arrived at T5, and hopefully you did not leave your phone in your luggage, that could make a whole difference, and if that happened often enough because of bad weather—and as someone who flies to London a great deal from the North, we know how often your plans can be thwarted by a change in the weather down here or other issues. There are so many potential aspects which are not within the control of the taxpayer and if someone tries to make sense of the time that you are going to have to spend, that could well have an adverse impact, and that is only one example.

Q125 ***Lord Powell of Bayswater:*** So in fact the uncertainty is worse than it was before?
Mr McDougall: You knew to some extent an element before, because we did not have that particular measure; we did not have that definition of a day in the UK, but this is a different kind of uncertainty, and I think it is because we are relying also on case law and cases from a different era, as we are with domicile, where the cases go back to a lifestyle which is not the way in which life is lived nowadays, for all sorts of reasons. There are sometimes things to be said for what happened then but it is not what happens now. I do think, absent a definitive statutory test, we are going to have ongoing uncertainty and we are going to have uncertainty that does not tend to arise in a number of other countries.

Q126 ***Lord MacGregor of Pulham Market:*** It sounds like another opportunity for high-level seminars and high-level tax advice.
Mr McDougall: It is wonderful. I do a lot of lecturing. It is good for that, but it is not actually a sensible system.

Q127 ***Lord MacGregor of Pulham Market:*** Can I just come back to this question of statute against case law? I am not clear in my own mind exactly what the real benefits of shifting from one to the other are. Perhaps you could just say a bit more about why you are advocating that. Secondly, in the light of the experience you have had in consultation in 2002, how complicated would it actually be to introduce legislation? Finally, perhaps in a note rather than now: you have referred to the US and Irish systems. It would be helpful to have a note, briefly, about how these work and how they could be applicable to the UK.
Ms Lagerberg: Picking up your point about the statutory test and why we think it is a good idea and why we think it could be better, the main problem is we do not have much statute on residence. There is just the 183 day rule. Most of the residence rules that have been applied over the last many years sit in an HMRC leaflet, IR20. That is not statutory. It

is not even regulatory. It is tertiary legislation. It has become very outdated anyway, and the idea was that it would be updated, and that was before these changes took place. It does give rise to uncertainty for people who just want to know "When am I resident and when am I not?" A lot of those issues are to do with people if they want to know when they have left the UK and if they have come into the UK within our residency system. It is a certainty point. Looking at the Irish and American experiences, it is much easier to say with absolute certainty where someone sits. You might not like the answer but you know what the answer is, and I think that is where we are at. We think that certainty would actually provide a very useful bedrock to a review of residency. We are happy to provide some information that we have on the Irish experience and on the US experience. I suspect the UK needs a hybrid of both to get to the point where it is workable, but both of them are very interesting in their own ways. The difficulty with the US test is that it is based on a very different regime. The UK regime does not necessarily read across.

Q128 ***Lord MacGregor of Pulham Market:*** One other subject, completely different, which is the *de minimis* rule, the £2000 *de minimis* rule. We have been receiving quite a lot of evidence that it is going to be very difficult to get this across to people, particularly to a lot of people who are earning very little in the UK, and how that is going to be done. Is it going to be done through employers or what? It would not catch the self-employed of course. That is one point. The other point is that it sounds as though it is going to be extremely complex for the HMRC to run, if they are going to take it seriously. It sounds as though it will involve quite a considerable increase in resources in the HMRC to make it work.
Ms Lagerberg: I absolutely agree with both of those points. 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, but also, it is not a topic of conversation that people tend to enter into. It is going to be a difficult message to put out 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. There are a lot of people potentially around that particular figure—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.

Q129 ***Lord MacGregor of Pulham Market:*** Would you just raise the limit?
Ms Lagerberg: We suggested raising the limit to round about the Personal Allowance. It is not a perfect fix but it does take away some of the issue. It does not resolve everything though. We would agree it is not a perfect fix at all.
Mr Roy-Chowdhury: We certainly welcome a *de minimis* and it should be higher but, in terms of the audit of people who say they are within the *de minimis*, where are the information powers for HMRC to go and audit whether people have actually submitted a correct return? OK, there is the Mutual Assistance Directive, there could be other double tax agreement ways they could get the information, but there is just a lack of ability for HMRC to be able to audit the return effectively under this *de minimis*. I think there is a concern how it will happen is really an open question.
Mr McDougall: On that one, in his open letter about what the proposal as originally drafted was supposed to mean, Mr Hartnett said that it was not the intention to require significant information from all the non-domiciled individuals. However, whatever the *de minimis* limit is, if it is to be properly policed, that will require all these to be potentially liable to inquiry and that has a resource as well as a principal matter, and the reason we suggested £5,000 instead of the original £1,000 was really, as with ICAEW, to try and equate it broadly to the level of the Personal Allowance because, in a way, that is a measure of income which should not be taxed. We also thought it would actually make it easier to police those around the margin, because those around the margin of £5,000 would be far fewer than those around the margin of £1,000 or in fact even £2,000.

Q130 ***Chairman:*** That takes us to the end of our second topic, which was the residence and domicile. Perhaps we can move on now to our last topic, encouraging enterprise. Looking at the clock, I would encourage questions and answers to be reasonably crisp. May I just kick off? Clause 28 increases the EIS investment limit from £400,000 to £500,000. Do you think that is a necessary change given that the limit was increased to £200,000 in April 2004 and £400,000 in 2006? Specifically, given that the Treasury issued a consultative document on the EIS on Budget day, might it not have been a better thing just to wait and see what the reaction to that consultancy document was going to be before changing the limits?
Mr Roy-Chowdhury: ACCA is in favour of the EIS scheme. We welcome the increase but we agree that a closer look needs to be had at the tax breaks for this scheme. The reason why we support it is

because, with the current credit crunch, there is clearly an issue of small businesses being able to get finance, and so, while we fully appreciate that there are studies showing that this does not necessarily help in terms of the longevity of a business, it is quite critical at the moment—this is our feedback—to businesses as a means of being able to obtain finance to keep going. So we are supportive of the increase and we are supportive of the scheme as it currently stands but consultation could be handled better.

Mr Haskew: 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. The reduction in the limits effectively has made it much less cost-effective to go down the route of raising money in this way, particularly when they are surrounded with a whole host of rules. It is probably one of the most complicated areas of legislation in many ways. Our concern is that the pressures from state aid rules, for instance, are making it very difficult for these schemes. We are not sure ultimately of the viability of them if we carry on down this route. If you look at the legislation, or the explanatory notes, it is all subject to state aid approval. We are very concerned that state aid is probably putting a stake through the heart of a lot of these enterprise schemes, and that perhaps there is a need for a complete review of the whole area in the light of issues like that.

Q131 ***Lord Sheppard of Didgemere:*** I am trying to join together two different conclusions it appears to me you have reached. ICAEW suggests there is even a case for abolishing venture capital schemes, whilst improving the general climate for business investment. By contrast, ACCA suggests that the scheme should be continued. Would you like to elaborate?

Mr Roy-Chowdhury: I have probably touched to some extent on the ACCA view as to why we came to this conclusion. Essentially, for small businesses, with rising house prices and low interest rates, they were able to self-finance. That is not the case any more, so we are very anxious that they are able to raise adequate finance, hence we want to ensure that the scheme continues, at least for the foreseeable future.

Mr Haskew: 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 potentially quite a small element of that. For instance, the ICAEW produce an enterprise survey report every year, but the biggest problems that small businesses face seem to be more in the areas of health and safety, employment law, VAT and PAYE problems and these sorts of issues. We feel that there probably is a need for more work to be done on the whole broader area of regulation of the small business sector. I recognize that in one of the consultation documents the Government touch on that but I think there is probably real scope to actually look at the broader picture of how we encourage business, looking at all the factors.

Mr Allen: If I could just add a point, the ICAS position—and I understand you have a copy of our written draft response to the consultative document—is that we support and wish to encourage the availability of such venture capital to support small business, but our concern is that the actual regimes are so complicated that people are actually denied access to them, either because of the professional costs that are required to advise on this, or they are simply frightened off, and secondly, as Chas said, the diminution in the size of business that can benefit from the likes of Enterprise Investment has also acted to make the thing less attractive. In principle, we would want to see the incentives retained, because we do think there is a mechanism that has the potential to help small businesses get the capital they need to expand.

Q132 ***Chairman:*** Do you think that your view of the complexity and the intimidating nature of the scheme is consistent with the statistics set out in the consultative document for the take-up of EIS investment?

Mr Allen: Yes. In the UK we have two systems: a system for the informed and a system for the uninformed. None of the uninformed are ever going to venture any place near this. Those that are very expert look at this as a very viable system, and our members are involved in that and they make strong representations that the tax incentives that have been gathered have helped to promote businesses that are now making a positive contribution to the economy, but in fact, that was on the basis of expert advice at the point of investment to identify those businesses that were viable, and the tax incentive is a bonus. The real problem is that for those who are not informed, it is too complicated to gain access, even through the first step.

Q133 ***Lord Powell of Bayswater:*** This is a follow-on to that question. You are no doubt all familiar with this University of Sussex study which suggests that the impact on companies is very restricted, and indeed, it may even make them under-perform, lower aggregate profitability and lower survival rates. Is this scheme really worthwhile?

Mr Allen: I have made the comment that we received representations from our members who believe it is worthwhile and, on the basis of angels funds on which they are involved, the skill is in identifying the right company in which to invest. The bottom line is that the tax tail should never wag the commercial dog, and therefore for those who are good at spotting the investment opportunity and the business model, this is a very good sweetener, and the feedback that they give us is that when you look at the future employment and VAT and payroll tax through Pay As You Earn, it is actually a good method but, of course, they would say that they are not advising those who fail, and that perhaps those who fail do so for different reasons.

Q134 ***Lord MacGregor of Pulham Market:*** My impression is that VCTs are more successful and there has been a much bigger take-up than EIS, and I notice in your paper to us you say that the problem is, as the Chairman was saying, that the legislation is so complex and subject to differing interpretations. You actually go on to say that in practice many professionals find the EIS intimidating. Is that the main reason why EIS is so unsuccessful?

Mr McDougall: I think it is one of the reasons, but if you are contrasting VCT and EIS, one must remember that VCTs are able to invest part of their funds other than in unquoted trading companies, so from a prospective investor's point of view, looking simply at income tax relief on the investment and the quality of the investment, you are more likely to retain your money or grow it in a VCT than in an EIS company, simply because an EIS company is that kind of company; a VCT is investing in a range of unquoted trading companies, but also to a limited extent elsewhere, and the general result seems to be that you are more likely to get an income reward more quickly from a VCT than you are from an EIS company, and such research as I have read tends to suggest that you are also much more likely to get your money back, but of course, there are some spectacular EIS companies where you do very well. One also has to remember that income tax relief on the investment is not the only reason for a business being structured as an EIS company. There are restrictions on getting that income tax relief for the people who are actually running the business and taking their main reward from it, but they can get the other tax benefit of an EIS company, which is the capital gains tax deferral. In lecturing about business structures, I encourage people to think about the EIS as a potential solution both for those who are involved and for the possibility of getting outside finance. Generally, on an unscientific questionnaire of those listening, the take-up is very low, I think partly because of the complexity and also because of the costs in trying to do it for a fairly small business. It is a specialist market.

Q135 ***Lord MacGregor of Pulham Market:*** It seems to me that the only attraction of EIS is the postponement of capital gains tax. Is that right?

Mr McDougall: In the right individual's hands, it is a big attraction.

Mr Roy-Chowdhury: That probably explains why there are less profits, because they are trying to grow the company and generates gains.

Q136 ***Chairman:*** Can we come to the study by the Institute of Employment at the University of Sussex, which looked at the impact of EIS and VCT investment on the recipient company. You will no doubt remember that its key findings were that overall the EIS and VCT investments have a positive effect on capacity building in recipient companies. However, in material terms, the effects remain at present very small. Second, that companies with EIS and/or VCT investment had lower aggregate profitability and survival rates over the period covered by the study. In the light of those conclusions, is it really appropriate for the Exchequer to subsidise investments by sharing the higher risk involved in young growth-orientated small companies?

Mr Haskew: Ultimately, I think this is a policy question for government. I think what it probably does show is that there probably needs to be further work done on it, and there needs to be probably more studies in relation to what I have loosely called the risk element and the reward. Effectively, taxpayers are putting money into this; what is coming back out and how does one evaluate what is coming out as to what is going in? It is almost like a business proposal really, and I think the studies are probably showing that there needs to be further work done on that. The jury is out, I suspect.

Chairman: Are there any further questions that Members would like to ask on this topic? In which case, may I thank you again for both your written evidence and for your very open discussion this afternoon, and remind you that you did say that you would give us two further papers. If there is any possibility that you will get particularly the paper on consultation to us by 14th May, that will be very helpful, as we have as a witness a few days later the Treasury, and it would help inform our discussion with them. Thank you very much indeed.

Supplementary memorandum by the Association of Chartered Certified Accountants (ACCA)

Open and Transparent Consultation

We hear a great deal about open and transparent consultation. This is rarely lived up to in real life. The consultation process tends to be flawed in that it is quite often held in an environment where the Government has usually dictated an agenda or would prefer one option against another and is largely going through a process so it can claim it conducted a consultation even though it did not listen to it. We would like to see true consultation starting with a clean sheet of paper where the options were properly considered and their was an audit trail through clear unambiguous minutes and written responses.

We also think this principle should apply across from the consultation to the tax measures themselves. Too many taxes are stealthy (eg excise duties and fiscal drag).

The Road Map

There needs to be a clear understanding of where we are currently in a given tax area and the Taxpayer, Government and International perceptions of that tax and where we consider policy should go.

Under our other suggestions we have indicated ways in which the neutrality of proposals could be achieved, certainly much more than currently, by taking the politics out of tax through the idea of the Tax Policy Committee. We recognise however that to expect politicians to leave the tax system alone is highly unlikely therefore most consultations will be a compromise.

The Measures

Where a particular area for potential change has been identified the Government should openly say what level of revenue it expects from the tax after the changes are made. Should it be tax neutral should it raise £x millions more or less tax. The consultation could then formulate policy with those political wishes in mind.

The Steps

(i) In opening the consultation HM Treasury or HM Revenue and Customs should prepare a full and transparent document to circulate. This should set out the options and where certain ideas are not put on the table it should stated clearly and openly why they were dismissed.

(ii) All taxpayers should be able to participate in writing in the consultation process. But all significant representative bodies should be called in for face to face meetings. Not as happened, as an example of how not to consult, for the Capital Gains Tax changes for 2008 where only four trade bodies were called in for the whole "consultation" for such a fundamental and critical area of change. It is important to make sure that the deadlines set for this part of the process is sufficiently long. A minimum of three months is generally considered to be reasonable.

(iii) It is important that the consultation document should come with a full impact assessment of the options for consideration.

(iv) Once the meetings and the written consultations have been received, and the deadline has passed HMT or HMRC should prepare an impartial synopsis of the feed back during the consultation period.

(v) The synopsis should then be discussed with the representative bodies and the conclusions decided upon.

(vi) In formulating the conclusions, which will go on to become the changes, dissenting views or material disagreements should be noted and revealed for all to see. Everyone who participated in the process should feel that they were taken account of.

(vii) Finally the legislation should be drafted and circulated for comment before formal publication.

Conclusion

In conclusion one would also add that 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 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.

8 May 2008

Supplementary memorandum by the ICAEW

Improving the Consultation Process

A supplementary note from the ICAEW Tax Faculty to the House of Lords Economic Sub-Committee on the 2008 Finance Bill.

Introduction

Consultation is fundamental to the development of a reasonable, usable and acceptable tax system. It allows the airing of views and the deliberation of issues. It can help build upon a sound idea, turning it into good legislation. It can also prevent poorly conceived ideas from becoming tax law. Consultation is important to the integrity and credibility of the tax system. It is for these reasons that we identified consultation as one of our 10 tenets of excellence in the Tax Faculty's discussion paper entitled "*Towards a better tax system*".

What should consultation be seeking to achieve?

The dictionary defines "consultation" as an "exchange of opinions", a "discussion, especially in order to ascertain opinions or reach an agreement" or the "process of discussing something either with experts or with other participants and asking for their opinions or advice". The underlying theme is a "two-way" process, where both the originator of the proposal and the person being addressed can debate and learn from each other.

The less obvious theme is that if you are going to embark on a consultation process, it should be with the intention of noting that advice (even if you do not always want to follow it) and explaining the resulting course of your actions.

Government recognises the importance of consultation. There are frequent requests for views and comments from interested parties. These take the form of formal and informal consultations.

Consultation should harness the experience of those who have detailed technical knowledge and who can pinpoint the possible traps new legislation may bring. A detailed knowledge of previous tax legislation is frequently helpful in considering new legislation, and many experienced tax practitioners, as well as others, freely give their time to assist with consultations.

We recognise that the consultation process should not take-away from the overriding principle that it is the Government that should be applying authority in the development of the tax law. The authority it has to do this is conferred by Parliament. Those asked to participate in the consultation process are not being substituted to take over this constitutional role. Nevertheless, once it has been accepted that consultation is an essential aid to the tax law process, it become necessary to ensure that consultation is undertaken in a manner which does more than pay lip service to the notion. Few would argue against the premise that consultation can play an invaluable part in the development of tax law.

Problem Areas

However, recent events such as the 2007 PBR policy announcements on CGT and residence and domicile have highlighted the need to improve tax policy formulation through improved consultation. There is a clear need to:

- consult at a much earlier stage in policy formulation; and
- ensure that proper consideration needs to be given to the comments that are made in the consultation process.

The need to consult before tax policy is decided

The theoretical approach to consultation as set out in the Code of Practice (see below) is not always reflected in the practical implementation. There is a need to consult much earlier in the process, ideally before the key policies have been decided.

In 2000, we remarked that the introduction of taper relief, which was a fundamental change to the taxation of individual capital gains, was introduced without any substantive consultation, either beforehand or at a later stage when draft legislation was included in the 1998 Finance Bill. The result was predictable, with the rules already having to be amended to correct poor legislation.

In 2008, we have faced exactly the same problem over the withdrawal of taper relief and its replacement with the 18% flat-rate. There was no prior consultation and the change has proved to be highly controversial with a number of amendments made to ease the transition to the new rules. This was not the only example of a lack of consultation—the proposed changes to the residence and domicile rules were similarly highly controversial. This lack of consultation on key policy changes is a recurring theme. In 2006, for example, changes to the inheritance tax rules for trusts were again announced without consultation even though a consultation process was in place about the income and CGT treatment of trusts.

The need to listen and act on consultation

Our experience is that once the Government formulates an idea, it is very reluctant to change or modify the proposal, except to a very limited extent. This merely fosters a widely held view that the Government pays lip service to consultation, even if sometimes it might take note if there is sufficiently strong opposition. In other words, whilst HMRC/HM Treasury may be consulting, are they actually listening?

If we take the example of the ongoing HMRC powers consultation, whilst on the face of it the consultation process has been very good, the many concerns that have been raised about these proposals do not often appear to be listened to and acted upon. There is little point in undertaking detailed consultation if genuine concerns raised are not acted upon. Again, this merely confirms in the eyes of many that the consultation process is little more than a rubber stamping of decisions that have already been made. This was not helped by the fact that decisions were announced in the Budget on 12 March 2008, a mere six days after the closure of the consultation period. We do not see how the responses could have been assimilated, summarised and decisions then taken and announced only six days later.

One of the few examples where the Government appears to have listened was the decision to "shelve" (rather than drop) the Income Shifting proposals as set out in the 2007 Pre Budget Report (the 2007 PBR). This followed on from detailed adverse criticisms from representative bodies.

Codes of Practice on Consultation

In order to have a workable consultation process there is a need to have some form of structure on which the process is based. This has been rightly recognised by the former Inland Revenue and Customs & Excise, who first published a Code of Practice on Consultation in January 1998. This arose as an adjunct to the Tax Law Rewrite Project and from an Inland Revenue report suggesting the need for a code of practice in this area. The Code was later updated in July 1999. The 1999 Code of Practice (the 1999 Code) has been further superseded by the Cabinet Office Code of Practice on Consultation, published in January 2004 (the 2004 Code). HMRC has also published a *Consultation Framework* which is designed to supplement the 2004 Code. The 1999 Code is still on HMRC's website although its precise status is no longer clear. Some of the statements in the 1999 Code are not reflected in the 2004 Code but are, we believe, still valid.

The 1999 Code starts with the statement that the Government "intends to consult on tax policy matters wherever it is reasonable to do so". We noted at the time that there is no definition of "reasonable", and this provided the Government with an open-ended opportunity for avoiding the necessity to consult.

The Introduction to the 2004 Code states:

> *Ministers retain their existing discretion not to conduct a formal written consultation exercise under the terms of the code, for example where the issue is very specialised and where there is a very limited number of stakeholders who have been directly involved in the policy development process. In these circumstances the general principles of the code should still be followed as far as possible, and departments should consider how to ensure that the public is made aware of the policy, for example through a press notice or statement on the department's website. This should state the Minister's reason for their decision.*

Paragraph 1.1 of the 2004 Code states:

> *Consultation is a continuous process that needs to be started early (note emphasis) in the policy development process.*

The inference from the 2004 Code is that consultation should be the norm is most circumstances where there are proposed major policy developments that affect a wide variety of stakeholders.

In relation to tax, the 1999 Code sets out circumstances when consultation might not be possible. These were:

- where there is the risk of significantly forestalling activity by existing or prospective taxpayers;
- where the area is market sensitive and where consultation could, of itself, lead to significant temporary distortions in taxpayers' and market's behaviours. For example, where consultation could create an unacceptable level of uncertainty, with a detrimental effect on major transactions and aggregate business activity until final decisions are announced and enacted;
- where Ministers deem it necessary to act swiftly (eg take anti-avoidance measures); and
- where policy develops significantly in the period between the pre-Budget Report and the Budget proper.

It also referred to the possibility of not consulting where a tax measure is minor, straightforward and non-contentious (cf the 2004 Code above) so that it does not justify the resources of full consultation.

On looking at the list of exceptions above, several points come to mind. Firstly, the genuine occurrence of these events tends to be small. They are the exception and not the norm. Therefore, it should be very rare for these incidents to be cited as a reason for not consulting and they should not be used as an excuse to avoid the consultation process.

Our view is that any Code of Practice should start from the position that Government must always consult on all major tax policy matters, except where it is likely that the Government's revenues will be seriously prejudiced (for example the need to act quickly to counter avoidance). Such circumstances will be quite rare, and the substantive reasons for the decision must be explained and published. Further, these reasons should be subject to review by an "independent" body, for example a parliamentary committee.

For these reasons we think that announcements such as those made in the 2007 PBR announcements on CGT and residence and domicile (to give but two examples) should have been subject to prior consultation in accordance with the principles set down in the 1999 and 2004 Codes.

As noted earlier and as confirmed in the 2004 Code, consultation should take place early in the policy development process, ideally before key policy decisions have been taken. If a wider written consultation is not possible in the very early stages, then we think that there should be informal consultation with the professional bodies and other stakeholders who are likely to be affected by any policy proposals.

Following the consultation, there should then be a period for consideration of the points raised by respondents and any arising modification of ideas. This would lead in such instances into a revised paper on the tax policy which may or may not at that stage include draft legislation. This would be fed back to those who had contributed at the initial consultation phase, plus any other relevant person, for any remaining comments and a detailed explanation as to why particular ideas were accepted or rejected.

Conclusions

It is clear that consultation is an invaluable part of the process of making tax law. It should be the foundation upon which all tax legislation is developed. Consultation should be open and constrictive and not secret and unsatisfactory. The Code is an important part of this process. It should be rewritten so that there should be a clear obligation to consult on tax policy issues. Any exceptions should be extremely rare, clearly defined and explained and also subject to independent scrutiny. It should also be made clear as to what is, and is not, within the consultation. The emphasis should be on consultation right at the start of policy formulation, well before policy decisions have been made.

16 May 2008

Further supplementary memorandum by ICAEW

Summary of Irish and US Residence Tests

Set out below are the basic residence tests in Ireland and the US.

1. Irish Residence Test

Taxes Consolidation Act, 1997 (Number 39 of 1997)

S 819 Residence

[FA94 s150]

(1) For the purposes of the Acts, an individual shall be resident in the State for a year of assessment if the individual is present in the State—

- (a) at any one time or several times in the year of assessment for a period in the whole amounting to 183 days or more, or
- (b) at any one time or several times—
  - (i) in the year of assessment, and
  - (ii) in the preceding year of assessment,

for a period (being a period comprising in the aggregate the number of days on which the individual is present in the State in the year of assessment and the number of days on which the individual was present in the State in the preceding year of assessment) in the aggregate amounting to 280 days or more.

(2) Notwithstanding *subsection (1)(b)*, where for a year of assessment an individual is present in the State at any one time or several times for a period in the aggregate amounting to not more than 30 days—

- (a) the individual shall not be resident in the State for the year of assessment, and
- (b) no account shall be taken of the period for the purposes of the aggregate mentioned in *subsection (1)(b)*.

(3) (a) Notwithstanding *subsections (1) and (2)*, an individual—

- (i) who is not resident in the State for a year of assessment, and
- (ii) to whom *paragraph (b)* applies,

may at any time elect to be treated as resident in the State for that year and, where an individual so elects, the individual shall for the purposes of the Acts be deemed to be resident in the State for that year.

- (b) This paragraph shall apply to an individual who satisfies an authorised officer that the individual is in the State—
  - (i) with the intention, and
  - (ii) in such circumstances,

that the individual will be resident in the State for the following year of assessment.

(4) For the purposes of this section, an individual shall be deemed to be present in the State for a day if the individual is present in the State at the end of the day.

S 820 Ordinary residence

[FA94 s151]

(1) For the purposes of the Acts, an individual shall be ordinarily resident in the State for a year of assessment if the individual has been resident in the State for each of the three years of assessment preceding that year.

(2) An individual ordinarily resident in the State shall not for the purposes of the Acts cease to be ordinarily resident in the State for a year of assessment unless the individual has not been resident in the State in each of the 3 years of assessment preceding that year.

S 822 Split year residence

[FA94 s153]

(1) For the purposes of a charge to tax on any income, profits or gains from an employment, where during a year of assessment (in this section referred to as "*the relevant year*")—

(a) (i) an individual who has not been resident in the State for the preceding year of assessment satisfies an authorised officer that the individual is in the State—

(I) with the intention, and

(II) in such circumstances,

that the individual will be resident in the State for the following year of assessment, or

(ii) an individual who is resident in the State satisfies an authorised officer that the individual is leaving the State, other than for a temporary purpose—

(I) with the intention, and

(II) in such circumstances,

that the individual will not be resident in the State for the following year of assessment, and

(b) the individual would but for this section be resident in the State for the relevant year,
subsection (2) shall apply in relation to the individual.

(2) (a) An individual to whom *paragraphs (a)(i)* and *(b)* of *subsection (1)* apply shall be deemed to be resident in the State for the relevant year only from the date of his or her arrival in the State.

(b) An individual to whom *paragraphs (a)(ii)* and *(b)* of *subsection (1)* apply shall be deemed to be resident in the State for the relevant year only up to and including the date of his or her leaving the State.

(3) Where by virtue of this section an individual is resident in the State for part of a year of assessment, the Acts shall apply as if—

(a) income arising during that part of the year or, in a case to which *section 71(3)* applies, amounts received in the State during that part of the year were income arising or amounts received for a year of assessment in which the individual is resident in the State, and

(b) income arising or, as the case may be, amounts received in the remaining part of the year were income arising or amounts received in a year of assessment in which the individual is not resident in the State.

2. US Residence Tests

Edited extract of the US statutory residence test as published by the US Internal Revenue Service in *Publication 519 (2007), U.S. Tax Guide for Aliens*

Resident Aliens

You are a resident alien of the United States for tax purposes if you meet either the green card test or the substantial presence test for calendar year 2007 (1 January to 31 December). Even if you do not meet either of these tests, you may be able to choose to be treated as a U.S. resident for part of the year.

Green Card Test

You are a resident for tax purposes if you are a lawful permanent resident of the United States at any time during calendar year 2007. (However, see Dual-Status Aliens, later.) This is known as the "green card" test. You are a lawful permanent resident of the United States at any time if you have been given the privilege, according to the immigration laws, of residing permanently in the United States as an immigrant. You generally have this status if the U.S. Citizenship and Immigration Services (USCIS) (or its predecessor organization) has issued you an alien registration card, also known as a "green card." You continue to have resident status under this test unless the status is taken away from you or is administratively or judicially determined to have been abandoned.

Substantial Presence Test

You will be considered a U.S. resident for tax purposes if you meet the substantial presence test for calendar year 2007. To meet this test, you must be physically present in the United States on at least:

1. 31 days during 2007, and
2. 183 days during the three-year period that includes 2007, 2006, and 2005, counting:
   (a) all the days you were present in 2007, and
   (b) one third of the days you were present in 2006, and
   (c) one sixth of the days you were present in 2005.

Example

You were physically present in the United States on 120 days in each of the years 2005, 2006, and 2007. To determine if you meet the substantial presence test for 2007, count the full 120 days of presence in 2007, 40 days in 2006 ($\frac{1}{3}$ of 120), and 20 days in 2005 ($\frac{1}{6}$ of 120). Because the total for the three-year period is 180 days, you are not considered a resident under the substantial presence test for 2007.

Days of Presence in the United States

You are treated as present in the United States on any day you are physically present in the country at any time during the day. However, there are exceptions to this rule. Do not count the following as days of presence in the United States for the substantial presence test.

— Days you commute to work in the United States from a residence in Canada or Mexico if you regularly commute from Canada or Mexico.

— Days you are in the United States for less than 24 hours when you are in transit between two places outside the United States.

— Days you are in the United States as a crew member of a foreign vessel.

— Days you are unable to leave the United States because of a medical condition that arose while you are in the United States.

— Days you are an exempt individual.

16 May 2008

Supplementary memorandum by the Institute of Chartered Accountants of Scotland (ICAS)

CONSULTATION: IS THERE A BETTER WAY?

We at the Institute of Chartered Accountants of Scotland were grateful for the opportunity to give oral evidence on certain aspects of the Finance Bill 2008. During the session, you requested support from the people giving evidence for what would be a good process of consultation and we are pleased to provide the following. This has been agreed with our colleagues at ACCA.

At present, there is concern that the process of consultation is variable both in its quality and volume. An example of good consultation has been the process by which HMRC has consulted first in private pursuing ideas and developing these before public consultation on the powers which it requires to ensure compliance. This process is helped by the fact that there is a common objective to assist all taxpayers to pay the right tax at the right time but a recognition that not everyone likes to pay tax and some will go to inordinate and unacceptable lengths to try to avoid or even worse evade the responsibility. The process by which consultation has occurred in the HMRC Powers Review has been a good process although there is still scope for improvement. Some of the powers being sought by HMRC give cause for concern that they may go too far in the invasion of privacy or do not give sufficient safeguards to protect the privacy of innocent individuals. Legislation is a blunt tool and it is difficult to balance the interests of all members of society.

The process has been good because there was an opportunity to discuss ideas and concepts at a mixture of workshops, written consultation and forums. But the process was flawed where it was felt that Civil Servants were using the process to tick boxes rather than actively listen and fully consider the implications of the responses received. An example of this was in the consultative document published in March 2006 which announced interventions. These were due to start irrespective of what responses to the idea were received. This is wrong. Effective consultation must:

1. Consider the debate and seek the views of those potentially affected.
2. Having decided as a matter of policy that the change is to be made and is necessary, consultation is a good way to see how best to implement the change. Where there are serious concerns these should be actioned wherever possible or the reasons for not accepting these concerns must be fully and adequately explained.
3. There should be recognition that change in itself is costly and troublesome. It follows that change should only be introduced when it is necessary and should not be introduced for political reasons.

Consultation helps because those that are responsible for policy and those responsible for implementing that policy may not necessarily anticipate the repercussions of the change they propose. An example of shockingly bad consultation was the introduction of the tax credit regime. In theory this appeared to be a politically desirable objective and a way of encouraging people back into work offering financial support for those meeting certain working conditions. In practice the scheme was appallingly badly designed and was simply unsuitable for the self employed as the measure of income and the measure of need did not match.

More recently, the changes announced to deal with capital gains tax (a simplification) and changes dealing with the taxation of resident non domiciled individuals are illustrations of poor consultation. Taxpayers are entitled to as much certainty as possible particularly when, in principle, they are required to self assess declaring their income and gains and calculating their own tax contribution. When the reform of capital gains tax was announced at the Pre Budget Report on 9 October 2007, it created uncertainty. Simplification is to be welcomed in a self assessment regime but poorly thought out methods of simplifying a form of taxation which has been subject to so much change in recent years is not in the public interest and not in the interests of the business community or indeed the Government. The business community loses confidence that they are dealing with a secure and certain (and fair) tax regime.

There is also concern at the sheer volume of consultation which the Government has initiated. Many interested parties view proposals in a voluntary capacity. Although consultation itself is good in principle, there must be better ways to do it and a more effective way of marshalling the volunteer resource that is prepared to consider the proposals within any consultation document. Another criticism of the present process of consultation is that often relevant and necessary information is not included within the document. This means that only those who are well informed about other matters or who have access to the information from elsewhere can actually respond in an informed way. It also deters people who are potentially affected from reading the consultation document if their first experience is that they are left having to identify the information which is missing but are unable to source this.

Consultation needs to be worthwhile with feedback being given to those who respond to the invitation. In an ideal and democratic world, consultation should be available on all proposed changes but in the real world there have to be pragmatic solutions. In particular, there cannot be real consultation where there is a concern that there will be forestalling and that people will abuse advance warning. Thus in tackling avoidance it is accepted that change will occur without consultation. But history shows that successive UK Governments have made a dreadful mess of the UK taxation system. There should therefore be a mechanism to look with hindsight at changes which have occurred and to consider whether the change was beneficial and whether subsequent change, particularly to tackle avoidance, could have been dealt with by other means.

In fiscal law, the timescale of an annual Finance Bill often leads to unrealistic timescales for consultation. This in turn leads to the introduction of defective legislation which requires constant amendment but does not always receive this. Hindsight would show that it is better to have less change and to introduce better legislation getting it right first time than the current process of enacting poor legislation.

Many consultative documents suffer because they are overly verbose without focussing on the real issues which would be of a concern and in the public interest. In addition, the questions raised are often not the most relevant to whether or not the policy being consulted upon should be developed. In principle, regulatory impact assessments (RIA) are a great idea but the reality is that the figures often produced lack credibility and are often unrealistic. The questions posed are often posed in a way that is biased and consultation could be improved if questions were set in a more impartial way. Perhaps there might be a way in which a draft RIA might itself be the subject of limited consultation.

Consultation must be sensitive to the requirements of the perspective reader. There is concern that consultation does not really touch or engage with "ordinary" members of society who have an average reading ability. Consultative documents require a high degree of literacy skill and the responses received may be biased towards a section of society that has such high literary skills but not representative of many people.

A model for good consultation would be:

1. Considered and rigorous testing of the ideas for change including a cost benefit analysis to show that if change was necessary, the method proposed was apparently the most efficient.
2. Discussion of the ideas for change with interested parties, confirming the ideas are worthwhile and supported with no or few unforeseen consequences.
3. Rigorous testing of other ways of achieving the same objective including consideration of the fundamentals. This is to address the sticking plaster approach which UK fiscal legislation has adopted for too many years.

   If the change is still justified, publish a consultation document giving a minimum of 13 weeks to enable potential respondees to consider the implications and respond in writing. During this period, there should be workshops with tax practitioners and other relevant individuals. Consideration might also be given to whether a workshop might prove helpful to assist those affected but less able to respond in writing to input views and discuss options.
4. Consider all views received carefully ensuring that concerns are adequately addressed and offering proper explanations of why recommendations to amend are accepted or rejected.
5. Prepare draft clauses and circulate these to ensure that these achieve their intended purpose, amending as necessary. Publicise the identity of those on any Standing Committee so that those wishing to make representations can submit these to the right people. Report any debate accurately ensuring that reassurances are given where appropriate and that these assurances are respected (not like *Pepper v Hart* where the Parliamentary assurances of the then Chief Secretary to the Treasury were subsequently ignored by the Inland Revenue until the House of Lords took them into account).
6. Enact the legislation.
7. Conduct a post enactment review and be prepared to amend the legislation when defects or unintended consequences are identified. In addition, if it can be shown that legislation does not achieve its effect, repeal it quickly and start the process again.

16 May 2008

WEDNESDAY 7 MAY 2008

Present		
Present	Barnett, L.	Sheppard of Didgemere, L.
	Blackwell, L.	Vallance of Tummel, L. (Chairman)
	MacGregor of Pulham Market, L.	Wakeham, L.
	Paul, L.	

Memorandum by the British Bankers' Association (BBA)

The BBA is the leading association for the UK banking and financial services sector, speaking for 223 banking members from 60 countries on the full range of UK or international banking issues and engaging with 37 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy. Financial services companies pay £12 billion directly in tax and their employees a further £15 billion in income tax. The sector contributes annually over £100 billion to UK economic growth and a trade surplus of £25 billion to the balance of payments.

We are pleased to submit the following written evidence to the House of Lords Sub-Committee on the Finance Bill 2008. In response to the invitation to contribute to the Sub-Committee's inquiry this year, the BBA has focussed its comments on the issues of residence and domicile, after some general initial comments on process. The matter of HM Revenue & Customs' (HMRC) powers, a further significant issue for the banking industry and not specifically listed as one of the topics of the Sub-Committee's inquiry but which falls within the Sub-Committee's remit of tax administrative matters, has additionally been flagged at the end of this submission.

General Comments

We believe that there is much that HM Treasury (HMT) and HMRC have done to review and improve the impact of the tax system on financial and insurance services.

Since the early 1980s a macroeconomic climate has been created within the country that has fostered UK financial services and has attracted firms of all types from around the world. In contrast to New York and Tokyo, which both have large financial services activities underpinned by demand from the domestic economy, London is predominantly internationally driven. The external perception of the UK has been that all governments through the last 25 years have sought to ensure both proportionate regulatory and tax regimes apply to this international industry. Over the last six months, however, this has been questioned on the back of major and unexpected changes to the tax regime, notably in respect of the residence and domicile rules. We are concerned that the individuals and businesses which are critical to the success of the UK's financial services sector may not perceive the UK as being as an attractive location as it was once considered to be and our detailed comments on the Finance Bill proposals are set in this context.

Policy Development and Consultation

Whilst there have been welcome cases of successful consultation, the Government's recent tax policy development has not inspired the full confidence of the financial services industry. A principal concern is that the full implications of some proposed tax policies were not envisaged or taken into account. 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. This requires full and timely external consultation. Consultation must be both on the policy and the detail of implementation, as it is meaningless to consult on measures to iron out the defects of a policy that has been developed without reference to stakeholders.

The lack of groundwork in the policy development of the residence and domicile rule changes was evident in the confusing and conflicting messages being given out. The inability of Government to articulate its intentions was unsettling, given the highly mobile nature of capital and talent, and particularly given the fact that the changes were due to come into effect imminently.

While subsequent discussions with HMT and HMRC have been helpful to clear up some pressing concerns, notably regarding the drafting of clauses in the Finance Bill in relation to deemed remittances, it is regrettable that these discussions could not have taken place before the Pre-Budget Report announcement, and it is also regrettable that we were not granted our request for a deferral of the residence and domicile proposals until a detailed and careful consultation could be concluded, to deliver a solution that would not result in damage to the UK's standing as an outward looking economy.

The BBA welcomes the announcement that the Government is to establish a taskforce, comprising private sector experts, recognising the need to ensure that competitiveness remains at the heart of any future reforms to the tax system. It is to be hoped that such a taskforce, in combination with more general and broad based consultation, will in future ensure that the fiscal environment supports the growth of the financial services industry.

Complexity of UK Tax Law and Size of the Finance Bill

The BBA has for a number of years expressed concern about the compounding complexities of UK tax law and the size of annual Finance Bills. This year marks no exception, with the Finance Bill running to 160 clauses and 46 schedules and the explanatory notes running to 1,148 pages.

There is a fundamental lack of certainty in UK legislation, which is concerning for business given the growth and complexity of UK tax law. This is compounded when, as in two cases in this year's Finance Bill, the existing law is amended retrospectively—in the case of Clause 55 by some 21 years. We also consider that there is an over reliance on guidance as a crutch for poorly drafted legislation. Lack of clarity in legislation and tax by guidance not only create unpredictability as to the ultimate legislation but give rise to an additional compliance and administrative cost for business.

Residence and Domicile: Clause 22, Clause 23 and Schedule 7

In its response to HMT's "Paying a fairer share: a consultation on residence and domicile", the BBA recommended that: the Government defer its proposals until a detailed and careful consideration of its objectives could be concluded, to deliver a solution that would not result in unintentional and irrecoverable collateral damage to the financial services sector.; that the Government conduct a full regulatory impact assessment on the proposals, setting out the purpose and intended effect of the measures, the risks, the benefits, consultation processes, the compliance costs for individuals and businesses, and any other costs and effects, including the effect of any projected loss in tax revenues (not only personal tax) as a result of individuals leaving the UK; and that an operational impact assessment is conducted to ensure that HM Revenue and Customs (HMRC) is sufficiently geared to cope with the additional burdens created by any changes.

The BBA considered that such a deferral would be necessary to give both the Government and stakeholders the time to fully explore the range of potential outcomes that could result from such significant changes. It is still our belief that the deferral of these proposals for full consideration would result in a more coherent and optimal outcome. As the Government has not granted this request and following on from the Budget announcement on 12 March 2008, and publication of the Finance Bill on 27 March 2008, we accept that the best way forward is to flag a number of key issues that require attention and resolution during the passage of the Bill. We nevertheless anticipate that further issues and consequences may materialise in future.

Clause 22—Periods of residence

The move away from the Government's initial proposal to include days of arrival and departure when day-counting, to counting only days where an individual is in the UK overnight was a welcome improvement on the original proposals, which would have severely compromised the competitiveness of the UK. However, the non-statutory 91 day average test remains out of line with the UK's global competitors, and we consider that it would be preferable to introduce a statutory test for residence.

Clause 23 and Schedule 7—Remittance basis

Unresolved issues related to changes to the remittance basis are significant for the BBA's membership as employers. Non-UK workers constitute a large proportion of employees in our sector, reflecting the industry's considerable success in attracting talent from around the globe, at all levels from graduate trainees up to top management. The primary concerns of the BBA's membership in this regard are:

— That years spent in full time education should be excluded from the seven-year qualifying test—the financial services sector is concerned to ensure that these measures do not significantly impact upon graduate and post-graduate recruitment. In an increasingly global marketplace, financial institutions are keen to attract the most able and talented individuals onto their graduate programmes. Of particular benefit are those who possess an understanding of particular cultures and/or speak the language of perceived key growth areas, such as China and South East Asia. Many such graduates will have been educated in the UK and therefore breach the seven year rule immediately or shortly after commencing employment. At an early stage of their career they will not be higher rate taxpayers. In contrast to their UK domicile peers, they will be forced to file UK tax returns and claim treaty relief for overseas tax suffered on investment income. This administrative burden is wholly disproportionate to the additional tax raised, if any, and we do not believe that the proposals should be targeted at this group.

— The mandatory extension of UK approved share plans to Resident but Not-Ordinarily Resident ("RNOR") persons—The Finance Bill proposes changes to the class of persons who must be invited to participate in offerings under the all-employee UK approved share plans ie Save As You Earn (changes to Para 6 Sch 3 ITEPA 2003 as proposed by Para 38 Sch 7 Finance Bill 2008—page 176 line 45) and Share Incentive Plan (changes to Para 8 Sch 2 ITEPA 2003 as proposed by Para 37 Sch 7 Finance Bill 2008—page 176 line 40). We cannot see a justification for RNORs to be included on a mandatory basis, nor does it appear that this is a planned policy change adopted by Government. The changes have arisen due to other legislative changes relating to RNORs and unapproved option plans. These changes in respect of unapproved plans are welcome as they provide RNORs with parity of treatment for persons ordinarily resident in the UK, but the mandatory inclusion of RNORs in the share plans are not welcome for the reasons below.

  Whether or not a person is RNOR is often dependent upon their intentions and there is no mechanism for the employer to know how or when these intentions have changed. An RNOR is, by definition, a person who does not expect to be in the UK for three years or more and who has no long term commitment to the UK. In contrast, the all-employee approved UK plans are for persons who will be participating for at least three years—in the case of SAYE for three, five or seven years (option vesting periods) and for SIP for at least five years (earlier withdrawal results in loss of tax relief). With respect to its inbound international assignees, many employers have a category of "short term assignments" whose contract is expected to last for two years or less. These employers do not want to be forced to offer participation in the UK all-employee approved share plans to this population. The RNOR will not benefit from participation and in many cases will be adversely impacted compared to continuing participation in home country arrangements.

  The adverse changes discussed above in respect of RNORs and all-employee approved arrangements could be avoided through the simple mechanism of changing each of the relevant sub-paragraphs, such that they do not refer to Section 15 ITEPA 2003 but, instead, merely referred to the requirement for inclusion in invitations of persons "resident and ordinarily resident in the UK". We understand that HMRC are focussing on whether or not it is possible to administer the plans in accordance with the proposed revised legislation. Whist it is possible to administer on this basis, it will clearly not be desirable for many international organisations to operate this way. International employers would like to continue to have flexibility in this regard.

— Uncertainty regarding the PAYE position from 2009/10—HMRC has produced a temporary solution to address the immediate term concerns of UK employers of non-domiciles, confirming via their "Frequently Asked Questions" page on their website that employers will not be expected to identify which employees are claiming the remittance basis and remove their personal allowance through PAYE for 2008–09. However, the HMRC FAQ page also states that "HM Revenue & Customs (HMRC) will be discussing with employers and representative bodies whether for 2009–10 and later years it would be advantageous to deal with some remittance basis claims through the PAYE system." Until such time, UK employers of non-domiciles will have unresolved concerns about the future interaction of the new residence and domicile rules with the PAYE system, and the potential liability for penalties.

The industry has also been unsettled about the impact of the remittance changes on its products and services. The BBA wrote to the Financial Secretary to the Treasury on 20 March 2008 to highlight concerns that the extended definition of remittance under the proposed new section 809H of Income Tax Act 2007 could give rise to significant difficulties for the banking and fund management sectors because customers on the remittance basis of taxation would face incremental tax liabilities from using UK financial service providers. Such customers would thus have an incentive to use overseas financial service providers instead of UK providers. During discussions, the BBA learned that one large private banking member, as a consequence of this change, was assessing whether to move one third of its UK banking operations offshore. The Financial Secretary to the Treasury was persuaded of the absolute necessity to amend the Finance Bill, and provided reassurance that it was not the Government's intention for the legislation to have the effect described. The BBA was reassured to have the Minister restate the Government's commitment to UK competitiveness, and we eagerly await the amendments.

Uncertainty remains about the treatment of particular products, such as the grandfathering arrangements for offshore mortgages. The provisions in Clause 86 of Schedule 37 appear potentially to be narrower than those indicated in Budget Note 104, which stated that the Finance Bill 2008 would include grandfathering provisions such that untaxed relevant foreign income used to fund interest repayments on existing mortgages secured on a residential property in the UK, would not be treated as a remittance on or after 6 April 2008. The Finance Bill in fact appears to mean that the grandfathered loan itself must have been used to acquire the interest in residential property (and not simply be secured on it) and thus seems to exclude the relatively common case where the pre 12th March loan is the result of a re-mortgage of the initial loan. If the expectations of the industry and clients are to be frustrated, the impact for the industry could be significant. The uncertainty, at any rate, is destabilising and could contribute to a deterioration in business activity for the UK.

HMRC Powers

Though not one of the specific topics on which your enquiries are focused, we feel that this issue is of such significance that we had to include a reference to it in our concerns.

We recognise the advantages of harmonising and modernising some of HMRC's powers, to ensure that the tax system encourages compliance, operates with minimum disruption to taxpayers and allows HMRC to take firm action against taxpayers that deliberately do not comply with the law. However, we are not convinced that there is merit in a relentless accrual of new powers, without evidence that HMRC is stocktaking and allowing previously introduced measures to bed in. This is particularly concerning when we consider that additional systems and powers may only serve to divert attention and resources away from existing unresolved issues.

The measures introduced in the Finance Bill 2008 are significant and wide ranging, and the specific measures included in the Finance Bill were not adequately consulted upon. For instance, Clause 10, Schedule 36 refers to an officer being able to enter any business premise to inspect business documents that are on the premises if reasonably required for the purposes of checking the tax position of any person. The BBA has enquired of HMRC whether it is their intention that this provision should enable HMRC to enter a bank branch to inspect business documents related to a customer. Such a power would be entirely at odds with our members' duty, under law, to keep their customers' affairs confidential. We consider that such a measure should be widely consulted upon, to establish whether such a power is proportionate or within the public interest.

Additionally, we consider that increased HMRC powers must be matched by adequate taxpayer safeguards, and we are dismayed to note an intention to place key taxpayer safeguards within HMRC's guidance rather than within legislation. We do not consider this approach to offer a suitably robust protection of taxpayer rights.

Conclusion

It is essential that UK competitiveness is again prioritised by the Government and Parliament. We consider that the mobility of capital and talent and the efforts of our international competitors to seize the competitive advantage have been underestimated. The UK economy and exchequer require the financial services sector to remain strong, and the UK's fiscal environment, international reputation, and flexible and skilled workforce need enhancement to do so.

30 April 2008

Memorandum by the City of London Corporation

1. The City of London Corporation aims to promote and reinforce the competitiveness of the UK-based international financial services sector by tackling issues which may impact upon the open, efficient and competitive environment for doing business in the City. The City of London Corporation therefore welcomes the opportunity to comment on current proposals on the taxation of resident non-domiciles (RNDs).

2. Proposals for reform of the system of RND taxation were put forward in the Autumn 2007 Pre Budget Statement. The appearance of provisions in the current Finance Bill are welcome in providing clarification of the treatment of RNDs given that a review had originally been announced in the 2002 Budget. Certain concessions such as, for example, the removal of any element of retrospection, have also been generally well received. It is the City Corporation's view, however, in light of consultation with business stakeholders, that the legislative proposals put forward may still have the potential to damage the wider economic interests of the United Kingdom. The concern is that the extra revenue generated by RNDs may be outweighed by the loss of talented people, together with their skills, earning capacity and the tax they already pay on onshore earnings and via VAT, Council Tax and other imposts.

3. The City Corporation is only in a position to comment on the situation in the financial and related business services (FRBS) sector but it acknowledges that other sectors, such as scientific research and high technology, are similarly affected. The City's observations do not directly concern those with ultra-high net worth status for whom the proposed legislation may represent little problem in financial terms. Nevertheless, the City contends that the role they play in generating employment and consumer demand, and therefore indirect revenue, should not be ignored. Similarly the impact of the perception, however misplaced, that RNDs are being made unwelcome should not be underestimated. Anecdotal evidence from contacts abroad, particularly in the Middle East, also reflects widespread concern among those who have assets in the UK. Their financial engagement here is of economic and political benefit to Britain and the potential removal of such assets from the UK banking system gives cause for concern at a time when liquidity is already scarce.

4. The City does not question the prerogative of the Government of the day to introduce the tax measures it feels are most appropriate in order adequately to provide public services. It is also accepted that taxes should be equitably applied and that all residents and businesses in the UK should pay a proper share of them. Nevertheless, the City Corporation believes that the existing RND system has attracted unfair criticism and while it may be perceived by some as unfair to domestic taxpayers, it has provided an environment in which foreign nationals with RND status have been able to make a major contribution to the wider economy through indirect tax and the generation of employment and export earnings.

5. The UK-based FRBS industry has, particularly over the 20 years since "Big Bang", become one that is internationally owned, internationally managed and internationally staffed. Many of those employed in it work for companies that have no particular attachment to a UK location other than the business environment. A significant proportion are foreign nationals for whom RND status, and the ability to retain capital offshore while paying tax on earnings specifically generated here, is an attraction. Like many of the companies that employ them, their own location decisions will be based at least partially on fiscal conditions, as well of course as on social, cultural and other factors.

6. Recently published research undertaken for the City by CRA International[1] illustrates that tax follows, and does not generally lead, business location decisions, but at the margin both tax rates and the operation of the fiscal system can act as an incentive for firms to move some or all of their business offshore. The wholesale financial services sector is especially mobile, when compared with other service sectors and with manufacturing. The majority of "City" activity is not tied directly to the domestic UK economy. Its location here reflects perceived business advantages. The two main factors for success in financial services—pools of capital and human expertise— can however easily be moved to other centres or not brought here in the first instance.

7. Estimates of the numbers working in FRBS and affected by the proposed changes vary but there is evidence to suggest that the number is likely to be significantly higher than one Government estimate of 4,000. The City has heard, for example, that just two major City institutions employ between them about 5,000 individuals likely to be affected by the new rules. The Society of Tax and Estate Professionals (STEP) estimates that there are between 110,000–150,000 individuals with RND status in the UK and that around a third of them work in senior and middle management positions in London-based financial and professional services. One identifiable and quantifiable cluster is the Greek ship-owning community, based here since the early 1960s and important in retaining the UK's cluster of maritime professional services. There is a real risk that, as other centres actively market themselves as alternative centres for shipping business, London will see a number of ship-owners close their London operations.

8. These individuals tend to have transferable skills which need not necessarily be applied in the UK. Their skills are in demand in other competing jurisdictions in Europe and particularly the fast-growing centres of the Middle East and Asia, where experienced asset and wealth managers, investment bankers and derivatives

[1] *The Impact of Taxation on Financial Services Business Location Decisions*, CRA International, published by the City of London Corporation, February 2008.

specialists are being actively recruited. The complexity of FRBS business is such that the loss of this talent, or even a substantial part of it, could damage the City's capacity to innovate and to provide the process of international trade and development with the level of services that currently generate export earnings and tax revenue for the UK. The domestic skills pool is insufficiently deep to fill these gaps. The loss of these talented individuals could persuade foreign owned companies to close or scale down operations here leading to a loss in the City's critical mass.

9. Research mentioned above at para 6 illustrates that both the personal and the corporate tax environment has an impact on financial services location decisions. Consequently the UK's competitive position is being eroded as other centres, in Europe and elsewhere, improve their own offering in an attempt to attract the finite and highly mobile stock of direct investment. Commenting on the fiscal regime generally, the report[2] says:

> "London, while it has become less competitive in tax, retains great strengths which inhibit a sharp outflow of firms. London benefits from the hub and cluster effects of being a great financial centre. Exchanges, skilled workers, the best professional advisors, infrastructure, and a strong regulatory regime are all here. All relevant counterparties are here. Not to be underestimated is the attraction to senior management of living in a great city with its schools, cultural attractions, and social life. Nevertheless, there is a feeling that a change in tone is occurring which makes London a less attractive place. The most mobile financial services firms do see that a tipping point could be reached if there are more negative surprises in the UK tax regime of the sort that have recently occurred. Seepage of jobs from London as a result of tax appears to have occurred already and may accelerate (perhaps even more so if there is an economic downturn)".

10. Although the report was finalised before the Government provided clarification that HMRC would not require disclosure of overseas earnings and announced other refinements in the Budget, the views of the business community noted in the research do retain relevance. This is particularly evident in remarks on the instability felt by some individuals and the view that they may be singled out by their status. This suggests that impact of the proposals will be felt much wider than the wealthy non-doms on which the debate has so far been focused. The report says:

> "Not surprisingly, there was much concern expressed about non-doms in the investment banks we interviewed. Many members of senior management in investment banks are non-doms, together with key personnel in trading and other operations. We were told that such individuals are being destabilised by the change in tax status and are either considering departure or demanding tax equalisation from their employer. In one investment bank, an entire London-based national team from a European country recently decided to leave London and return to their home country because they were offered tax incentives to come back (such deals seem to be on offer to attract London-based professionals back to their country of origin). In a high-profile move, Goldman Sachs has announced it will establish a bank in Dublin that will become the centre of its European banking operations. It will employ 'high-value' individuals and conduct activities such as funds management; and this specifically in response to an attractive tax rate in Ireland and a perceived change in the UK tax climate. While it is stated that payment of the £30,000 fee would preserve non-dom status for these individuals, there was a view that 'you might as well put a red flag on your file at HMRC, now they know for certain that you have significant offshore wealth".[3]

11. 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. Recent amendments to the proposals, removing retrospection and an undertaking that HMRC will not enquire into the offshore assets and earnings of such individuals are a partial reassurance, but an annual impost of £30,000 may make a significant difference to the standard of living of those more modestly remunerated. In a number of cases, where two such individuals are married, a total levy of £60,000 could well be felt by those living in or around central London, where accommodation and other costs are already high by international standards.

12. The changes in policy may also impact upon the position of students coming to the UK for secondary, graduate and post-graduate education. Any combination of school and university, or university, post-graduate and professional studies, could well exceed seven years. The fees they pay are of direct benefit to the economy, and the experiences of those who go on to be influential in the financial world are no less likely than those of others in informing a sense of belonging when it comes to decisions about a business location.

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[2] Ibid, pg 5.

[3] Ibid, pg 60

13. There is no set, universally agreed City view but the tone of comment has nevertheless demonstrated the strength of business feeling. Following substantial consultation with the business community and other stakeholders, the City Corporation suggests that whilst the amendments reflected in the proposed legislation improve substantially on the original proposals, the legislation is still:

— Possibly running the risk that it will drive away mobile talented individuals; and

— unlikely to raise net revenue other than in the very short term, while possibly damaging the critical mass of the economy over the longer term[4].

14. 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. Any immediate boost to tax revenue in the short term is likely to be more than outweighed by the loss of both direct and indirect tax revenue as those affected take their skills to other centres which they perceive as more sympathetic in fiscal terms.

May 2008

Memorandum by Alex Henderson, advisor to the City of London Corporation

Introduction

1. This briefing note will be confined to the impact of changes to the taxation of residence and domicile. It will consider broader issues, outline significant points of detail and highlight areas of continuing concern.

Background to the Changes to the Taxation of Residence and Domicile

2. The special tax treatment of non-domiciled individuals and the rules relating to residence go back to the original introduction of income taxation in the UK at the time of the Napoleonic wars. The treatment of non-domiciled individuals has been governed by a mixture of statute, limited case law and to a very limited extent HMRC practice. The treatment of residence has been laid down by statute but amplified by substantive case law (some of which is over a century old) which has been collated with HMRC practice in their booklet "IR20".

3. In recent years there has been concern about the extent taxpayers can rely on HMRC practice with regard to residence. The measures regarding the treatment of non-domiciled taxpayers worked largely well in practice but mainly because they limited the attention of the UK tax system to amounts earned or (mostly income) brought to the United Kingdom.

4. The Government announced a review of the treatment of residence and domicile in Budget 2002 (there have been a number of previous reviews, which concluded that no change was in the best interests of the UK). A background paper was published in 2003 and Budget 2004 indicated that a consultation paper would be published setting out possible approaches to reform. This was long delayed. The Treasury papers accompanying the 2007 Budget simply commented (at paragraph 5.102) "The review of the residence and domicile rules as they affect the taxation of individuals is ongoing."

5. The treatment of non-domiciled individuals is of special concern to the City. Many employees and owners of financial institutions are themselves non-domiciled. City businesses are international in outlook and many are international in operation. They look at the UK as one of a range of potential locations for providing their services; the rates of tax and stability and certainty of the tax regime are key factors. Many City businesses provide services to non-domiciled individuals in managing their wealth or otherwise advising them. The complexity of international operations and the international mobility and outlook of both clients and the people and institutions that serve them has been steadily increasing.

6. By definition non-domiciled individuals are not permanently settled in the UK which remains one of a number of countries where they can be resident and/or do business without being taxed on their worldwide income and gains. Although often thought of in shorthand terms as "the super-rich", non-domiciled status extends to all persons who are not settled permanently or indefinitely in the UK and encompasses those

[4] The Society of Trust and Estate Practitioners suggests that, all other things remaining equal, in the first year of operation the new rules could raise £800 million in direct revenue, but cause the loss of up to £2 billion in business and indirect taxes.

without significant wealth who are coming to the UK simply to work. There is no precise number of non-domiciled individuals currently resident in the UK. Some estimates suggest there are several millions. Whatever the figure, it is hugely more than the 100–150,000 range generally cited by HMT/HMRC, this figure being based on the numbers HMRC know about as people who complete tax returns. It ignores "ordinary" employees (many of whom will work for City firms), workers in such industries as agriculture and hospitality, and students.

7. Changing the tax regime relating to residence and domicile has effect not only for private individuals but also but also businesses employing them (particularly if they are "tax equalised" ie the employer undertakes to ensure neutrality of the taxation consequences of being posted to the UK) or servicing them. The changes affect therefore many persons in the City directly or indirectly.

Pre-Budget Report Changes

8. Very considerable reforms to the taxation of non-domiciled individuals were, however, announced in the Pre-Budget Report on 9 October 2007 to take effect from 6 April 2008. The Press release announced five main areas of reform (which appear in one form or another in the current Finance Bill):

(i) Changing the treatment of days of arrival and departure in computing residence.

(ii) A withdrawal of allowances from persons claiming non-domiciled reliefs.

(iii) A £30,000 charge where persons have been resident in seven out of 10 tax years.

(iv) Tightening of the rules regarding remittances of income.

(v) Tightening of the rules for structures involving trusts and companies.

9. A Consultative Document was released in December 2007 but consultation was limited to whether further changes should be introduced to increase the contribution of non-domiciles (paragraph 3.3). Draft legislation was promised towards the end of 2007 but in practice this was not released until 18 January. Consultation continued via discussion with various interested bodies and revised draft legislation was released in the Finance Bill on 27 March together with a summary of responses to the Consultation. Some of the more complex parts of the legislation were incomplete and details are awaited by way of Finance Bill amendment.

Broad Impact of the Changes

10. It will be evident given the background of extremely lengthy and unresolved consultation detailed above that affected individuals, their employers and their advisers were extremely surprised and dismayed by the extent of the changes announced in the Pre-Budget Report and their swift introduction.

11. The affairs of non-domiciled individuals or those whose residence status changes, whether or not particularly wealthy, can be complex. This is borne out by the length of time it is taking to produce legislation to govern the new regime.

12. The measures were introduced with effect from the current tax year and with no transitional measures, so very little time was available for individuals to rearrange their affairs to take account of the new regime and any planning that was done needed a large element of educated guess work.

13. Because no systematic information is kept about non-domiciled taxpayers, it is of course impossible to be definitive about the short or long term effects of the changes. Some of the effects such as decisions not to come to the UK or to set up businesses here will not necessarily be visible in the UK. It is possible to infer however that the sudden truncation of consultation process, the wider than expected changes and the delays in producing a finalised regime have undermined confidence in the certainty of the UK tax regime.

14. The measures apply to specific classes of individuals but affects them, their spouses and civil and other personal partners, children and grandchildren. There are also significant consequent issues for businesses involved with those individuals. The time pressures, uncertainty and wide-ranging impact of the changes caused concern therefore to a wide range of persons.

15. Many taxpayers who found the non-domiciled regime an attraction of residence or doing business in the UK have now necessarily looked at their options in other countries. The Republic of Ireland, for example, similarly has a non-domiciled regime while Switzerland is well known for its "forfait" system of lump sum taxation. In the short term it is not straightforward to move residence of an individual or business,

in the medium to longer term taxpayers and businesses can be expected to continue to assess the factors drawing them to the UK. If the regime proves onerous in practice and clients move out of the UK or employees find their tax burden (including compliance obligations) unacceptable then businesses can be expected to follow. The City seems particularly vulnerable to this, given the essentially mobile and international nature of its business base.

16. It should be noted that HMRC and Treasury listened to matters raised by interested parties who were concerned about the impact of the changes and introduced amendments to the original legislation. In particular they acted to relax or relieve measures regarding the definition of residence, the creditability of the £30,000 charge for US purposes, the treatment of trusts, the requirements for disclosure, the treatment of art on public display and raised or introduced *de minimis* levels. Amendments to deal with services provided in respect of overseas assets are awaited. Some policy and technical matters remain unresolved or unexplained however. The more significant of these are detailed below.

More Detailed Impacts of the Changes

17. The definition of residence has been amended to take account of days when an individual is present at midnight. While some detailed points remain about the definitions this is a sensible change. However, this statutory rule only applies to the 183 day test of residence. Many international workers are assessed for residence on the basis of the 91 day test of regular residence for that period—a test dependent on HMRC practice which has not yet been republished. The UK remains one of the few OECD countries without a comprehensive statutory code of residence for modern living and working practices.

18. The loss of personal allowances (and CGT annual exempt amount) for anyone who elects for the remittance basis is triggered immediately—there is no seven year period. This has the potential to affect City employers: many non-domiciled employees will find that their UK tax bills increase (through being taxed on worldwide income or through loss of personal allowances). That will result in the employees expecting their employer to compensate for any additional tax through tax equalisation agreements, increasing employment costs or simply adding to administrative burdens around sorting out tax issues for affected individuals. It is also not clear how the new regime will interact with some of the practical measures which HMRC had developed under the old regime. A particular issue for example is how HMRC Statement of Practice 5/84 is to be regarded under the new regime. This relieved the need for expatriates to examine the source of a remittance to the UK every time a remittance was made to the UK out of an account containing overseas earnings. It is currently not clear how or whether this will continue to operate. It appears policy and legislation in these practical areas is still being developed as unforeseen complications are brought to HMRC's attention.

19. There is also a subtle point coming out of the seven year period for the £30,000 charge. The City has a good track record in hiring very able graduates, a significant proportion of whom have come to the UK to finish their education. A student who has done "A" levels and degree course in the UK will already have logged five out of the potential seven years and is likely to be less keen to take a UK-based job if there is a any significant "home" income involved.

20. The new regime more consistently taxes non-domiciled individuals on a remittance basis. It is unclear what the overall policy objective behind this measure is since money is brought to the UK either to fund expenditure or make investments. These contribute to the economy and its fiscal base; a remittance to fund expenditure may produce more tax in respect of VAT and income tax/NIC/corporation tax than the tax levied on the remittance itself (which ranges from 18% to 40%).

21. The revised legislation published on 27 March 2008 relating to the treatment of offshore trusts introduced some significant and welcome relaxations to the regime governing non-domiciled individuals who own assets via trusts. In particular they will not be chargeable on gains on UK assets unless this money is brought to the UK and all assets owned at 6 April 2008 are rebased for the purposes of the tax charge on capital payments made to them. A similar change has not been introduced however where assets are held via companies. It is not clear why there is felt to be a need to discriminate in favour of taxpayers who use trusts over those who use companies or in favour of those who were present in the UK/had trusts at 6 April 2008.

22. It is similarly unclear from the legislation whether remittances by trustees or companies they control will be treated as remittances by the settlor of trusts and it remains the case in the current draft legislation that for example investment by a privately owned offshore company into the UK could be treated as a taxable remittance to the UK by a non-domiciled individual who owns as little as 10% of that company.

23. The (in fact quite narrowly drawn) measure requiring disclosure of trusts was withdrawn and statements from HMRC showed sensitivity to the concerns of non-domiciled individuals about disclosing their affairs in constructing the rebasing election. Wealthy non-domiciled individuals often have very significant concerns about security in disclosing information about their wealth to any party and most non-domiciled individuals see it as fair to disclose details of income and assets in the UK to HMRC but question why assets held and used overseas should be within this. Despite the particular sensitivities noted above HMRC will retain powers to make enquiries into worldwide assets under their general enquiry powers and to an extent taxpayers are taking it on trust that HMRC will use those powers responsibly.

24. The new s832(3) ITTOIA 2005 in paragraph 49 of Schedule 7 reverses the longstanding case law rule that income tax cannot be charged when the source of that income is no longer owned. This was a widely known and adopted planning technique amongst non-domiciled individuals. There is no time limitation on this change with the result that records may not be available to identify whether a remittance post 5 April 2008 falls within this measure. This is perhaps the most widely applicable of numerous detailed measures which are requiring non-domiciled individuals to incur time and cost in reviewing their affairs in detail.

25. Given the obvious complexity of some of the changes required for more complex offshore structures involving trusts and companies and the difficulty of drafting these it would be highly desirable for the measures relating to those areas to be postponed till the tax year beginning on 6 April 2009.

26. While the £2,000 *de minimis* amounts in new section 809C and s809T of ITA 2007 are welcome, they still appear too low. Small gains or small amounts of income eg from letting out a property in the home country or employment overseas can cause the measure to be exceeded with the result that the individual will need to file a tax return and assess their liability to tax under two bases. This will create a significant burden for taxpayers and also HMRC. In the first year of operation there will be significant changes required to PAYE codes. The extension of this legislation across large numbers of migrant and temporary workers in the UK will at best create a diversion of resources for HMRC and at worst could foster a culture of non-compliance in a sector of the economy. Fixing the *de minimis* at the same level as the personal allowance and allowing all or half of the capital gains annual exempt amount would be a logical way to remove much complication from the system relieving individuals, businesses and also HMRC from drains on their resources.

Going Forward

27. The commitment in the Chancellor's Budget speech not to amend the provisions further for the remainder of this Parliament and the next is reassuring to the City, although a little double-edged. As noted above, this legislation remains work in progress and it will be necessary to monitor its effects in practice and its practical implementation over this period. A number of points remain unresolved at the time of writing and it would be remarkable if legislation of this technical complexity did not contain some anomalies and require further revision in the future to ensure it operates as intended.

28. There is a real need to rebuild confidence in the UK's tax system for individuals and businesses affected by these changes (which are many in one way or another in the City). Although we are not likely to see a sudden exodus, thanks in part to the changes made to the draft rules, the image of the UK as a place that welcomes international skills and wealth and wants to attract them has been significantly affected. Some will leave; more will not come in the first place; some employers will redirect expatriates away from the UK: it will be interesting to see how much net tax is actually raised by these changes in the long run.

29 April 2008

Examination of Witnesses

Witnesses: Mr Michael Snyder, Deputy Chairman of the Policy and Resources Committee, Corporation of the City of London, Mr Alex Henderson, Adviser to the City, and Mr Ian Menzies-Conacher, Chairman, Tax Panel, British Bankers' Association, examined.

Q137 ***Chairman:*** Welcome to our witnesses from the City of London and the Bankers' Association. Thank you very much for giving up your time. Thank you very much too for your very helpful written submissions which we have ready carefully. We will go into questions and we will concentrate, if you like, on residence and domicile, which I think was what you were writing about for the most part. If we have time, we might move on to one or two other things like capital gains tax. Was there anything you wanted to say by way of introduction or would you like us to go straight into questions?
Mr Snyder: I think it is best to go straight into the things you wish to talk about.

Q138 ***Chairman:*** Tax policy on residence and domicile has been under review to a greater or lesser extent for many years. The present review was started, I think, in 2002. Why do you think concrete proposals emerged in the Pre-Budget Review in 2007 rather than at any other time? Do you welcome at least that the uncertainty of the review has been removed? Do you have a view on the policy reasons given for the proposals? I quote from the Treasury: "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."
Mr Snyder: I think we have to really understand why it started. This arose out of a series of articles in *The Daily Mail* some 12 years ago relating to Greek shipowners who were living in big houses in Hampstead and paying tax on about 10,000 a year. That was where the public perception of this issue started. Why it arose in the Pre-Budget Report I suspect everyone in the room knows as well as I do. Having had a tacit understanding that this would stay under review for a goodly time, if not decades, in terms of not rocking the boat, making it politically unacceptable to say one is doing nothing but at the same time not wishing to affect the competitiveness, not just of the City but of business in the UK in an increasingly globally competitive world; and to therefore be forced into a situation of doing something for accidental, political reasons across the political spectrum, I am glad to be able to say, was very unhelpful. I think we ended up in a position which was not very good from a perception point of view in particular. The second part of your question was about putting uncertainty aside. I am probably in a relatively small minority within the City saying yes, it would, because having had the public furore and media frenzy over the non-dom and residence issues this further fuels the fire of misperceptions about the proposed regime and undermines the competitiveness of the City. I think the answer is that we do need 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. Nevertheless, I think closure is now essential because the longer this goes on the worse the perception from overseas of the UK as a competitive place to operate a business will be.

Q139 ***Chairman:*** Do you think the policy argument makes sense?
Mr Snyder: I am afraid I do 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 of 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. What appears to be fair—everyone can, I suspect, see it is fair—on the one hand is very unfair to the British taxpayer because they will end up having to pay more in the longer run. Secondly, there is a misperception about non-doms that are resident here, which is that they are paying tax on everything they earn here, everything that arises in terms of direct investment here. It is only those assets that are either held through overseas vehicles or held overseas that are not remitted to the UK on which they are not paying tax. Arguably, that is not the question that is being put to the general public. There is an impression given that they are not paying any tax at all, which is wholly unfounded.

Q140 ***Chairman:*** Can I just put one supplementary to the BBA? You comment on the lack of ground work in the policy development and the confusing, conflicting messages being given out. What do you think should be done differently?
Mr Menzies-Conacher: Fundamentally, it goes back to the fact that we think there should have been a better, fuller, more comprehensive consultation over this. When you refer to the review that has taken place since 2002, I do not think that was a particularly open review. It did not seem to involve many people and certainly did not address the sorts of issues that eventually emerged in what is now the Finance Bill. From that point of view we did not have a comprehensive understanding of the policy rationale that was driving these changes. They

appear to have come out very piecemeal. 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. It is that uncertainty that we were really getting at there. In terms of your question on the uncertainty of the review, I would agree with the comment before. First of all, if you put in narrowly in the context that the old review created uncertainty, absolutely not. There was a completely universal view that it had been kicked into the long grass and was just going to stay there. No one was really concerned about that. People were not worried about that. I accept that having taken the genie out of the box there is a problem. Having done that, you do need to get some conclusion. I still think that on balance it would have been better to have deferred it for a year to allow a lot of the detailed problems that they are now seeing emerge to be resolved properly.

Q141 ***Lord Wakeham:*** The genie is out of the bottle and you want it cleared up but also there are those who say it should be deferred for a year or so in order to clear up some of the uncertainties that are there. You come down in the camp on the side of: let us get a conclusion but there ought to be a delay for clearing up some of these things for a year or so. Is that the view?
Mr Henderson: There are certainly some more detailed measures where we have even yet to see the legislation, particularly governing companies and trusts. It does seem to me that there is a clear case for deferring the more complex measures to be worked out in detail. There is another area which one can argue either way which is around the practical implications of the new measures, how they are going to work with PAYE codings and things like that, where all the detail is still being worked out now, but it is harder of course to delay that.

Q142 ***Lord Wakeham:*** We have to deal with the Finance Bill and either it is in or it is not. If there is a case for a delay which some people are saying ----?
Mr Menzies-Conacher: The concern at the moment is 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.

Q143 ***Lord Sheppard of Didgemere:*** Talking about the issue of residency, starting from where we are today rather than where we would like to be, is it better to follow the principle we have had for some years of case study and practice or to get a proper legal definition of residency and to discuss the thing fully and end up with an agreed formula?
Mr Snyder: It would seem to me that having a proper formula built into the legislation would obviously be desirable as opposed to relying on the Revenue and Customs to continue their practice as announced. I think it is unrealistic to think we are going to get that this side of this particular bit of legislation. On balance, I would leave it to the practice for now and hopefully this can be wrapped up in a future Finance Bill in terms of codifying what it is, because I do not think there will be time now.
Mr Henderson: 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.

Q144 ***Lord Sheppard of Didgemere:*** Obviously over the last X years you have discussed this issue and sometimes it has been hidden in the long grass. More recently, have you discussed the question of residency with the Revenue?
Mr Henderson: It was raised as recently as last Friday at the Finance Bill open day with HMRC who referred it back to the Treasury as a policy matter.

Q145 ***Lord Wakeham:*** They would not give you an answer?
Mr Menzies-Conacher: No. The only thing that emerged from the Treasury side was in their formal response to the "paying a fairer share" consultation, published at the end of March, which was fairly dismissive of the idea of a statutory residence test. It was saying they thought the present one was more flexible and preferable. Unfortunately, I think "flexible" is code for uncertainty.

Q146 ***Lord Barnett:*** Have you spoken to *The Daily Mail* and any other parts of the media who, having brought this on you might say from what you have said, now probably do not like what they have brought on?
Mr Snyder: I would guess they love what they have brought on because it means there is more frenzy to feed. On the other hand, what is very interesting is that when the original proposal was announced there was this enormous heat built up over it and you saw it in every newspaper, but since the various clarification and modification measures were announced—I do not know if you have noticed—I have not seen a great deal of comment about it. There is some but not a great deal. From my point of view and from the point

of view of the competitors of the City, that is really important because we are not just talking about reality; we are talking about perception of reality. Perceptions are what influence businesses' investment decisions. For me, while one can talk to the media—and we have talked to them; there have been plenty of articles quoting me—the reality is that it is much better to say it is unfair not to tax those who are over here, living in our houses and taking our facilities and so on. It is quite a difficult one.

Q147 ***Lord Barnett:*** On this question of uncertainty, if you have been involved as I know you have for a long time in these matters, any major new tax introduction will inevitably mean that future Finance Bills would be amending it regularly. That has been my experience for five years as chief secretary a long time ago, so you cannot be too surprised. A delay would surely add even more uncertainty as you recognise yourself. I am not sure about the other two of you.

Mr Menzies-Conacher: We are where we are now. As we said in our written representations, we would much prefer to have a deferral up front and sort it out. We are now in a position where we have to just try and get as many corrections of things in the Finance Bill as we can and some, like statutory residence, I agree, we would certainly advocate but that can be next year.

Q148 ***Lord Sheppard of Didgemere:*** To avoid getting into party politics, especially as I would be on the wrong side of the discussion but was the fact that this suddenly came on to the agenda a complete surprise to the City?

Mr Snyder: It was really. I did get a phone call from the person who was announcing it at the party conference on the Monday. I received the phone call on the Sunday, warning me that this was about to happen. That was the only advance notice that came and then of course the reaction from the government in terms of its announcement was perhaps not altogether surprising but nevertheless unhelpful. That is why I say it is across the party spectrum, as it were, that it has been unhelpful. Vince Cable has also been saying some unhelpful things. I had conversations with all three gentlemen and, with the benefit of hindsight, perhaps there would have been a different approach. However, as I think we have all acknowledged, we are where we are and therefore we just have to make the best of what we have in the time frame that is available. What I would make a plea for is that your Committee in conversations with the government, on the few things that could be done to try and help, ensures that they are done to make it better in its process through to enactment.

Q149 ***Lord Paul:*** Talking to various people all over the world, the reaction has been terribly bad to the extent that the Conservative Government and the last Labour Government have worked very hard to make Britain a very attractive country for investment. Those sorts of announcements by both parties have ruined all the good work that has been done. Do you hear the same?

Mr Snyder: Frankly, yes. We do hear the same. I think we have to be reasonably balanced about it however. In one of your draft questions later on it says, "Where is the balance?" There is always a balance in these things in terms of the people who are being taxed. For me personally, I think it has been a big blow but what is important is that we get certainty, we put it behind us and mitigate it to the best extent that is possible. The government obviously listened to quite a bit of those representations in doing so. We just need closure because otherwise this is going to rumble on in the press and media and, as you say, that fuels the perception or misperceptions I think in a lot of cases, because the difference that it will make to the very wealthy is irrelevant and the middle people, which is 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.

Q150 ***Lord Paul:*** This uncertainty is only removed for a period of seven years. Beyond that, it is still uncertain.

Mr Henderson: Yes. I think that is a fair point. Looking further ahead, there is still uncertainty around the regime. I can probably highlight two points. As Michael was saying, what we have now a lot of people feel they are willing to try and make work. There remains a concern though that we still do not have the legislation or the practical details and there is yet to come the HMRC reaction to that and the normal submission of tax return and inquiry process. As you probably know, there are severe concerns around confidentiality and what that will mean going forward. The issue will not go away for a period of time.

Q151 ***Lord MacGregor of Pulham Market:*** Can I come on to middle earners? Indeed, not just middle earners depending on how you define middle earners—if you define them in the City, it is rather different from defining them elsewhere—but also lower earners and also the point about how it operates in practice. You drew attention in your paper to the

fact that you thought the number was likely to be significantly higher than the government estimate of 4,000. You drew attention to the STEPS estimate of up to 150,000. I take it that most of that comes into middle earners and lower earners. Perhaps you can confirm that and say whether you think the figure is right. The £2,000 *de minimis* limit that others have put to us seems extraordinarily low. It is very difficult to get over to people, particularly since as I understand it from your note HMRC are not going to work through PAYE in the first year. How do you see this operating below the high network individuals? How can HMRC monitor compliance over what assets are being brought into the country? How can you avoid increasing employer costs? I would be grateful to hear you elaborate.
Mr Snyder: The issue is that we estimate that sort of number. A lot of it is anecdotal because of course none of us has the definitive information. HMRC do not even know exactly what they have in terms of the people who are not making the returns or whatever. It is quite difficult and I sympathise with the difficulty over figures but anecdotally I can give you one example of the level of interest in this and the numbers. In one very large, international investment bank in the City, they have a series of seminars. Normally, they struggle to get 30 people to these seminars. They put one on on non-doms and had 700 people apply. They had to run the course obviously many, many times. It just gives you a flavour. The reality is that the 2,000 limit is ridiculous. The only thing I can think of is that, because they put £1,000 out and we all said this had to be higher, they thought doubling it would do the trick. If I can give you one practical example of that, if somebody is coming in—let us just take a middle earner in City terms in terms of these investment banks—let us say someone between £75,000 and £125,000, which would not be unreasonable and they would be leaving their country. They probably owned a house in their country which they are not going to be using so they would let it out. Unless it is very small and in a low income earning country, the chances are that the rent that they would receive on that would be vastly greater than 2,000. It just seems to me therefore that the limit is not even allowing ordinary people who would go on to these secondments in City terms to be able to let out their house without fairly serious implications, having lost their personal allowance and so on. Arguably, that is nothing really to do with their lifestyle or their utilisation of resources in the UK. I think it needs to be considerably higher than the £2,000.

Q152 ***Lord Barnett:*** What figure would you put on it?
Mr Snyder: Probably about 30,000 a year. I cannot really see that it should be bigger than that because it is not relevant to the UK economy and activities and their utilisation of resources and therefore arguably is not really relevant to the UK tax system.

Q153 ***Lord MacGregor of Pulham Market:*** Others have argued for raising the personal allowance level, a lot of people who at the moment are not filling in self-assessment forms and so on. Perhaps you could answer that in relation to the other questions on practicalities.
Mr Menzies-Conacher: There is one thing that is overlooked in relation to the £2,000. That is income or gains. You can get gains in the UK calculated in sterling. You can run some numbers and people with relatively small assets denominated in euro which are held for a few years and sell now, even if they are making a euro loss with the appreciation of the euro, they will make a gain that is taking them over the £2,000. They will not even know that. They will not realise it. They will not think about it. It is a minor example of what I believe is likely to be the case. There will be substantial non-compliance with this. In certain regions the Revenue attitude almost seems to have been, "We do not care about that" which I think is depressing. That is not the right approach to this. There is a real problem that people will not appreciate. There are an awful lot of people who are non-doms who are not at the wealthy end. The very wealthy will have advice and everything else. 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. You are likely to end up giving some form of tax equalisation to pay for the loss of the allowances they were going to receive, maybe not the £30,000 depending on how long they are here. 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. At the moment we have a temporary fix in that that will be ignored for the first year and we will just have to sit down and have some discussions about how to deal with the practicalities going forward. A simple answer from an employer point of view is that you would get the Revenue to issue a notice of coding and you stick to it. That is what you do. You apply it, but whether that is going to produce the right answer or give the Revenue more trouble in due course because they are going to have to then go and produce self-assessment for individuals—what happens after they have left the country? There is a raft of unknown issues with this, all of which at that level are likely to come back to the employer. At the moment, we do not know. One of the big problems, coming back to the question of how many there are, when this was first mooted at a corporate level we tried to find out how many relevant people we had. Our HR systems do not tell us because we have never needed to know.

You have very high paid assignees coming in. You know about heavy hitters but an awful lot of people you do not. I had a woman working for me and I did not know she was a non-dom. I never needed to know. That is partly why I think there is no answer to how many are out there. There are an awful lot more than people think about. There may not be that many who are going to pay the 30,000 but that is a very different question.
Mr Henderson: In answer to your question on the personal allowance point, as Michael said, ideally it would be as high as possible. The personal allowance was put forward as a workable number to try and take as many as possible out of the system while meeting some of the policy objectives that we understood lay behind these measures, and also not complicating the tax system still further with rates, thresholds and numerous different numbers.

Q154 ***Chairman:*** In both of your written submissions you helpfully brought out the effect on those who have been in full time education in the UK. You suggest that the proposals should not be targeted at this group. I wondered if you might expand on that. What changes would you wish to see? Secondly, specifically to the BBA, you bring out the mandatory extension of share schemes to those not ordinarily resident in the UK and the incentive to use overseas financial services providers, where some government action is promised, and the grandfathering arrangements for offshore mortgages. These are new points for this Committee so could you expand on them for our benefit and say how significant you think those issues are?
Mr Menzies-Conacher: On full time education, the question is what change would we like to see. 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.

Q155 ***Chairman:*** If you have a student visa, it does not count?
Mr Menzies-Conacher: Yes. Disregard it and carry on from there. On the mandatory extension of the share scheme, the UK has this rather odd concept of resident but not ordinarily resident, which seemingly is one of our many historic hangovers. In this particular case what we think has happened again is probably just an inadvertent drafting point. The amendment changed it for another area which had a consequential knock-on here. The problem is that if at the moment we have to state the normal SAYE schemes that we and most large corporates run, they are all employee schemes. At the moment we do not have to make them available to resident but not ordinarily resident. It is optional. If you have to bring them in mandatorily, the problem will be that these people tend to come and they will go again certainly within the three, five or seven years of an SAYE contract. You are bringing them in to a scheme which is probably wholly inappropriate to them. They may well be taxed in their foreign domicile. Certainly they are not going to get the benefits of it. There is a lot of to-ing and fro-ing. How do you track it? How do you know if they have arrived? Administration. The other thing that is particularly odd about it is if you bring them in for accounting purposes. We now have to account for the cost of share based payments and the value of the options granted to them under these particular schemes. Even if the chap goes again six months later, the accounting rules require you to continue to write off the cost of the option. There are a lot of serious problems with it. We think it is inadvertent. Hopefully it can be resolved. All we would like is to see that go back to the status quo—i.e., it is an option—but in most cases you would offer people like that an international share plan which is more appropriate to international staff, not UK domestic schemes which are probably not appropriate at all.

Q156 ***Lord Sheppard of Didgemere:*** Can I just go back to the point you were making about full time education? Have Universities UK or any university authority picked up and joined in the debate about the issue?
Mr Menzies-Conacher: I have seen a number of comments. One came from LSE which I do not have with me. They were quoting the percentage of their students who are now non-resident or non-dom in this case. It is a very large proportion. Those are the people we are trying to recruit from. They certainly raise concerns about their own academic staff. I have seen some about this but I do not think I have seen it majored on.
Lord Sheppard of Didgemere: Probably in this group you are addressing a lot of university chancellors and we all recognise the significance of these issues.

Q157 ***Chairman:*** Overseas students finance the tertiary sector.
Mr Menzies-Conacher: Absolutely. It is a bad idea to discourage them. The incentive to use overseas financial providers was a reference to investment management basically. At the moment under these proposals, if fees are paid to a London investment manager or other resident non-doms global portfolio, those fees when they are paid are treated as a remittance or would be treated as a remittance and hence would become liable for tax, depending what

election you have made. The consequence of that would be that as in most cases such expertise is easily available and certainly would be made available—Geneva for example—if you could have your same portfolio run offshore without the tax consequences, you would do so. That was raised with the Treasury. We got a response from the Minister, Jane Kennedy, saying that this would be addressed. We have not yet seen the revised clauses to address it but we hope it will be. Even though it gets resolved, it is another issue of not having the stuff fully thought out in the first place. We are tripping up against quite serious business consequences which did not have the time to be thought through properly. Grandfathering arrangements for offshore mortgages is in one sense a relatively narrow point referring to the change in definition of remittances. Until 6 April, the position was that if you took out a mortgage albeit on a UK property but from an offshore provider, to the extent that interest was paid on that, that was not treated as a remittance to the UK because it was paid offshore. That was in the PBR and the Budget notes thereafter announced as a loophole that had to be closed. Going forward, that is fine. That is what it is. The concern is that in the Budget note it was described differently to the Bill. The word "grandfathering" is a bit of jargon, but simply where a loan was in existence as at 6 April it continued to be treated for tax purposes in the same way, unless it was repaid or varied or whatever. The detailed wording in the original Budget note referred to that loan being secured on property. The Finance Bill wording is different and refers to the loan being used to purchase property, the obvious consequence being that anyone who has re-mortgaged which is relatively common these days in between the original purchase and 6 April lost that grandfathering. Everyone had been working on the assumption of the Budget note, that that was what we understood it was going to be, because that was what was in the drafted clauses in January as well. The Finance Bill comes out and all of a sudden it appears that a whole raft of people who thought they were safe are not. That again was raised at the Finance Bill discussion meeting last Friday. I think that is acknowledged probably to be an error in the Finance Bill drafting and hopefully will be corrected.

Q158 ***Lord Wakeham:*** Can I ask a more general question about consultation? This Committee has over the years always taken a considerable interest in the degree of consultation, whether it is adequate and, as you know, there are arguments both ways. If there is too much consultation too soon, the winners and losers get cracking and all sorts of things happen. There is criticism about the degree of consultation. Have you a view as to how we could organise these things in this country better to keep the balance between the Revenue and the taxpayer but to be better able to deal with it for the future?

Mr Snyder: It is a very difficult one because, as you say, if you have too long a consultation period it becomes unwieldy and if you have too short a one you do not get the right information. Personally, I do not think it is necessarily to do with the length of the consultation. It is about the preparedness and really hearing as opposed to going through elaborate listening mechanisms and being able to get the correct information to ministers, frankly. I had a meeting with Jane Kennedy and Andrew Maugham, the chairman of the Council of Economic Advisers on this matter. When they 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. You have to have the ability to be able to have access to ministers in a way that can actually influence them. It is really the mechanism of finding out how ministers can hear the true picture. They have to form a balance. There is a balance in all these things. I am not suggesting there is a right or wrong, but they need to understand the implications sometimes of some of the proposals. A lot of what is wrong is in terms of the anti-avoidance provisions and assuming that everyone is bound to be a crook unless they are proved otherwise, which is wholly wrong in my judgment both as a practising accountant—I should declare that interest—but also from my position in the City, seeing how people react to it. My feeling is it needs to be a real preparedness and openness to hear the proper arguments, not ones that are exaggerated or put in for sectional interest, but ones that are trying to get the real implications known on particular aspects. There are some very important ones in terms of anti-avoidance. Alex, if he gets an opportunity, might mention one or two in a minute because they are really fundamental but have not really got over.

Q159 ***Lord Wakeham:*** Many of us sitting round here have been Treasury ministers.

Mr Snyder: Exactly.

Q160 ***Lord Wakeham:*** We understand some of the things you are saying and the message I am getting from you is that you think HMRC have a view as to what should happen, as a result of which ministers do not get as clear a picture of the difficulties as they should.

Mr Snyder: Being careful in my language, with the changes at the Treasury with Gordon Brown moving to Number 10 and a number of other people who historically had been in the Treasury, there was quite a strength of people. That changed and I think this happened at just the wrong moment when there perhaps were not those with such experience there who could resist the worst excesses of HMRC.

Q161 ***Lord Barnett:*** I should declare an interest as a retired former accountant and a Treasury minister. Is it not really the case on most of these occasions that junior Treasury ministers do not have a clue in any government and it is more that HMRC or the Revenue should understand it and should be able to explain what you are saying to Treasury ministers? Would that not be the case?
Mr Snyder: I think it should be the case if they are being balanced, but I do not think at the moment that they are.
Mr Henderson: I suspect one of the problems is that HMRC do not actually understand some of the practical implications of the measures they are putting forward. I think this process has shown that. We referred to offshore mortgages. That is a classic case where there was an unforeseen consequence of the changes that were being introduced and there are still unforeseen consequences in the draft legislation we have now.

Q162 ***Lord Barnett:*** A lot of people of course simply do not know the difference between evasion and avoidance very often, and that would probably include junior Treasury ministers, would it not?
Mr Snyder: It certainly did not include the previous junior Treasury minister.
Mr Menzies-Conacher: In process terms, this certainly was not a good consultation process but there have been lots of very good consultation processes as well. You have to learn the lessons from the good as well as the bad. One of those is that there is clearly an issue with getting across. A lot of the consultations—I spend a lot of time on this—are precisely to try to get across business issues, concerns and practicalities. I have no criticism of Revenue or Treasury people who do not understand those because why should they? It is my business; it is not theirs. It is my job to explain it and hopefully explain it properly so that it gets understood and gets addressed correctly. Where I see this process working best is where some of these discussions can take place, not behind closed doors, but in an informal, preparatory way so that some of these issues can be aired up front and perhaps some of the "non-starters" can be killed before they go anywhere. Once that has been done, we can move on to the next phase of public consultation and so on, with a slightly more finalised product. There are other criticisms of it that people would be aware of the current consultations on taxation of foreign profits. The process on that has been an extremely good one and I would commend that. It may not necessarily at the moment be producing the right answer but that is a slightly different question: is the process right? I think the process is quite a good one.

Q163 ***Lord Barnett:*** I was just thinking of the serious business consequences you spoke about. I do not know what evidence you have of that, whether increasing the 2,000 to 30,000 would be a means of helping or whether you think a change in the seven year rule might be an easier way forward.
Mr Snyder: I think it is unlikely that the government is going to move on the seven year rule. I certainly hope that they will reconsider and get an increase in the threshold under which it applies, but perhaps Alex could tell you the one, for me, really startling issue. I think that might help in terms of inward investment into this country.
Mr Henderson: What Michael is referring to is a detailed issue. As well as the 30,000 and the personal allowances which we have talked about a lot, there is a tightening of the rules around remittances into the UK. Those were substantially tightened and caused a lot of concern when the measures were first announced. They were relaxed but for example they were only relaxed in the case of trusts. Now, if a non-domiciled individual does not have a trust they are penalised and they are strongly incentivised not to invest in the UK or to remit money into the UK. It remains an unresolved issue.
Mr Snyder: In particular, this applies inadvertently to companies. If a company wants to invest—
Mr Henderson: Exactly. If a company in which you are invested itself invests in the UK, that can be treated as a remittance. It remains in the legislation.

Q164 ***Lord MacGregor of Pulham Market:*** That was one of the points I wanted to raise with you. Presumably, it applies even to bringing in money to buy a home?
Mr Henderson: Yes, it would.

Q165 ***Lord MacGregor of Pulham Market:*** There are a number of others in your note which we do not have time to go into but which are obviously serious and unresolved. The question I wanted to ask in terms of consultation or lack of it is: can you in your experience ever recall another major tax change where there are so many serious, unresolved issues at this late stage of the Finance Bill?
Mr Henderson: This has had some unique features.

Q166 ***Chairman:*** We are running out of time. If there are any things that you wanted to say on the other two topics, capital gains tax and encouraging enterprise, speak now or for ever hold thy peace.

Mr Snyder: From the City's point of view, I do not think they are desperately relevant to the City. With my business hat on, having been on the Small Business Investment Task Force, I can see that the EIS scheme and the Venture Capital Trust will have a really good effect at the middle level. They do not ever affect the bottom level because no one wants to put their money in, however much tax relief they get. You need to be addressing that at a business level. That will help. 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 10%, then taking away the 10% and then having to introduce the £1 million limit was not a particularly helpful way of giving a message out again from government and the Revenue saying, "We really wish to encourage this area." Having said that, the difference between 18% and 10%, the 10% with all sorts of loops and hoops to jump through, is a marginal decision because you could easily fall foul of the business taper relief conditions. I think it is a judgment call. The way it was done was not particularly helpful. I do not know if enough was said about reducing the rate of other capital gains tax from 40 to 18. There was a balance in there somewhere and I would like to see them perhaps have a revolving limit of the entrepreneurs' relief. In other words, every five years you might reinstate it to a zero clock.

Mr Menzies-Conacher: I have just one personal observation on CGT. I do find it very strange, the message that is being sent, that this is in effect to encourage short-termism. It is meant to encourage long-termism, but abolishing indexation and creating a whole class of losers to pay for the changes does not seem a particularly equitable way of going about it.

Chairman: Thank you very much indeed for your time, for your written submissions and indeed for answering our questions so fully and interestingly. If there is anything that you would like to add, by all means send us another note.

(The Committee suspended from 4.26pm to 4.39pm for a division in the House)

Memorandum by the Confederation of British Industry (CBI)

1. Introduction

As the UK's leading business organisation, the CBI speaks for some 240,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

The CBI welcomes the opportunity to give evidence to the House of Lords on aspects of the Finance Bill 2008.

2. Documents

Attached to this paper are:

A. CBI evidence to the House of Commons Treasury Select Committee on the Budget 2008—"CBI Analysis of the 2008 Budget".

B. CBI post PBR 2007 written suggestions to the Prime Minister on Capital Gains Tax.

C. CBI post PBR 2007 submission to the Treasury on Residence and Domicile.

D. CBI press release of 28 February 2008 on Residence and Domicile.

E. CBI Tax Task Force consultative report "UK Business Tax: a Compelling Case for Change" March 2008.

3. Written Notes Ahead of Oral Evidence

We have been asked to focus our attention on three main areas:

— Capital Gains Tax and the new Entrepreneurs' Relief.

- Encouraging enterprise—taking into account three Government Budget Day Documents.
  - Enterprise: unlocking the UK's talent.
  - The Enterprise Investment Scheme.
  - A Study on the Impact of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) on Company Performance (HMRC Research report 44).
- Residence and Domicile.

4. Encouraging Enterprise

Finance Bill Clauses

The Finance Bill Clauses under consideration are very limited in their impact. Clause 28 increases the investors annual limit from £400,000 to £500,000. 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. However, we see no reason why there should be any limit at all—the few investors with sufficient wealth to invest over £500,000 in EIS companies should be encouraged to do so.

A better objective would be to make the EIS more attractive to a wider number of investors, with smaller sums to invest, through improvements to the regulatory regime concerning EIS Approved and Unapproved Funds.

Clause 29 excludes the activities of shipbuilding and coal and steel production from all three venture capital schemes. This clause is also expected to have little impact. The coal, steel and shipbuilding industries are so capital intensive that companies in these industries are unlikely to qualify for the EIS in any event.

Enterprise: unlocking the UK's talent

The Government's new enterprise strategy sets a 10 year vision for the Government's objectives on enterprise. It was published against a seriously negative backdrop given the breakdown of trust between the entrepreneurial business community and the Government incurred, in particular, by the changes to the capital gains tax regime. The CBI has welcomed the strategy as a first crucial step in re-establishing the Government's commitment to enterprise. However, its value will depend on the implementation of the proposals and its ability to encourage all government departments to commit to promoting enterprise.

The strategy is built around the framework of five enablers of increased productivity: culture, knowledge & skills, access to finance, the regulatory framework and business innovation. And, an initial set of proposals have been made under each of these enablers.

The CBI was pleased by the strategy's overall focus on encouraging growth of firms and its ambitious nature. In addition, a number of the proposals, as well as announcements in the Budget, reflect CBI lobbying and are in direct response to suggestions made by the CBI. However, there is still much to do rebuild relations with the entrepreneurial and SME community, particularly in the tax area. The CBI recommends revisiting the review of small business taxation undertaken by the Treasury in 2001 with more comprehensive consideration being given to the impact of tax changes on entrepreneurial and SME businesses as recommended in the Treasury Select Committee's Ninth Report of session 2007–08.

Enterprise Investment Scheme (EIS)

We believe that, given the right conditions, the EIS has a key role to play in encouraging enterprise. However, if the EIS is to be allowed to develop its full potential, a thorough overhaul of the legislation is needed, going beyond the scope of the March 2008 Treasury/HMRC consultation document. The CBI will be making a detailed response to this consultation, for which the closing date is 20 June 2008, on the basis of current discussions with Members.

Entrepreneurs' Relief

The introduction of an entrepreneur's relief is too limited in its scope and application to encourage the entrepreneurial risk-takers that the UK needs to nurture and generate. In addition, the draft legislation was only published on 28 February 2008 and came into force on 6 April causing further uncertainty in the business community. It has not offset the financial damage to the entrepreneurs, investors and small business owners who made long-term business planning decisions on the basis of the former CGT regime nor will it incentivise serial entrepreneurs.

5. Residence and Domicile

Unlike the response on Capital Gains Tax, on Residence and Domicile the Government have responded or is still in the process of responding to the large number of issues that the CBI has raised, as mentioned in Attachments C and D and subsequently. We are not in this note examining detailed wording as the process is still in progress.

Employers' concerns about possible PAYE implications of the new regime and City worries about the taxation of deemed remittances in relation to financial and other services provided in the UK are two areas where there is now better understanding between the Government and business than existed for a long period after the PBR. However a number of points raised by the private sector still remain to be resolved.

Unfortunately until a revised Finance Bill draft text is produced it will not be possible to gauge how well the draftsman has reflected understandings reached in discussions with the Government and Ministerial assurances on particular topics. All of this adds to the complexity and uncertainty of the UK tax regime and the full extent of the reactions of affected taxpayers will not be known until all the detailed issues are resolved. Any change from the existing rules will produce negative effects on taxpayers and some sectors such as maritime and financial services seem particularly vulnerable to emigration from the UK. The final figures reflecting the overall negative impact of the proposals are not known at this stage.

Consultation Process

Common threads between the Capital Gains Tax and Residence and Domicile proposals have been the lack of adequate prior consultation and the need to fit a great deal of comment and observation into the very compressed timeframe between the PBR and the Budget.

In both cases 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 the case of Capital Gains there was a complete reversal of established Government policy with no prior warning of imminent change. In the case of Residence and Domicile the CBI had no inkling of the changes announced.

The CBI has long argued that the tax policy making and legislative processes (including Parliamentary scrutiny) would be greatly enhanced by improved consultation before Government decisions are made. The CBI believes that such consultation would greatly improve the range and quality of the evidence on which Ministerial, Parliamentary and other decisions have to be taken and on how best to implement those decisions. It would also help the UK's international tax competitiveness by avoiding the damaging perceptions of uncertainty and instability created by surprise announcements as well as heading off unintended consequences.

Following the 2007 PBR, the high profile negative public comments and the lack of understanding of both policy aims and details of implementation mechanisms have been damaging to the UK's international reputation. Moreover for both Capital Gains Tax and Residence and Domicile the problem of uncertainty has been exacerbated by evolving changes of policy stance. This has been particularly acute in relation to Residence and Domicile where there has been and continues to be a stream of official material, some of which has been contradictory. This is set out in more detail in Attachment C.

Furthermore, in the case of Residence and Domicile there are still issues which remain to be resolved either by way of response to questions already raised or by way of revised draft Finance Bill clauses to give effect to policy decisions now taken following post-PBR discussions between the Government and business. These would, in a prior consultation process, normally have been identified and worked through before legislation was presented to Parliament.

The CBI's recent Tax Task Force Report (Attachment E) reiterates the case for improved consultation in tax matters as one of its key recommendations for enhancing the international tax competitiveness of the UK.

It is self-evidently better to have an effective consultation process than to be forced into the sort of fire-fighting role in which business has found itself since the PBR. The CBI strongly believes that such consultation would be beneficial to both Government and business and that steps towards it should be taken immediately.

6. Overall Outcome

In Attachment C we set out a number of principles or yardsticks by which we assessed the Residence and Domicile proposals. The Government has moved towards meeting our concerns in a number of areas, for instance in relation to trying to reframe the proposals so as to prevent double taxation in respect of US taxpayers. Other improvements are referred to above and in Attachment A. However it remains a priority objective to ensure that Residence & Domicile reform does not penalise talent which has already come to the UK from abroad nor deters future arrivals. Given the influx of investment and skills from the US to the UK it is particularly important to ensure that problems arising from mismatches between UK and US rules are satisfactorily resolved, a process which may take longer than is available before the completion of the passage of the Finance Bill through Parliament.

In broad terms adding to the complexity of the UK tax system is not the direction in which the CBI wants the Government to go as it is a negative factor in international competitiveness.

The Capital Gains proposals have created the perception of a sudden abandonment of a clear, longstanding, policy objective of encouraging business, with no adequate replacement.

Unfortunately it cannot be said that the overall outcome of either the Capital Gains Tax or the Residence and Domicile changes is an enhancement of UK international tax competitiveness.

The welcome announcement by the Chancellor of the Exchequer of the new business/government forum on tax to look at the long-term challenges facing the UK tax regime and ensure competitiveness endorses the calls the CBI has long made for competitiveness to be at the forefront of thinking in relation to tax reforms.

April 2008

Memorandum by the Institute of Directors (IoD)

Introduction

This evidence has been prepared in response to a request from the House of Lords Sub-Committee on the Finance Bill 2008. It covers the topics on which the Sub-Committee has said it wishes to concentrate.

Capital Gains Tax and the Entrepreneurs' Relief: Clauses 6 and 7, and Schedules 2 and 3

1. The original proposals on capital gains tax, published at the Pre-Budget Report, led to a strong adverse reaction from the business community. The subsequent announcement of entrepreneurs' relief went some way to addressing business concerns. It now seems very unlikely that the whole package will be changed significantly before enactment of the Finance Bill 2008, so we think that the most useful things to consider are the extent to which the concerns initially expressed were justified (because that will have relevance to future policy-making in relation to capital gains tax), what lessons can be learnt for future policy-making in general, and issues which might create pressure for change in future years.

Justification for the initial concerns

2. The proposals naturally caused concern because they meant that some people would pay significantly more than under the existing regime, not just because there would be no opportunity to get the effective 10% rate given to higher-rate taxpayers by full business assets taper, but also because the operation of the business assets taper (multiplying gains by 25% and then taxing them at the full rate) meant that the annual exempt amount of £9,200 was effectively multiplied by four and because it was proposed to take away indexation allowance accrued up to 1998.

3. Many significant tax policy changes generate winners and losers, and the losers always make more noise than the winners, so some complaints were inevitable. Unfortunately the choice of rate, 18%, meant that the overall package was projected to increase total tax revenue. The Pre-Budget Report estimate of the increase was £900m a year once the system had bedded in. If the Government had chosen a rate of 15%, that would have made the package revenue-neutral, allowing the Government to argue that the winners were as significant as the losers. That would not however have disposed of the complaint that the losers were concentrated among the owners of businesses, and the winners among higher-rate taxpayers who owned non-business assets and were moving from a minimum 24% effective rate to an 18% rate. It would also have upset the Government's overall budgetary arithmetic.

4. One important point to consider is the extent to which the proposals amount to retrospective taxation. If one taxes gains on disposal of the assets, then any policy change is going to lead to retrospection in the sense that the tax regime applying to disposals will sometimes differ from the regime which applied when at least some of the gain being taxed accrued. Taxpayers might well complain that if only they had known, they would not have invested in the assets concerned (given that additional tax burdens would change the balance between risk and reward) or they would have disposed of the assets earlier.

5. The six months notice given in this case, with the changes only applying to disposals after 5 April 2008, does not entirely address this point because not all assets can sensibly be disposed of quickly. A business, for example, might need further development over a period of years before it could be sold at a good price. 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 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.)

6. 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.

7. 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.)

Lessons for policy-making

8. It is clear that the Government could have had an easier time, and the debate could have been conducted in a much less heated fashion, if the Government had started by saying "here is a proposal, we are not sure that it is a good one and we are not committed to it, but we would like to hear people's views". The reaction might well have been "no, that is a daft idea" or, more constructively, "we can see what you are trying to achieve and here is a better way of achieving it". The Government would have had to be prepared to say "sorry, that was a daft idea and we won't pursue it". But if there were no initial commitment to the proposal, it should be possible to say that. There is no shame in putting forward daft ideas. We all have them sometimes, and the only way to sort them from the good ideas is to put them forward for debate.

Issues which might create pressure for future changes

9. The entrepreneurs' relief is subject to a lifetime limit of £1 million of gains. While this is reasonably high at the moment, serial entrepreneurs may well find that the limit runs out over an extended career. We therefore consider that the limit should be kept under review.

10. An employee holding shares in his or her employer was able to obtain the business assets taper under the old regime, but will not be able to obtain entrepreneurs' relief unless he or she holds at least 5% of the employing company—which most will not. This will not matter to the majority of employee shareholders, who will have their gains covered by the annual exempt amount or who will be using tax-privileged employee share schemes. Even outside that class of employee, some rarely obtained the full business assets taper because they sold shares after less than two years (the share identification rules meant that the shares most recently acquired were identified with disposals). But there will be some employee shareholders who will be made worse off by the change, and this may create pressure for change, perhaps through modification of the conditions for entrepreneurs' relief.

RESIDENCE AND DOMICILE: CLAUSE 22, CLAUSE 23 AND SCHEDULE 7

11. The Government's initial proposals, as announced in the Pre-Budget Report, were changed substantially over the following months. The final package is a great improvement on what was initially proposed, although it will still drive some people away from the UK. Those who have not benefited much from the changes to the original proposals are the non-domiciled with overseas income of over £2,000 a year, which will include many professionals who come to work in the UK and who let out properties, or have modest investments, in their home countries. Even though the £30,000 charge for the remittance basis will not apply for the first seven years in the UK, a period long enough to cover many secondments to the UK, the loss of personal allowances in return for the remittance basis will apply from the beginning. There is a very good chance that the Treasury has scored an own goal here, harming the British economy and decreasing total tax revenues.

12. Our other concern is over the policy-making process. As with capital gains tax, it would have been much better to announce the proposals as possibilities to be discussed, rather than as firm decisions which then had to be altered in the light of protests. It was however fortunate that the initial estimates of revenue to be raised (in the December 2007 consultative document Paying a fairer share) did not include revenue from gains made in trusts, so that the Government could decide to offer a re-basing to April 2008 without giving up any revenue which had already been taken into account in budgetary arithmetic. 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.

13. There was also some surprising to-ing and fro-ing over the draft legislation which was published in January. A letter of clarification was issued by the Acting Chairman of HMRC in February, and the press reported unattributed comments from officials to the effect that the draft legislation had been published by mistake. We think it most unlikely that it was published by mistake. The subject matter was well-known to be politically sensitive, and documents of that nature are not normally published without careful consideration by very senior officials in both HMRC and the Treasury.

Encouraging Enterprise: Clause 28, Clause 29 and Schedule 11, Taking into Account Other Documents Published on Budget Day

14. The increase in the maximum relief under the Enterprise Investment Scheme (EIS) will of course be welcomed by substantial investors under the scheme, but 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.

15. The exclusions of shipbuilding and of coal and steel production were forced on the UK by state aid rules. The exclusions are defined in the legislation by reference to European Union documents, but there has been concern that the scope of these exclusions was not immediately clear to potential investors and investees. For example, is yachtbuilding within the scope of shipbuilding? It would have been preferable for these exclusions to have taken effect for shares issued after (say) 5 October 2008, so as to give companies planning a share issue time to determine their eligibility, rather than, as is actually the case, the exclusions taking effect for shares issued after 5 April 2008.

16. The consultative document on the EIS concentrates on administrative obstacles to the use of the EIS. We agree that this is something worth looking at. Anecdotally, we have heard that some investee companies do not bother with the scheme because it is too much trouble to ensure that the companies will qualify. There is however a widely-used facility to seek advance assurance from HMRC that one will qualify, and the officials considering such applications are generally considered to be very helpful.

17. Another problem is that there are too many traps for the unwary, innocent-looking transactions such as repurchases of preference shares which can lead to the loss of relief. Sometimes the detailed rules which create such traps are there for good anti-avoidance reasons, but it is not obvious to the layman that one needs to check for traps in such areas.

18. We support the document *Enterprise: unlocking the UK's talent*, which contains several worthwhile proposals. We are very glad to see, in chapter 5, recognition of the costs of regulation. But there have been several initiatives to reduce regulatory burdens in recent years, and we really do need to see substantial reductions in regulatory burdens this time, as opposed to the fairly modest reductions that we have seen hitherto.

19. Chapter 6 of that document covers innovation. Paragraph 6.17 mentions open innovation. It is important for the Government to appreciate that very often, the best thing it can do to encourage innovation is nothing. Open-source software is a good example of what can happen without official intervention and without rules beyond the basic legal framework which makes the GNU General Public Licence possible.

22 April 2008

Examination of Witnesses

Witnesses: Mr John Cridland, Deputy Director-General, Mr Mervyn Woods, Head of Taxation Policy, CBI and Mr Richard Baron, Head of Taxation, Institute of Directors, examined.

Q167 ***Chairman:*** Welcome back and welcome to our witnesses from the CBI and the IOD. Thank you very much indeed for giving up your time to be here today and thank you for your very useful written evidence. Is there anything you would like to say by way of introduction or shall we go straight into questions?
Mr Cridland: Nothing from me.
Mr Baron: No, nothing.

Q168 ***Chairman:*** I know you are fairly short of time and we have not too much time so we will try to be fairly concise at our end and perhaps I could encourage you to be the same at your end. If I can kick off with capital gains tax and entrepreneurial relief. The October 2007 PBR said, "The Government is committed to ensuring that the UK has an internationally competitive capital gains tax system that promotes flexibility and competition, and responds to the changing needs of investors . . . [The reform] will put the CGT regime on a more sustainable footing and help investors plan for the long term." How successful was it in achieving those aims? Insofar as it was not, where did it fall down? A specific question for the IOD, if I may, in your evidence we were not quite sure whether you were intending to imply that the original proposals were "a daft idea" or not, and do you not welcome the simplifying element of that? You also imply that changes might be made on a revenue neutral basis, but would not a consideration of this nature tie the hands of the Government unreasonably, in that the only time they could make a change would be when it was revenue neutral, so why should it not be open to the Government to simplify with a single rate but choose that rate so that overall revenue is increased?
Mr Baron: Perhaps I could take your questions in reverse order, if I may. Of course it is open to the Government to propose changes which are not revenue neutral, we merely suggested that if they had done it would have taken a lot of the sting out of that debate because they could have said, yes, there are winners and losers but at least the winners are as big in cash terms as the losers. So it is a consideration. Should you make changes on a revenue neutral basis or a revenue increasing basis? In this case they chose a revenue increasing one which I think is probably the meaning of the word "sustainable" in the quote you gave. The Government meant: we want something sustainable, ie we want something which will fit in with our other proposals and give the right balance to the Budget. You asked about competitiveness; your first point. Yes, it does make the regime reasonably competitive internationally, the problem is we are starting from where we were. The 18% rate may look reasonable if you just compare it with rates in other countries but it was for business owners a worse deal than they had under the old regime. I think it sent very much the wrong message to say, "You were going to have 10%, the current Government a couple of elections back introduced that, now we are going to take that away from you", so it is really about the messages being sent within this country. I am sorry you had another point?

Q169 ***Chairman:*** I had one about your "daft idea".
Mr Baron: Yes. What I meant in that part of the written evidence was that there are some ideas which come out of Government which are daft ideas—we all have daft ideas—and it is helpful to put them forward in an open-minded way and say, "We do not know if this is a daft idea, please give us your opinion." I did not mean to imply in that paragraph in my written evidence that this particular idea was necessarily daft, I think these things are too complex to make a single sweeping judgment about a whole policy package.

Q170 ***Chairman:*** The CBI's point of view? Is this an internationally competitive regime?
Mr Cridland: I feel it failed the Government's own test. It has materially and inimically altered the reasonable expectation of many thousands of entrepreneurs, and I think the most insidious aspects are that we no longer treat business assets held for a reasonably long period more favourably than we treat speculative investments. I think that is a retrograde step. I think it is also unreasonable, leaving aside the headline rate, to remove the reasonable expectations long-term entrepreneurs heading towards retirement had for indexation relief. So the lack of a taper and special status for business assets and the removal of indexation are both significantly inimical. The relief that the Government provided in the concessions it put forward after the concerns expressed by the business community help a particular sort of entrepreneur, they help the corner shop entrepreneur, and that is a valuable thing to do but they do not help the entrepreneurs in CBI membership who invest consistently—sell one business and reinvest in another business to grow significant growth small business with high employment opportunities—because for them the £1 million lifetime limit is barely significant.

Q171 ***Lord Wakeham:*** I will continue in the same tone and ask some questions which arise directly out of your evidence. One of the things I ask you is, should the principle of taxing a gain be determined by the law in force at the date of disposal and not preserved within these changes? The IOD sees these changes as retrospective. That is the first question. Does the removal of indexation to April 1998 (frozen indexation) seem justified in the context of the overall package? Would the IOD enlarge on their suggestion that deemed disposal at 5 April 2008 be allowed? And one question which really arose from the answer the CBI gave us a minute ago, there is an argument for the point you put but there is another argument that it would have eliminated very largely the simplification proposals which were part of what the Government said, and I just wonder where you see the balance of that?

Mr Cridland: On that particular point, 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 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.

Mr Baron: Your questions to me relate to the issue of retrospection. I guess to quote Cyril Joad, it all depends on what you mean by retrospection. It is possible to see the changes as retrospective in the sense that if someone bought an asset 20 years ago the gain accrued is partly under the pre-1998 regime, partly under the 1998 regime, and then suddenly they find a completely new regime which may only apply for the last few months of their period of ownership of the asset. It is possible to see that as retrospective, but you could equally argue a different definition of retrospection. The suggestion that we made that they could have allowed you to have a deemed disposal at 5 April 2008, to cover the gain accrued up to that point, would be one way of taking away pretty well any charge of retrospection, so the gain accrued under the old regime, you could tax under that regime and a gain accrued from now on under the new regime. It would have introduced some complexity and in particular you would have had to do some valuations, although we have had valuations built into the system in the past, in particular valuation as at March 1982 has been an important part of the tax system for a long time. The question of removal of indexation is of course only going to be significant for people who have held assets since before 1998, because indexation stopped accruing at that point, but if somebody had held an asset from somewhere back in the 1980s and it had not grown in value enormously then the indexation would make a significant difference to the effective tax rate on the gain. It was surprising, and I suspect it was motivated simply by budgetary considerations of how much money they wanted to give away, that they chose to remove that indexation, which after all had already been computed, was a known amount, so taking away the right to use it was not really simplification. It was also a little surprising, as I touched on in our written evidence, that they left open the door to people who are either married or in civil partnerships to preserve indexation simply by doing an inter-spouse transfer before 6 April 2008.

Q172 ***Lord Wakeham:*** There were a number of well-publicised arrangements. Do you think the Government should have taken steps to stop those?

Mr Baron: I do not think that stopping them would have been the right thing because that actually would have made it look even more retrospective; there would have been a much stronger case for saying it was retrospective if you did not have that opportunity to do that little bit of tax planning. On the other hand what is unfortunate is that those opportunities were limited in the case of indexation to those who were married or in civil partnerships, and in the case of those who wanted to create deemed disposals using trusts to those who had the right kind of advice. If you are going to leave open that sort of opportunity to forestall forthcoming tax change, then you should do so explicitly and say, "Here is an option, tick this box on your tax return to take advantage of this."

Q173 ***Lord Sheppard of Didgemere:*** Do you think we are going back to the period of yesteryear when there was a great deal of debate and a great deal of action between income and capital and shifting between the two for individuals? Do we think that is likely to reappear and go against the simplification point if it exists?

Mr Woods: My Lord, I think it is inevitable it will reappear. It is clearly something which HMRC does not think is sufficiently serious to warrant specific anti-avoidance measures. I am not privy to their thinking on this, why they came to that conclusion, but either they think it is an imaginable amount or they think alternative anti-avoidance measures which have been introduced since the heyday you are referring to are strong enough to tackle that sort of thing in another way. Time will tell. 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."

Q174 ***Lord Barnett:*** I am interested to hear that the CBI, as you put it, are not fans of simplification; you like to leave everything alone, it is much easier than making changes. Your case then is not simplification is all right but the rate is wrong, you are against simplification full stop? You want to keep the taper relief with all its complications?

Mr Cridland: In principle, as evidenced by our recently published Tax Taskforce Report, we are great supporters of simplification but I would suggest my Lord that any simplification proposal, as with any other Government proposal, should pass a proper cost benefit analysis. In this particular case, the disbenefits of the measure significantly outweigh any particular benefits of simplification. What I was suggesting was, certainly as far as the CBI was concerned, the CBI Small Business Council and our entrepreneurial members, there was no great appetite to see simplification in this particular area.

Q175 ***Lord Barnett:*** So you are still not avid fans of simplification but in this area, not in other areas?
Mr Cridland: Simplification has to pass a cost benefit analysis, a case has to be made on its merits.

Q176 ***Lord Barnett:*** Turning then to the entrepreneurial relief, you referred to it as "helping the corner shop". I know you may not be very close to small businesses but corner shops do not usually make—I know £1 million is not a lot of money to the CBI—capital gains of £1 million, do they?
Mr Cridland: We are very close to small businesses, small businesses which tend to associate themselves with the CBI and sit on our Small Business Council may be very small, my Lord, but they are growing small businesses. For a growing small business that level of relief is not answering the challenge. I am afraid you can see that from the Government's own estimates of how much the concession costs the Government, £200 million, and how much they believe they will still recoup, £500 million, which means the real value growth of small businesses—the entrepreneurs who sell a business for £5 million and immediately reinvest it in another business and five years later sell that for £10 million and create jobs—are not likely to be able to take advantage of the lifetime limit.

Q177 ***Lord Barnett:*** Perhaps somebody with a few dozen corner shops, but let's leave that aside. When somebody starts a small business—I declare an interest of some 12 years ago—my experience is that you do not ask yourself when you start, "If I make a huge success and make capital gains when I sell, I will be very concerned about the tax relief", the first thing you want to do is make a profit. Is that not the concern of small businesses who are starting an enterprise?
Mr Cridland: Tax, I would willingly accept, is one of a number of factors and I do not think the CBI has ever said it is the overriding factor. Equally, as you will see from the submissions we made to the Government at the time of the debate on the Pre-Budget Report, we were not seeking to hang on to a headline rate of tax for long-held assets of 10%. The principles, my Lord, were more important to us. The principles that these changes had not been consulted upon, that these changes were to some degree retrospective, that the failure to treat serial entrepreneurs with long-term assets differently from speculative investors was a mistake, and that indexation removal had changed people's reasonable expectations. The rate itself was less significant in our deliberations.

Q178 ***Lord Barnett:*** Is it not always very difficult, the question of consultation has been raised by Lord Wakeham, for any Government or Treasury or Revenue in advance of a major change to discuss that kind of detail publicly?
Mr Cridland: I do not think so, my Lord. I think we have now reached the point in the development of globalisation where tax decisions can cause companies to uproot and move to different domains, where the Government needs to recognise it is just as important to consult on the tax as it is to consult on regulation, and if Parliament is entitled to consider Green Papers, White Papers, Draft Bills in some cases in other areas, I see no reason why it cannot do that in relation to tax. More importantly, I think the difficulties, sadly, which we take no pride in, that the Government has got into with capital gains tax and with some of the other tax measures in the Finance Bill show it is in the interests of Government to consult. I think the relationship with the CBI, and I suggest with the IOD, is mature enough that if they came to us and said, "We want a real debate with you about this tax because we do not think it is sustainable going forward, we believe simplification is the primary objective, you cannot say keep the status quo, CBI, there are going to be changes, how would you achieve our Government objectives?" that is a perfectly fair challenge to put to us, but they did not put that challenge to us.

Q179 ***Lord Paul:*** Is the introduction into the entrepreneurs' relief of a lifetime limit a reasonable compromise? The IOD want the limit of £1 million kept under review and are concerned that it may discourage investment by serial entrepreneurs. Perhaps you would expand on this?
Mr Baron: £1 million certainly sounds like a lot to most of us, but if you think of it in terms of, say, a 40-year career, you would use that up at a rate of £25,000 a year, and if you were making gains of that sort of amount then you could eventually run out of it. The successful serial entrepreneur of course will make gains of more than £25,000 a year over a 40-year career, perhaps not evenly, perhaps smaller to start with and getting bigger, but one can easily see it running out, and of course it is the successful ones we want to encourage. We think it needs to be kept an eye on, the Government will get information from

people's tax returns on how much it is being used, and it should be in the diary now to come back to it in, say, five years' time and say, "How is this going? Are we in danger of perhaps not putting off the person starting their first business, who may well not have this in the forefront of their mind, but putting off the person who already has some success and sold on a couple of businesses and this is running out and they are thinking, 'Do I want to go through all that again, take that risk, have all the hassle of starting a third business?'"

Q180 ***Chairman:*** The other two topics we want to deal with are residence and domicile and encouraging enterprise and we are a little short of time. Were there other questions anyone wanted to ask on this or anything else you specifically wanted to say on capital gains tax?
Mr Cridland: No, my Lord, that is very helpful.
Chairman: In which case, perhaps we can move on to residence and domicile. Lord Blackwell, would you like to start off?

Q181 ***Lord Blackwell:*** Thank you, Lord Chairman, and I apologise I missed some of your earlier responses. The tax policy on residence and domicile has obviously been something which has been under review for quite a while and has been discussed. One of the questions we are interested in is why this particular timing? Why did it come out in 2007? Given that it has been talked about, is there advantage out of the fact the uncertainty has been reduced and it has now been crystallised? How do you see the way and how this has been handled?
Mr Baron: I think the answer to timing is quite simple, they were bounced into it by an announcement by the Conservatives. To what extent they had been planning this policy in advance, I am not sure. Of course if there were a Sword of Damocles hanging over all the non-domiciles saying, "Well, something might happen sometime in the next year or two", then it would be helpful to have the uncertainty removed, but given that nothing had happened for a long time I am not sure that Sword of Damocles was looking particularly threatening. In terms of the handling of it, I think it was very unfortunate, as with capital gains tax, that the Government started by saying, "This is what we are doing", then there was a big row and then, "Maybe we'll talk about it", rather than saying, "This is what we are thinking about, what do you think about it? What are the pros and cons?"
Mr Cridland: I would only add to that, and concur with those comments, 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. Again, given my comment earlier about rates and other unintended consequences, whilst there has been some debate about the £30,000 fee, actually the much greater concern was to do with other matters such as the treatment of trusts which only became apparent much later in the process. So I think from the CBI's point of view the consultation was inadequate. Whilst there had been in earlier years consultation, that consultation I think I am right in saying had come to a close and it was not current, and I do not think many people in the business community were expecting changes at this time.

Q182 ***Lord Blackwell:*** If they look at the impact of this policy, the justification as set out in the consultation document was broadly that here are individuals who are enjoying UK services and want to contribute to them. I know you have done some numbers on the arithmetic, (a) do you think that was a reasonable objective and (b) do you think the arithmetic will actually work out and will raise money for the Exchequer?
Mr Baron: Fairness is always a laudable objective but it is a very elastic concept. Once you get beyond the point of saying that it is fair that somebody with more money should pay at least as much tax as somebody with less money, it can mean many things to many people and of course you do have to juggle that against pragmatism. There is a question, and it is a very serious question, of whether the Government has actually scored an own goal and that the consequences are actually damaging to the British economy and indeed damaging to tax revenues. We do not know. The numbers which the Government put out in December in the document called *Paying a Fairer Share* were admittedly very soft. They said, "We are not certain about these numbers but we think it is something of this order." So it is possible that the true number, the true impact on tax revenue, is negative. I am sure the range of uncertainty, given behavioural effects, is that wide, but nobody knows what will happen. Of course nobody will ever know because by the time you look back on people's tax returns after you have them in a few years later, other things will have changed as well and you will not be able to separate out the effect of this.

Q183 ***Lord MacGregor of Pulham Market:*** We have been receiving quite a lot of criticisms, some very major, some very detailed, about the proposals as they now stand in the Finance Bill. I do not want to go back but looking at the Finance Bill as it is now, which provisions would you pick out as being the most contentious still and why? I know the CBI were arguing in February that the proposals should be scrapped and started again, which is probably not going to happen, so are you now more optimistic that something will emerge that you can live with from the

negotiations and live with by the time the Finance Bill has become an Act?
Mr Woods: My Lord, I think we will have to live with it because the Government has indicated it is not going to reverse its policy, so the best attempt we can now make is to get closure on something with the best changes to the Bill we can achieve. One of the big uncertainties of course, as we pointed out in our paper, is whether the US tax authorities will see the £30,000 charge in the same way as the UK tax authorities. This has always been a big issue, it is still unclear and, as of the most recent pronouncement by HMRC, we will not know the answer to that until the Finance Bill has gone through and the Americans are asked to comment on actual legislation as opposed to a proposal. So we are left with a great big uncertainty as regards the Americans. There are also other areas where there is a great deal of uncertainty still to be resolved, some of which are positively acknowledged as such and I think PAYE and the impact of all these proposals on employers is one of those. We are very pleased the Government has now committed itself to consultation on PAYE, because it is certainly not clear from the scheme of the thing as it currently stands whether it can be subjected to PAYE as we understand it, and it certainly could not, prior to the announcement it was going to be deferred, have been applied from the beginning of this financial year. That was simply an impossibility which we put to the Treasury and happily they acceded to that point. Whether we get movement on things like the £2,000 threshold remains to be seen. I would have thought the Government might be willing to move on that if for no other reason than it is very difficult to see how HMRC will actually police that in practice. Is there, as John Cridland referred to earlier, any cost benefit to be had from trying to run round checking up on £2,000 earned abroad by somebody who is picking strawberries in Worcestershire? I very much doubt it. I doubt whether HMRC have actually got the manpower to do that sort of checking up even if they wanted to. So it might well be that they would want to revisit that and consider it should be made into something more realistic. Those are some of the areas that need to be looked at, but PAYE from an employer's point of view was a complete no-go area and so I am grateful we have got time to think about that and discuss it.

Q184 ***Chairman:*** There were a number of calls, including from both of yourselves, for all or part of the proposals to be deferred from April 2008. What do you make of the counter argument that it was right to proceed to eliminate continuing uncertainty? You have already talked about prior consultation but do you have any other comments about the overall handling of the initiative? Are there any major concerns apart from consultation?
Mr Cridland: 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. Many of the international visitors whom the CBI meets and discusses with are just surprised that the Government has given a signal, as they see it, that that capital and those people are no longer necessarily as welcome in the United Kingdom. I fear that damage is done. What I would say in contrast to the capital gains tax story is that I do think the Government belatedly, to be fair to them, listened to the concerns being expressed and whilst, as Mervyn has said, we need to look at the detail of these proposals as the Finance Bill progresses in principle some of the most major concerns, both for employers and for individuals, have been addressed. This was never a debate about the £30,000 fee but it cannot be sensible for the tax affairs of individuals who play such a critical role to the UK economy in the City—but not just in the City, some of our major manufacturing companies across the land—to be publishing draft proposals in January which affect their tax affairs as soon as April. We know, and I am sure you have heard, that professional firms between Christmas and the end of March, were unable to take on more work in this area because of the advice they were needing to give individuals, and that is just not a commonsense way of addressing matters of this kind.

Q185 ***Lord Wakeham:*** There is one aspect of it which we have had some evidence about and that is the question whether, having gone down this road, the Government would not have been wiser to have brought in legislation to determine whether someone is a UK resident to replace the practice of case law which underlines the present approach. Have you a view on which would have been the better process?
Mr Baron: I think that would have been a good thing. In general it is better to legislate where you can straightforwardly, rather than rely on inherited practice or case law. I think this is a case where you could lay down very straightforward, precise tests in legislation.
Mr Cridland: I would concur with that view.

Q186 ***Lord Wakeham:*** What about the uncertainly about the new day counting rules? Whether you approve of it or not, is it pretty clear what is now intended?
Mr Baron: I think it is pretty clear now. The only uncertainty was what to do about transit passengers, people who maybe land at Heathrow and leave from

Gatwick and maybe answer an email on the bus in between, or something like that. We seem to have got sensible practice on that. Obviously the Government did move from saying, "We are going to count both the dates of arrival and departure" to saying, "We are just going to count the date of arrival" and it is very good they made that change, but of course that was never a matter of uncertainty, it was perfectly clear what was meant by that, it was just a policy we wanted changed.

Q187 ***Lord Sheppard of Didgemere:*** Would you like to comment on the whole question of compliance costs and how that fits in with the personal tax allowances and how it affects both the employer and the individuals concerned? Will it be sorted out in time? What would you do to get it simplified and quickly?
Mr Baron: The main thing to look at there is the increase to £2,000. The original proposal was of course £1,000 so putting it up to £2,000 is a significant improvement. I am 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." As has already been said, 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.

Q188 ***Lord Sheppard of Didgemere:*** Would you see a change in the £2k to £3k, or even £5k, being adequate? Our previous speakers were talking about a factor of 15 as the change which is necessary.
Mr Woods: Unfortunately, my Lord, we have not got a Revenue cost benefit analysis which shows us where the break-even point would come. I would have thought the point at which you should set the exemption threshold would be the one beyond which the Revenue would see themselves in a positive position as opposed to one where there is nothing in it for them anyway. What is the point in setting a threshold which will not produce any revenue?

Q189 ***Lord Wakeham:*** Do you think they have got that figure?
Mr Woods: I hesitate to say. I suspect not otherwise I would have thought they would have put it into the public domain but that is pure speculation. The point is, given we have got the KPMG Report on reducing admin burdens, et cetera, why on earth would one want to introduce a whole new raft of admin burdens which rise in the opposite direction to no net benefit to the Exchequer? I really cannot see any gain to be had from that.

Q190 ***Lord Barnett:*** In paragraph 14 of Document C you expressed those concerns about it not going to raise any revenue, so do I understand from what you are writing and saying that you would be happier with tax levels which did raise more money?
Mr Woods: No, I think what we were saying was that before coming forward with what actually amounts to a very great complication of the tax system, as opposed to the Chancellor's announcement of the simplification agenda, there should be a jolly good case made out to justify that complication. We do not think from the figures which we have seen and the evidence which has been produced by the Government to date that there are those arguments and they have been made out.
Mr Cridland: We were looking, my Lord, at the net tax take, trying to make the point that a number of these non-doms actually pay a significant tax of other sorts in the United Kingdom and if, looking at the pessimistic side, a lot of these people choose not to be here in the future, then the Government could find itself out of pocket.

Q191 ***Lord Barnett:*** So the strawberry pickers would have other revenue as well?
Mr Cridland: Quite possibly.

Q192 ***Lord Barnett:*** So why would a strawberry picker want to bother with claiming non-dom status?
Mr Cridland: Clearly the people we are concerned about are likely to be high value individuals in the City whose contribution through their spending power in the UK—

Q193 ***Lord Barnett:*** So you are not really talking about strawberry pickers?
Mr Cridland: In this particular case we were not.

Q194 ***Lord MacGregor of Pulham Market:*** Could I come back to the point you raised about the HMRC delaying for one year the PAYE issues and so on? There are obviously a lot of complications. Looking ahead, would there still not be increasing employment costs as a consequence of denying personal allowances from day one on an employee's tour of duty in the UK?
Mr Woods: Yes, there would.

Q195 ***Lord MacGregor of Pulham Market:*** Would you like to quantify that and say how you deal with it?
Mr Woods: In the course of the discussions we have had, we will be challenging HMRC (and the Treasury to the extent it is a policy issue rather than a compliance issue) to justify imposing on employers yet another raft of burdens relating to the PAYE burden as a whole and to what benefit. As John Cridland and Richard Baron have already said, the whole question of this exercise needs to be examined carefully and

coolly in the light of the evidence available. I have to say I am pleased to date the Treasury has recognised that PAYE is not the straightforward thing they originally suggested in response to questions and are now going to revisit it, and I think over the course of the consultation period they are going to engage in we will have the opportunity to put before them all of the instances where there could be difficulties and try and work out optimal solutions.

Q196 ***Lord MacGregor of Pulham Market:*** Do you think there is another way of dealing with it apart from raising the threshold quite substantially?
Mr Woods: You can always take everything out of PAYE and leave it to self-assessment.

Q197 ***Chairman:*** I think we should now move on to the third of our topics which is encouraging enterprise. Perhaps I will ask the first question on this and then pass on. Clause 28 increases the EIS investment limit from £400,000 to £500,000. Do you think that was a necessary change, given that the limit was increased to £200,000 in April 2004 and £400,000 in 2006? Given that the Treasury issued a consultative document on the EIS on Budget day and there were various other documents published on that day, do you not find it surprising that the change to the EIS limit was made in advance of wider consideration of these publications? Would it not have been more sensible to stand back and assess where all this might be taking us and then introduce a broader package if it seemed desirable?
Mr Baron: I do not think the increase to £500,000 was necessary. Obviously it is nice for people who are already planning to invest rather more than £400,000 in qualifying investments. There is a general question, as I mentioned in the written evidence, of should you be increasing special reliefs or should you be saying, "No, we will keep them where they are and when we have got scope we will cut tax rates across the board." That is the important policy question about the direction of the tax system and obviously a very broad one. You ask about the relationship between the increase to £500,000 and the consultation document, I see them as pretty well independent because the consultation document was concerned with a lot of administrative issues—are there particular obstacles? Obviously the limit is only an obstacle to someone who has got that kind of money, and the consultation document was clearly focusing on different types of obstacles. So I am not at all worried that they chose to change the limit at the same time as issuing that consultation document.

Q198 ***Chairman:*** Does the CBI take the same view?
Mr Cridland: Broadly. For CBI members there is rather more excitement about the consultation document than there is about the 500,000 limit. The reason that the EIS has not been the success we would have hoped, albeit it is an important part of the Government's enterprise agenda, is because of the complexity of the scheme rather than the levels of relief; the complexity and the regular changes to the scheme. So the consultative document is the best hope to get the EIS where it needs to be by tackling a range of issues such as connected parties and others which make the scheme very difficult for many individuals to make it work.

Q199 ***Lord Paul:*** The IOD suggest there might be a case for abolishing the venture capital schemes to reduce tax rates across the board. The CBI thinks that a thorough overhaul of the EIS legislation is necessary. How widely spread is the dissatisfaction with the EIS scheme as presently constituted? The CBI wants to see the regulatory regime improved. This ties in with another Government publication on Budget Day, *Enterprise: Unlocking the UK's Talent*. Do you have specific changes in mind?
Mr Cridland: If I may comment on the enterprise strategy: there were many elements of the enterprise strategy which the business community will welcome, the notion for example of regulatory budgets in government departments I think is a novel, imaginative approach. There were some very important areas to do with innovation, the use of innovation vouchers for small businesses, which is something we very strongly support. 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. For our membership it is a bit like a doughnut, it is hollow in the middle, 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 them on enterprise taxation, given it has increased small firms' corporation tax and then made changes to capital gains tax, both of which were unwelcome, I think the enterprise strategy is going to have to work very hard to convince the business community that it is valuable. Whilst in principle we are supportive of the EIS, as you rightly say from our evidence, at the moment there are complexities in the scheme which need addressing but it is not the most important thing for entrepreneurs. Entrepreneurs have had ten years when the Government had put in place a range of measures which are very welcome and supported. In the last year, the Government appears to be reversing its strategy and small businesses are scratching their heads and wondering where the Government is on this issue, notwithstanding the enterprise strategy.

Q200 ***Lord Blackwell:*** I do not know whether you have seen the study by the Institute for Employment Studies, University of Sussex, but its key findings are that neither the EIS nor the VCT investments have a material effect on fixed assets and employment in

recipient companies; it has some effect but not very much. Companies with EIS and VCT investments tend to have lower profitability and survival rates. Firstly, do you accept the results of that analysis? Do they accord with what you expect? Does it lead on to the question of the validity of the Government subsidising risk-taking in this way and do you think it is justified?
Mr Baron: I think the limited success does raise the question of the wisdom of Governments trying to, if you like, manipulate the economy and encourage the economy in particular directions by special reliefs. As I have already indicated, a big debate about the general direction of the tax system is something which we ought to have. The second conclusion which you mentioned from the study deals with companies with EIS and VCT investments having lower aggregate profitability and survival rates, but the cause and effect may be the other way around. It may be that if your business is marginally profitable or rather high risk given its likely profitability, you will only attract investors in and your business will only get started with the advantages of the EIS and it may be that which biases the outcome. So EIS may not be the cause of the problem, it may be the reason why businesses which have problems exist.
Mr Cridland: I would very much concur with that view. Frankly, the results surprised us. They do not fit in with our anecdotal experience but we have no reason to question them and when we tried to rationalise why the researchers found that result we came to the same conclusion, that the causal relationship may be different.

Q201 ***Lord Blackwell:*** So you are generally supportive of these schemes if they are simply enough to be effective?
Mr Cridland: Yes. The CBI Tax 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. That is the long-term vision and therefore any intervention, be it an R&D tax credit or an EIS, that complicates the system has to be demonstrably successful. But I do think with the EIS there have been constant changes to the scheme and we have never had in a sense a fair run of making the EIS work.

Q202 ***Lord MacGregor of Pulham Market:*** I think you have made your position about the complexity of the EIS clear, can I ask you whether you think the scheme is capable of reform given the underlying policy reasons which determine much of the complexity? That is question one. Question two follows on from the last question. EIS of course is really quite different from the VCT scheme and sometimes they are lumped together, in my view mistakenly. Do you think the criticisms you have been expressing of the EIS scheme also apply to the VCT schemes?
Mr Baron: Firstly, is the EIS capable of reform? Yes, of course you can cull a lot of the complicated restrictions around it, the problem is that some of those restrictions are there for very good anti-avoidance reasons and if you culled all of the restrictions which surround EIS investment the Revenue might find the cost of it rocketed and it got abused in all sorts of ways. So one can see why a lot of complexity is there. This is the problem if you try and do something special for a particular group, you then need a whole raft of legislation to make sure you only do it for that group in the way you intended and not for other groups or not in ways you did not intend. That goes with the territory of special reliefs. EIS and venture capital trusts, I think the main criticism which does apply to both is the complexity, a lot of the rules are the same or very similar for the same kinds of reasons of wanting to target particular groups.
Mr Cridland: I would concur with that. Just to give an example of one of the things which frustrates business people, the connected parties criteria, I came across an example recently of two partners in a small planning business who had made a separate investment in the same business but because they were partners in their employing business were considered to be connected parties. That does not seem to me to be a necessary restriction on the use of that scheme. You will quite often find people who are in the same community helping to support through investment the same small business, so to me it was an unintended necessary complexity.

Q203 ***Lord MacGregor of Pulham Market:*** That applies to the EIS?
Mr Cridland: Yes. There are things which could be done to the EIS which would improve it without opening up the problems which Richard described which, as with Richard, we would not want to run the risk of—the avoidance issue.

Q204 ***Lord Barnett:*** You are saying there are other ways of helping when looking to improve the EIS scheme. Have you spelt them out specifically to the Revenue?
Mr Cridland: Not recently. We will be doing in response to the consultation exercise, we will be consulting carefully and putting in a detailed submission on it.

Q205 ***Lord Barnett:*** I am very glad to hear that but you want to make it more simple, it is too complex. Is the problem here that because of the complexity many small firms simply do not know it is available and are not claiming it?

Mr Cridland: Yes.

Q206 ***Lord Barnett:*** That is the big problem, is it not?
Mr Cridland: Indeed it is, and one of the reasons why we did not get too excited about moving from 400,000 to 500,000 was because there will be people who will benefit and we do not want to throw the thing back in the Government's face. One of the reasons we do not get too excited is that for me the target group we need to help is at a much lower level of relief and for many of them, given the complexity that such a scheme will always have, it is much more likely they will get involved in the EIS through an approved or unapproved fund rather than through an individual. I think through the consultation, my Lord, we have to focus on who we are trying to reach and have a simple approach to helping those people use the scheme to good effect.

Q207 ***Lord Barnett:*** If we are not careful some small firms might be suing their advisers for not telling them?
Mr Cridland: Anything is possible.

Q208 ***Chairman:*** I think we have come to the end of our questions and I would like to thank you again for spending your time with us this afternoon, both for your written evidence and for your very helpful answers to our questions.
Mr Cridland: Thank you, my Lord.
Mr Baron: Thank you.

Supplementary memorandum by the City of London

Introduction

1. This supplementary briefing note outlines significant outstanding issues that remain at May 2008 to be finalised as part of the substantial revisions to the taxation of residence and domicile. The note has been produced by Alexander Henderson, Partner, PricewaterhouseCoopers LLP for the City of London, in consultation with Michael Snyder, Deputy Chairman of the City Corporation's Policy and Resources Committee. It focuses on two areas:

i) Points within the current published legislation of particular concern.

ii) Points that are not within the legislation but will require action or review in the future.

In each case an outline of the issue is given together with a brief background technical description. This note is not intended to be a comprehensive list of issues but concentrates on areas on greatest significance.

Issues within the Current Published Legislation

Treatment of Offshore Companies

2. The treatment of non-domiciled individuals who have interest in offshore companies will be significantly worse than those who hold assets (including interests in offshore companies through trusts). There does not appear to be a clear policy reason for the distinction which incentivises non-domiciled persons to complicate their affairs and discriminates against those who hold assets personally. As part of the relaxation of the original measures applying to more complicated structures, grandfathering of gains prior to 6 April and taxation of gains on UK assets on a remittance basis were introduced for trusts but not for companies. The new statutory code that will apply under s13 TCGA 1992 for non-domiciled investors in closely held companies should be harmonised with the measures for taxation of trusts under s86, s87 et seq TCGA 1992.

Connected party remittances

3. Non-domiciled persons who have invested in overseas companies could find that use of funds in the UK (for consumption of goods or services for that company or investment in UK assets) is treated as a taxable remittance by them personally. This is unfair since they may have no control over the activity of the company and seems contrary to the interests of the UK as it creates an incentive to avoid investing in or engaging with the UK economy.

Mixed funds

4. The new regime needs to take into account HMRC practice in the new statutory framework for the treatment of mixed funds (ie bank accounts which contain funds which are sourced from monies containing various types of income or gains). The new regime includes new and complex statutory measures governing mixed funds. However, it does not take account of HMRC practice in SP 5/84 which was a simplifying measure to allow expatriate employees to remit funds to the UK out of accounts into which they had had earnings paid, without having to examine the source of the funds on a daily basis. This is currently an acute issue as it affects many employees in the City: the first monthly pay day under the new regime has now passed and it not yet clear what the legislation and practice will be.

Points Requiring Future Action or Review

Residence test

5. No provisions have been brought forward as part of the Finance Bill for a wider statutory framework for deciding residence. A statutory test of residence would give greater certainty to taxpayers and employers and should be brought forward later.

6. The tests for residence in the UK are a mixture of statute, case law and HMRC practice. Much of the case law is very old and was developed in a time when international communications were much less developed than currently. The UK does not have a clear system for deciding residence laid down in statute and is out of step with other major countries.

HMRC enquiries into taxpayers' affairs

7. It remains to be seen whether the new regime will meet concerns that were expressed about confidentiality of taxpayers' overseas affairs. It will be necessary to review the extent to which HMRC use their general enquiry powers to seek information from those who are non-domiciled, very wealthy people (who are serviced by City institutions) and moderately wealthy ones (who City institutions employ) have, *inter alia*, significant personal security concerns about releasing details of personal overseas assets to any party, including the UK Revenue authorities. Some sympathy has been expressed with these concerns by HMRC and specific disclosure obligations from the new regime have been removed or reduced. However, much will depend on the extent to which HMRC make enquiries into individual returns using their existing powers. These enquiries normally take place with a time delay of several years so the issue will remain a live one for some time to come. Clearly HMRC have to have the power to make enquiries into the tax affairs of non-domicileds as part of their normal control procedures. The issue is the manner, frequency and range of these enquiries into individuals' overseas interests which may legitimately be outside the scope of UK taxation.

De minimis levels and difficulties of compliance

8. The *de minimis* levels for the operation of the new regime (eg the £2,000 limit on overseas income) are too low and need to be kept under review. While not expected to be a problem for City employers/ees and spouses/civil partners to comply (albeit with increased administrative burden), a concern remains that across the economy as a whole the new regime will apply to many temporary and migrant workers who may have overseas earnings or rental income on the home they have left behind but who will be unaware of their obligation to submit a tax return. This is likely to cause a significant burden for HMRC in educating and assisting these persons with their obligations, processing their returns (and in due course adjustment to PAYE codings). A fear remains that at best this will be an inefficient use of HMRC resources over time and at worst it will institutionalise non-compliance in a sector of the economy, neither of which will help with confidence in the UK as a place to do business.

14 May 2008

MONDAY 12 MAY 2008

Present	Barnett, L	Paul, L
	Blackwell, L	Powell of Bayswater, L
	MacGregor of Pulham Market, L	Vallance of Tummel, L (Chairman)

Memorandum by the Law Society of England and Wales

General Comments

The Bill contains a number of proposals which continue to be the subject of considerable debate. We would note that there are a number of provisions in the Finance Bill which when the Bill was published were accepted by HMRC not to be in final form. These will be subject to Government amendment. This is indicative of the lack of time and consultation in seeking to implement these proposals and hampers the ability of the professional bodies to make constructive comment.

Entrepreneurs' Relief

This relief appears to have been modelled closely on retirement relief—repeating many of the deficiencies that were contained in that relief. It appears to have been drafted in a hurry without full consideration being given to the alternative business structures in place in the modern age. Also the relief for trustees needs to be brought into line for the relief for individuals so that the relief is effective and fair, rather than full of traps for the unwary.

Residence and Domicile

In common with many other professional bodies we believe that the effective date for the proposals (particularly those dealing with the "anomalies") should have been delayed until at least April 2009 in order to provide for proper consideration and consultation.

The provisions are complex and intricate, and, as indicated, in places currently incomplete. The speed of implementation gave taxpayers little time to re-organise their affairs and any re-organisation that was undertaken prior to 6 April 2008 was effected in a cloud of uncertainty regarding the shape of the rules in the their final form.

The UK taxpayer is used to a system under which new rules are introduced to apply from a particular date, the legislation is then fleshed out, subsequently debated in Parliament and enacted, very often in a slightly different form. Historically proposals enacted in this manner did not have retroactive effect. These new rules have been sprung on foreign, often exceedingly mobile, individuals out of the blue after years of Budget announcements indicating that the rules were still under review but no changes were proposed. 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.

Specific Comments

1. Capital Gains Tax

Repeal of sections 77–79 Taxation of Chargeable Gains Act 1992

Certain changes (namely those effected by paragraph 5 of Schedule 2—the proposed repeal of sections 77 to 79 Taxation of Chargeable Gains Act 1992) have been introduced under the heading "Rate: consequentials". The Explanatory Notes (paragraph 9) state simply that "The introduction of a single rate of CGT for trustees and individuals means that the application of sections 77 to 79 would have no effect on the rate at which the gains were charged to CGT. The sections will serve no useful purpose in future, and are accordingly repealed".

The relevant provisions contain the rule whereby gains of a UK-resident trust under which the settlor has an interest are taxed on the settlor and not on the trustees. Whilst it is true that the bald rate of tax payable by the trustees and by the settlor will be the same, the repeal has two other important consequences related to the amount on which tax is calculated at that single rate:

- if a settlor has allowable losses from the current or previous years, he is enabled to set these against gains attributed to him from the trust. This amendment will deny that offset, and will therefore (where personal losses are present) increase the amount that is charged to tax; and
- similarly, if gains of a trust are attributed to the settlor, the amount on which he must pay the tax will be worked out with the benefit of his personal annual exempt amount. This can operate either in favour of or against HMRC: if the settlor had no other gains in the year, a larger exemption is made available than would have been available to the trustees; on the other hand, if the settlor had made personal gains which use up his annual exemption, then repealing sections 77–79 allows the trustees to use their annual exemption which would otherwise have been wasted.

Neither of these changes is "consequential" on the change of rate, and it is noteworthy that, with a settlor whose income makes him a higher rate taxpayer, there has been no difference between the rate of CGT payable by him, or by the trustees, for several years.

Vulnerable person's election

The provisions of Finance Act 2005 relating to the vulnerable person's election proceed on the footing that, but for such a person's disability or minority, property that is in fact held in trust for him would almost certainly have been given to him outright. They are designed to ensure that the vulnerable person is not disadvantaged by the use of the trust. In the CGT context, these rules have operated hitherto by treating him (where the trustees so elect) as if he were the settlor of the trust, thus bringing into operation TCGA 1992 sections 77–79 which attribute the trust's gains (net of trust losses) to the vulnerable beneficiary: Finance Act 2005 section 31. (If the beneficiary is not UK resident but the trustees are, then a similar result is achieved by sections 32–33, giving relief to the trustees that is calculated on a corresponding basis).

Paragraph 17 of the Explanatory Notes states that "The result of the changes to section 31 of Finance Act 2005 made by paragraph 16 of the Schedule is that where the vulnerable person is resident in the UK, the trustees' liability to CGT in respect of chargeable gains on the disposal of settled property held for the benefit of the vulnerable person (described as "qualifying trust gains") is reduced to the amount of CGT that would have been payable by the vulnerable person in respect of those gains if they had arisen directly to the vulnerable person. This replaces the previous rule, which used section 77 of TCGA 1992, so that the vulnerable person was charged to CGT as though the qualifying trust gains arose directly to him".

The amended section 31(2) and (3) as set out in paragraph 16 fail to achieve the stated result. If qualifying trust gains arose directly to the vulnerable person, he would be enabled to set off personal losses (which could have been realised before the onset of his disability and carried forward, or could have arisen in respect of assets held on bare trust for him). This is the result that is achieved by the existing rule which imports the operation of TCGA 1992 section 77, taken with section 2(4)–(5) of that Act. Under the revised formulation of Finance Act 2005 section 31, offset of those losses appears to be denied by the words "[if . . .] no allowable losses were deducted from the qualifying trust gains", which should bar only the deduction of losses that had accrued to the trustees (because the trustees' liability without the election will have taken those losses into account already).

Abolition of "kink test" and of "halving relief"

The abolition of the "kink test" by paragraphs 57 to 71 of the Finance Bill has the effect that the acquisition value of an asset disposed of after 5 April 2008 is always treated as its value on 31 March 1982.

The abolition of "halving relief" by paragraphs 73 and 74 has the contrary effect that it remains necessary to look back to an acquisition before 31 March 1982.

Halving relief was never more than a rough and ready measure to recompense those who had acquired assets after 1982, but subject to a claim to holdover or rollover relief such that (apart from the relief) their effective base cost would have reflected a pre-1982 valuation or acquisition cost.

Now that every other provision in the capital gains tax legislation uses 1982 values where otherwise an earlier cost or value would apply, it is inequitable that halving relief should be abolished but the abolition of "halving relief" should be brought into line with the abolition of the "kink test" by substituting a March 1982 value as the acquisition cost.

2. Entrepreneurs' Relief

There are various areas where we consider Entrepreneurs' Relief falls short of what is appropriate, in many cases because it is modelled on retirement relief. We set these out below.

Transitional period where assets used for purposes of a business

Entrepreneurs' Relief will not be available to an individual who makes a disposal of an asset which he has not used personally in a business during the three years before the disposal. Business Asset Taper Relief would however be available after 5 April 2004 where the business was carried on by someone other than the owner. The Law Society has proposed an amendment to introduce an additional but temporary category of material disposal of business assets which will give Entrepreneurs' Relief to someone who used an asset for a business before April 2004, and then permitted another person to use it for a business instead, in the expectation that his business asset taper relief would remain available.

The amendment proposed would will assist eg a farmer who, after 5 April 2004 in the reasonable belief that following changes made by Finance Act 2003 his tax rate would remain at 10% because Business Asset Taper Relief treatment no longer required the asset owner to be directly involved in the business, retired and let his farm to a younger farmer. The amendment gives the taxpayer in this position a period of five years to make alternative arrangements, or to make a disposal within the Entrepreneurs' regime. This is limited to taxpayers who had personally carried on the business before handing over to another party, so excluding the property investor. Without an amendment along these lines, a retired farmer or other trader could well be wholly denied Entrepreneurs' Relief by reason of no longer being directly involved in the business.

Assets disposed of before business ceases

We also consider that Entrepreneurs' Relief should be altered so as to provide that relief may apply to assets disposed of during the 12 months before the cessation of business. The amendment gives a time frame for disposing of assets similar to that which applies for roll-over relief.

The purpose of the amendment is to prevent Entrepreneurs' Relief being unfairly denied when, in the course of winding up a business some assets are disposed of **before** the actual cessation of the business. In the case of eg a farmer retiring, if he ceases trading and sells the farm within three years after ceasing the trade new section 169I(4) will ensure that he gets relief (so relief covers assets disposed of on cessation of the business and for a period afterwards). But if he sells part of the farm say six months before cessation he may be denied relief under the principle laid down in the case of *McGregor v Adcock*. That case was under the now repealed retirement relief on which, as mentioned above, much of Entrepreneurs' Relief is based. A taxpayer aged 70 had farmed for over 10 years. He sold five acres for which outline planning permission had been obtained. It was held he was not entitled to the relief as he had not sold the part of business but merely an asset. While Entrepreneurs' Relief extends to the disposal of assets in use at the time of cessation it should also apply to disposals before cessation.

Entrepreneurs' Relief should be extended to cover trust businesses

Trustees can claim Entrepreneurs' Relief for assets used by a beneficiary, where the beneficiary carries on the business, but not where the business is carried on by them. The Law Society has proposed that a new provision be introduced to give relief in these circumstances.

Trustees are often empowered to carry on a business and it can be advantageous for them to do so, for example to be able to claim Inheritance Tax Business Property Relief and Capital Gains Tax roll-over relief. Many trustees of farmland are involved in the farming of the land. The amendment enables the trustees to claim Entrepreneurs' Relief for the capital invested in the business itself, just as they would have been entitled to Business Asset Taper Relief.

Entrepreneurs' Relief should be extended to cover trust shareholdings where an individual has an interest in possession

A "disposal of trust business assets" only qualifies for entrepreneurs' relief when trustees own shares in a company if:

- — an individual has an interest in possession in those shares; and
- — the company is that individual's "personal company", which means that, in his own right, the beneficiary must have a shareholding of at least 5%; and

— the individual is an employee or officer of the company.

In particular, as presently drafted, trustees do **not** qualify for Entrepreneurs' Relief on the basis of a trust shareholding of more than 5%, even where an individual who is an employee has an interest in possession in that 5%, unless the beneficiary also has a personal 5% or more shareholding in his own right.

It is far from clear that this was the intended effect of this provision. Even if it was, it is unfair to families who, for historic reasons, hold family assets in trust.

Suppose a family company has two directors, who are the widows of the founders of the company.

Both the founders have died, leaving their 50% shareholdings, in one case, outright to his widow (who is also the mother of his children) and in the other case to a trust giving his widow an interest in possession for her life, but providing that on her death, the shares pass to the founder's children (who are the widow's stepchildren).

Since their respective husband's deaths both directors have contributed equally to the success and growth in value of the company. But because of family circumstances, one shareholding qualifies for Entrepreneurs' Relief and the other does not.

Entrepreneurs' Relief should be extended to assets used for the purposes of a business carried on by a beneficiary's company

The new section 169J Taxation of Chargeable Gains Act 1992 gives trustees the right to claim Entrepreneurs' Relief for land, or premises, or other assets used by a beneficiary in his business provided the beneficiary is a sole trader, or trades though a partnership. As presently drafted, if the beneficiary trades through a company, the trustees can only claim relief if they dispose of shares in that company.

It is illogical to discriminate between business structures by denying the relief where the beneficiary trades through a company. The amendment ensures that the Entrepreneurs' Relief will be available for assets held in trust, and used by the beneficiary for a trade, whether he trades as a sole trader, or a partnership, or through a company. (For this purpose we have suggested adopting the requirement that a company should be the beneficiary's personal company, without in this case attributing to the beneficiary any shares held by the trustees).

Entrepreneurs' Relief should not be restricted by a non-business use or payments of rent to the extent this occurs before 6 April 2008

Entrepreneurs' Relief will be restricted to part of a gain arising where an asset disposed of was used for non-business purposes during the taxpayer's ownership, or a rent is paid for its use. The amendment limits the effect of these restrictions as applied to periods of ownership before 6 April 2008.

Non-business use of an asset, after 5 April 1998 restricted the availability of Business Asset Taper Relief. The new section 169P(4)(a) will have a retrospective effect by bringing into account non-business use before April 1998 to restrict the proportion of the gain taxed at 10% under Entrepreneurs' Relief. A similar point arises with the new restriction where rent is paid eg to a partner for use of an asset by the partnership. The payment of rent would not restrict the Business Asset Taper Relief before 5 April 2008. The new provisions should be altered to ensure that the retrospective effect of the new rules is neutralised by ensuring that non-business use before 6 April 1998, and payment of rent before 24 January 2008 (when Entrepreneurs' Relief was announced) for use of a business asset, do not restrict the Entrepreneurs' Relief now available, and allows a transitional period of one tax year for restructuring where these conditions would otherwise be breached by the payment of rent contracted for before 24 January 2008.

EMI Options

Entrepreneurs' Relief is not available until the shares have been held for one year. In the case of an employee holding shares under an EMI option, this means that the relief will not be available until one year after the exercise of the option. As the purpose of the new relief should apply equally to employee optionholders and shareholders to promote investment and recruitment in companies, the Law Society has proposed an amendment to allow the EMI optionholder to count his period of ownership from the date of grant of the option in the same way as paragraph 14, Part 4 Schedule 7D TCGA 1992 allowed taper relief to be calculated from the date of grant.

3. Residence and Domicile

3.1 *Residence Test*

Generally the UK tax residence status of an individual is determined by the number of days that he is present in the UK. The rules are extremely complex but broadly there are two "day-count" tests.

Under statutory provisions an individual is UK resident if he spends 183 days or more in the UK in anyone year.

Under the second test (in effect, developed out of case law and set out in non-statutory guidance published by HMRC called "IR20") the individual is UK resident if he spends an average of 91 or more days in the UK calculated over four UK years. This test is of particular relevance to "short term" visitors to the UK who, when they visit the UK, do not plan to spend a sufficient amount of time in the UK to be resident from the day they first arrive. The test is relied upon by many visitors to the UK, including persons who come to the UK to undertake business transactions in the UK.

For the purposes of both tests days of arrival to and departure from the UK were not counted.

It is proposed to alter the test of residence by counting any day where the individual is present in the UK at midnight (excluding only days spent by passengers in "transit").

Clause 22 introduces amendments to effect this change for the purposes of the 183 day test.

The Explanatory Notes indicate that a change is required because "recent case law has indicated that HMRC's guidance on "day-counting" as it stands creates a degree of uncertainty". The Explanatory Notes acknowledge the limitation of the proposed legislative changes and state that changes to the "91 day" test will be effected "in line with the statutory amendment introduced in clause 22". A new version of IR20 is, however, still awaited.

It is submitted that the uncertainty of the "old" residence rules did not arise solely in the context of the "day-counting" guidance. In recent cases (such as *Gaines-Cooper*)—which largely relate to persons leaving the UK rather than visitors to the UK—greater consideration has been given to matters other than "day-counting". IR20 does not give sufficient guidance to prospective visitors—or those wishing to cease UK residence—on those issues. It is, however, assumed that the only changes which will be made to IR20 are those required to bring the guidance in line with the changes proposed by clause 22 so that the past uncertainty will continue.

Individuals should know whether their plans will cause them to be UK tax resident or not and to that end we would support the other professional bodies who are calling for a clear statutory test to be introduced with effect from 6 April 2009, This would provide sufficient time for full consultation on the proposals which have been previously submitted to HMRC. It would also obviate the need for clause 22 at this time. We submit that effecting a change to the "day-counting" test this year and then introducing a statutory test in 2009–10 will further undermine the reputation of the UK tax system and should be avoided.

3.2 *Remittance Basis*

A number of issues arise out of the proposed complex rules. HMRC have indicated that amended legislation will be published during the course of May reflecting Government amendment of provisions which were not in final form when the Finance Bill was published on 27 March 2008. The amended form of the legislation is not yet available and accordingly the comments in this briefing are made in relation to the legislation as published on 27 March 2008.

3.2.1 Compliance concerns

We are, alongside the other professional bodies, concerned to ensure that the new rules do not impose unfair burdens or requirements upon residents of the UK with which they are unable to comply. In that context we would submit in particular:

- That the de minimus limits in section 809C should be increased to address the needs of those whose levels of foreign income/gains may not previously have justified sophisticated professional representation.
- Section 809D should apply where an individual has a small amount of UK income (eg bank interest) within the personal allowance—to avoid the need for a tax return to be completed where no tax would be due (but a return is required to claim the remittance basis).
- That persons who are resident and domiciled (but not ordinarily resident in the UK) and who are taxable on the arising basis by reference to gains (because of their resident/domiciled status) should be entitled to the annual capital gains tax exempt amount (section 809F).

— That the definition of "relevant person" is too widely drawn, A liability could easily arise on an individual where funds are remitted to the UK by a "gift recipient" in circumstances over which the individual has no control (eg an unconditional gift to an adult child which the adult child then chooses to remit to the UK for the benefit of his minor child—who, as the grandchild of the individual, is a relevant person for the purposes of section 809K. Also in the context of a divorce where a payment is made by the individual to an ex-spouse which the ex-spouse then uses for the benefit of the individual's child). In such circumstances the ability of the individual to file a compliant SA return is compromised.

— That it will not be possible for persons who have relied upon the long accepted "source ceasing" rules to be able to produce evidence regarding the provenance of funds the source of which ceased many years ago.

3.2.2 Deemed Remittances

The exchange of correspondence between Angela Knight CBE of the British Banking Association and the Rt Hon Jane Kennedy MP to Angela Knight CBE of BBA highlights the fact that the Government did not have sufficient time to properly consider the consequences of the draft legislation and the potential damage to the UK investment management industry of that draft legislation. The issues in relation to the draft legislation (and in particular sections 809K and related provisions) are not confined to those involved in the investment industry. Trustees of non-UK trusts will be deterred from seeking advice from professional service providers located in the UK for fear of making a remittance of funds to the UK. We are informed by HRMC that the amended legislation expected later this month will deal with the issues addressed by the banking community but are less assured about the position for other professional service providers. The provisions as drafted do not support Government contention that the provisions are "comprehensive, workable or fair".

3.2.3 Retrospection

In his letter of 12 February 2008 the acting Chairman of HMRC gave certain reassurances regarding the manner in which the legislation would be drafted. Once such reassurance was:

> "There will be no retrospection in the treatment of trusts and the tax changes will not apply to gains accrued or realised prior to the changes coming into effect".

We would submit that the legislation does have retrospective effect and would draw attention to the following in particular:

(a) *Rebasing election*

(i) *OIGs*

The rebasing provisions in paragraph 112 Schedule 7 do not seem to have any effect on offshore income gains (OIGs) to the extent that they are not matched with capital payments in the year they arise. (Broadly speaking, the OIG legislation imposes an income tax charge on gains arising on a disposal of an interest in a certain types of "roll up" investment fund).

Paragraph 29 of the "Aligning the capital gains tax treatment for non-UK resident trusts" note issued on Budget day stated that "any rebasing election made by the trustees will apply to OIGs in the same way as to ordinary gains". However the Bill as issued on 27 March 2008 does not seem fully to reflect that statement.

Non-resident trustees will be able to elect to rebase trust assets to market value as at 6 April 2008 so that trust gains accruing but not realised before 6 April 2008 will not be chargeable if matched to capital payments made on or after 6 April 2008 to non-UK domiciled beneficiaries. However, it seems that the rebasing election can only apply (under paragraph 112(5)(a)) to gains that are actually matched with capital payments under sections 87 or 89(2) TCGA 1992.

OIGs are only matched under sections 87 or 89(2) if (as per section 762 ICTA 1988 as amended) capital payments are made in the tax year in which the OIGs arise. If this is not the case then (absent any defence under section 737–742 ITA 2007) OIGs are thereafter treated as income for the purposes of chapter 2 of part 13 of ITA 2007. When matched in future years it will not be under sections 87 or 89(2) TCGA 1992.

Accordingly the rebasing provisions in paragraph 112 would not seem to have any effect on OIGs to the extent they are not matched with capital payments in the year they arise, as they are not matched under sections 87 or 89(2) TCGA 1992 and the full gain will be chargeable to income tax which seems unfair and contrary to the reassurances previously given.

(ii) *Personal companies*

The denial of rebasing to companies held in personal ownership is unfair and penalises non-domiciliaries who have not previously been able to take advantage of the use of trusts.

(iii) *Alienation*

Confirmation is required that gains recognised on the transfer of assets into trust on or before 5 April 2008 will not be within section 809R if remittances are made by the trustees to the UK after 6 April 2008. HMRC has long accepted that gains deemed to be realised on the transfer of assets to non-UK trustees could not be remitted to the UK. It should be clear that section 809R relates only to gains realised on or after 6 April 2008.

3.2.4 Remittances and Employment Income

(a) *General Structure of Alterations to ITEPA*

The current scheme of the legislation contained in the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") is that there are a number of sections dealing with particular circumstances. Section 15 contains the charge for general earnings of employees who are resident, ordinarily resident and domiciled in the UK, section 21 contains the charge on earnings other than chargeable overseas earnings where an employee is resident or ordinarily resident but not domiciled in the UK and section 25 contains the charge on general earnings from duties performed in the UK for an employee who is resident but not ordinarily resident in the UK. The two remittance based provisions are section 22 and section 26 which effectively provide exceptions to sections 21 and 25 respectively. Section 22 deals with chargeable overseas earnings (those are earnings from duties performed abroad for a non-UK employer by an employee resident or ordinarily resident but not domiciled in the UK); such earnings are taxed on a remittance basis. Section 26 deals with an employee who is resident but not ordinarily resident in the UK where the employee has earnings which are not in respect of duties performed in the UK—such earnings which fall outside Section 25 are also on a remittance basis.

The scheme of the changes is to extend section 15 so as to apply it to "UK resident" employees. In other words the restriction which currently limits section 15 to the UK domiciled employee is removed. The effect of extending section 15 in this way is that sections 21 and section 25 are no longer needed, and are accordingly repealed. Sections 22 and 26 are then updated to introduce the new remittance regime into these provisions. As currently drafted there is no overlap in ITEPA between section 15 on the one hand and sections 21, 22, 25 and 26 on the other. Each of the main charging provisions applies to different circumstances, as described above. Furthermore, the remittance based sections, sections 22 and 26 are carved out from sections 21 and 25. As the provisions are proposed to be amended section 15 covers ground also covered by the revised sections 22 and 26. The Law Society has proposed an amendment to make it clear that earnings within sections 22 and 26 are not also charged by section 15.

(b) *PAYE issues*

The provisions of Schedule 7 bring the securities income of all UK resident employees within PAYE but it is understood that Government amendments will be introduced to exclude securities income taxable only on the remittance basis from PAYE. This is the unspoken assumption underlying paragraph 34. Paragraph 34 allows an officer of Revenue and Customs to treat an employee as if he has claimed the remittance basis for the purpose of making a PAYE direction. It does not however allow employers to make such an assumption in operating PAYE without applying for a PAYE direction.

Where an employer anticipates that an employee will claim to be on the remittance basis, it must carry out an apportionment calculation to make its best estimate of the PAYE due. If the employer is not able to assume that a remittance claim will be made, it will be forced to deduct PAYE from 100% of the income. This means that there is a significant risk of an employer over-deducting PAYE and creating recovery problems for employees.

Paragraph 34 also limits the operation of the provisions to UK resident employees whereas section 690 applies to non-resident employees working in the UK.

(c) *Share Schemes*

As explained above the scheme of the changes to ITEPA is to repeal sections 21 and 25 of ITEPA as part of the alterations to the remittance basis and to extend the scope of section 15 so it charges the general earnings of all UK resident employees. This charge is then carried through to other parts of the legislation. This has the unfortunate side effect that shares in approved share incentive schemes have to be offered to all employees who are UK resident, that is including those employees who are resident but non-domiciled and whose earnings are on a remittance basis and also those employees who are not ordinarily resident in the UK and who have earnings from duties performed outside the UK. It seems to us that there are no grounds for making this change and the rules operate perfectly satisfactorily as they are—indeed to make the change will force employers to make offers of shares to employees who are not those who ought properly to be within the scheme.

(iv) *Restricted Securities and elections*

Paragraph 31 has the effect of applying the employment related securities rules in chapters 2 to 4 of part 7 Income Tax (Earnings and Pensions) Act 2003 to employees within the remittance basis.

Chapter 2 contains the "restricted securities" rules. Under these rules, an election—a section 431 election—can be made, to allow employees to whom the rules apply to pay income tax on acquisition of the securities, in the hope that the securities will grow in value, such that any growth in value will be subject to capital gains tax. Section 431 elections are therefore an important way in which taxpayers can manage their tax liabilities.

Section 431 elections have to be made within 14 days of the acquisition of restricted securities. Securities acquired by employees who are resident but not ordinarily resident will only become restricted securities when the Finance Bill receives Royal Assent and Schedule 7 takes effect. However, paragraph 76 of Schedule 7 provides that the amendments have effect where securities are acquired on or after 6 April 2008.

As a result, it is not possible for remittance basis employees to make a section 431 election where they acquire such securities after 6 April but more than two weeks before Royal Assent. This is clearly unacceptable (and presumably unintentional—such a state of affairs is not justifiable on policy grounds). Similarly, remittance basis employees who take up duties in the UK some time after acquiring restricted securities should be able to elect within 14 days of becoming subject to the restricted securities regime.

4. Encouraging Enterprise

We have no particular comments to make on clause 28, clause 29 and Schedule 11. These clauses increase the amount of relief for EIS investments and alter certain provisions relating to venture capital schemes to prevent venture capital schemes (EIS, VCT and corporate venturing schemes) investing in ship building and coal and steel production. This is in order to comply with the EU guidelines on state aid to promote risk capital investment in small and medium sized enterprises. EU requirements, we believe, also led to changes in the Finance Act 2006 reducing the gross assets of investee companies to £7 million immediately prior to an investment being made (and £8 million immediately afterwards) and to changes last year, in particular that the target companies must have fewer than 50 employees.

There are a number of points that we would make about the EIS and VCT schemes in general against the background of the documents published on Budget Day by HM Treasury and HMRC:

1. The study on the impact of the EIS and VCT schemes on company performance contains some quite interesting conclusions, but not ones which particularly reveal any better way of targeting these schemes. There was no particular evidence that EIS or VCT schemes were associated with high or real gross profit levels. Generally it appeared that VCT and EIS investments were associated with lower profit margins than the control group although profit margins improved over time. EIS and VCT companies were associated with higher levels of investment and employees. VCT investments generally had high gearing throughout the period of the investment by the VCT and the target company. EIS investee companies were associated with some evidence of lower gearing to start with (perhaps because they had received equity investments through the EIS scheme and could not raise debt), the gearing increasing over time (presumably as the business results improved). There seems to be higher sales turnover of VCTs and EIS and some growth in labour productivity. The results of the study were not particularly conclusive and the investments did not generally lead to, or did not appear to lead to, a large number of high growth companies being produced. It appears about 25% of companies fell by the wayside. However, the policy point was made that it was only a minority of young companies that would need external equity finance in order to accelerate development in their early years. Yet this small number of companies was likely to have a disproportionately large impact on employment, creation and innovation. The period of activity of the study appears to have been focused on the years 1999–2005, which was associated with a boom in investment in "high-tech" companies, followed by a collapse of this sector. This has affected some VCTs.
2. The HM Treasury Paper "Enterprise: Unlocking the UK's Talent" has a chapter dealing with "Access to Finance", which one would expect to be the chapter most closely associated with EIS and

VCTs. Having said this there is relatively little mention of these initiatives in this chapter, there instead being mention of the SFLG (Small Firms Loan Guarantee Scheme), Enterprise Capital Funds, Business Angels and so on. The Enterprise Capital Funds are a relatively recent programme. These generally take the form of limited partnerships with the government as an investor. The government provides up to two thirds of the capital in each ECF but takes only a limited share of profit to encourage private investors to participate. The ECF initiative has become popular in government, but this perhaps illustrates the tendency for new initiatives to be introduced without overhauling or abandoning any other initiatives. The result would appear to be that any small business is faced with an array of possible sources of capital or debt or subsidy, all of which have their own sets of rules.

3. The EIS and VCT schemes are designed to ensure, so far as possible, that money is invested in a company and used by that company for the purposes of its trading activities. (This is not always achieved. It is possible for money to be invested in a company which buys another business. This is treated as, subject to certain conditions being satisfied, a qualifying activity for the purposes of both schemes. This is probably appropriate as otherwise the business acquired might not be able to receive further capital for expansion). Both schemes have very complex rules. For example, in both schemes it is not possible for a company invested in to control a company which is not a subsidiary. Moreover if the money raised is to be invested in a company, that company has to be controlled by a greater percentage ownership—often 90%. There are particular rules which cause problems with each of the schemes. A VCT cannot control a target company which it invests in. This means that it is always a minority shareholder which can sometimes be out voted; if other investors are not VCTs they will not have the same constraints as the VCT will have in relation to decisions relating to an investee company—for example should the target be taken over, perhaps, by a non-UK company? Should it move its trade abroad? Should it raise more capital and should shareholders participate? Questions of this nature can cause VCT concerns which other investors may not have, as they may affect the qualifying status of the investment for the VCT.

4. Similar issues will arise for EIS investors, although most constraints cease to apply after three years. The same control issue arises with an EIS company—EIS relief is not available to an individual if the company invested in is controlled by another person, or if there are arrangements to control it. An external investor, taking a minority stake could cause an issue to arise because if he "acts together" with other investors, he can become connected with them, which aggregates the rights of these investors, and has the result they may all control thereby preventing relief being available. Shareholders agreements have to be carefully drafted to address this problem. An additional test is that an EIS investor cannot be connected with the company in which he invests, which means that he cannot take and cannot with any person connected with him take, over 30% of the share capital or the share capital and loan capital, voting rights, or be entitled to more than 30% of the assets in the event of a winding up. Nor can an investor be a director. It would appear that the effect of the relief is not to allow an investor to invest in a company that he knows much about. The fear is that if an investor has control he will manipulate the company and transfer value in and out of it and that relief should not be given to someone for investment in his own business—although it has to be asked what is wrong with investing in your own business, providing it is investment rather than recycling of capital. However there are a whole series of protections within the legislation which ought to prevent this occurring. The control test can be a real disincentive when another party is investing in a company where others have EIS relief or where a VCT holds a stake.

5. There is something of an obsession under both sets of rules with asset backed investments. This means that property based activities and activities involving farming and market gardening are excluded from the schemes. It is thought that such activities, because they are asset backed are "safe". However, they may not be asset backed to a great extent, and even if they are there may be considerable risk associated with the activity regardless of whether there is asset backing.

6. The problem with the schemes such as EIS is that there will always be intermediaries seeking to achieve tax advantaged risk free investments. This causes there to be considerable numbers of rules on the statute book which can often deter the genuine case and prevent that investee company obtaining relief. There are rules which, following upon this theme, requires an investee company to invest the funds raised relatively rapidly (80% within one year). The purpose of this rule, of course, is to prevent the company becoming a safe "money box" company. On the other hand to force an investee company to invest funds rapidly may not be in the best interest of its business—it may be preferable to not to invest funds that rapidly in order to obtain the best return and to limit risk. There has been relaxation of this rule over time, which is helpful, but it illustrates the problems arising.

7. In many cases with EIS relief if there is a breach of the rules the company simply ceases to qualify, which means the tax relief on investment (that is the relief given against income tax) becomes repayable. There are different periods for this purpose; the main period, broadly, being three years after the investment is made—with EIS companies (and VCT investee companies) there is a tendency not to carry out activities which might otherwise be in the company's interest if that would give rise to a clawback of any tax reliefs. In other words the tax relief becomes more important than the business objective.
8. The schemes generally assume that profits will be realised from an exit—so there is a capital gains tax exemption for the first disposal of a target company by an EIS investor, and a VCT company does not pay capital gains tax if it is on the disposal of shares in a target. However, a VCT is also designed so that income can be generated with only one tax charge. within the original investee company. A dividend is not taxed in the hands of a VCT and neither is it taxed in the hands of an investor of shares held in a qualifying limit. This is potentially rather attractive as it could mean that the rates of tax on distributed income and the rate of tax on capital gains are not too dissimilar. It has to be said that VCTs do not often pay dividends and we would anticipate that the same is true for EIS companies. Probably with this in mind, EIS relief does not appear to cover dividends which remain taxable in the hands of the investor. The hoped for return is therefore in terms of an exit. Yet the investment sizes of the companies is now quite low. between £7 million and £8 million in gross assets. This will mean that EIS investors may have to sell early as they cannot take part in later funding and retain their reliefs as the later funding may take the assets of the investee company over the assets limit. This creates an issue for an EIS or VCT investor. If they do retain their investment and do not take part in a subsequent funding round (because no relief would be available for that investment) they may find it much reduced in value following a later funding round in which they do not participate. Investors are often penalised for not taking part in a later funding round. The relief for an owner manager is now entrepreneurs relief. This has different conditions attaching to it from EIS, but also exempts capital gains. This relief is not restricted by a gross assets test, which means that different holders may be driven by different tax reliefs and consequences. In addition (as for EIS investors) the owner manager has a similar disincentive to take profits out of his business in the form of remuneration or dividends as the overall rate is higher than that on gains.

The above touches on some of the many issues involved, which are complex and involve the interaction of the reliefs with other reliefs and business behaviour.

7 May 2008

Memorandum by the Law Society of Scotland

The Law Society of Scotland is delighted to have the opportunity to present evidence to the Finance Bill Sub-committee on the topics under consideration.

CAPITAL GAINS TAX AND THE ENTREPRENEURS RELIEF: CLAUSES 6 AND 7, SCHEDULES 2 AND 3

The rate of capital gains tax is policy issue on which the Society would wish to comment.

The Society supports the simplification of the tax system, and accepts that the introduction of a single rate of capital gains tax could have resulted in simplification, however the inclusion of the new Entrepreneur's relief reintroduces the very complexity which the reform was intended to solve.

The Society also has serious concerns about the way in which the changes were introduced. In particular the Society would make the following points:

— The removal of indexation relief with no rebasing of assets means that inflationary gains will be taxed. Although the well advised may have been able to take steps to mitigate this, for example by the transfer of assets between spouses, other taxpayers will suffer an unexpected and essentially retrospective tax charge on inflationary gains.

— The abrupt removal of taper relief without any transitional period confounds the legitimate expectations of many taxpayers, including owners of businesses and employee shareholders.

— 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.

- Many taxpayers took steps to dispose of shares and other assets before the end of the tax year, and the time scale for many company disposals was accelerated considerably. Figures recently released suggest that applications for tax clearances in the last quarter of the 2007/8 tax year were 50% higher than in the previous year. It is regrettable that a major change in the tax regime introduced with undue haste has resulted in the tax tail wagging the commercial dog.
- There is likely to be confusion in the minds of taxpayers who expect the Entrepreneur's relief to be a replacement for taper relief whereas in fact the requirements are different in many respects.
- It is unfortunate that the Entrepreneur's relief does not extend to employees with small percentage shareholdings such as those participating in share ownership schemes in larger companies. The Society believes the relief should be extended to all cases of employee share ownership.
- Property let to a company or business will not qualify for Entrepreneur's relief to the extent that rent has been paid, whether before or after 6 April 2008, whereas the payment of rent did not affect the availability of taper relief. The Society believes that rent paid in periods prior to 6 April 2008 should be ignored in determining whether Entrepreneur's Relief is available.
- The Enterpreneur's Relief is based on the Retirement Relief code which is understood to have been withdrawn because of undue complexity. The restriction of Retirement Relief to cases where there has been the disposal of the whole or part of a business gave rise to particular difficulties. There are a number of tax cases from which guidance can be drawn, however the Society does not believe it is appropriate for taxpayers to be required to read tax cases in order to complete their self assessment tax returns.
- It needs to be clarified that a part disposal of a partnership can qualify for Entrepreneurs Relief; and it might be thought that this restricted certain sole traders also. In general terms the disposal of part of a business should clearly qualify and the definition of part of a business should be wide. As a matter of principle, should the relief not simply be available for the disposal of assets used in a business, rather than of a business, because it is the business assets which give rise to capital gains tax rather than the business itself.
- The Society believes that the availability of Enterpreneur's relief should be extended to all cases of trustee ownership. There is no reason why discretionary trusts owning trading business assets should be excluded from the relief.
- On defining a trading company, the test introduced by the insertion of section 165A is too onerous. Section 169L already excluded investment assets.
- A claim is required in relation to the year in which the disposal is made, but it may not be known, especially with a disposal of business assets before the cessation of a business under section 169I(2)(b), whether a claim is possible or desirable. There may be other such circumstances—and in general the possibility of a claim should be allowed "within such longer period as an officer of the Board may allow".

Residence and Domicile: Clause 22, 23 and Schedule 7

Residence

The Society welcomes the clarification to calculation of the number of days an individual spends in the UK, but believes that this clarification should be extended to the introduction of a statutory residence test. The question of whether an individual is resident here is cloaked in too much mystery, and requires consideration of extra statutory concessions and HMRC guidance.

Domicile

Whether or not the UK should continue to operate the remittance basis of taxation for non domiciled individuals is a matter of policy on which the Society would not wish to comment.

The Society has serious concerns about the way in which the changes were introduced.

- Consultation took place about residence and domicile a number of years ago, and it is unfortunate that the current changes were introduced without any reference to those professional bodies and others who invested considerable time and effort in the previous consultation.

- The provisions included in the Finance Bill are complex, tortuous and in many cases incomplete, due to the very short timescale in which they have been drafted. It is understood that parts of the legislation will have to be introduced by way of amendment during the passage of the Bill. It is hard to see why this legislation needed to be introduced so quickly.
- 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.
- Non-domiciled taxpayers of modest means are unlikely to be aware that under the new regime they may no longer be entitled to personal allowances. Changes need to be made to ensure that these taxpayers are not inadvertently in breach of the law.
- The potential loss of personal allowances will also result in increased compliance burdens for employers.
- The new rules may also affect students coming to the UK to study, and the Society believes that the seven year period should only start to run when full time education has ceased.
- There appears to be a degree of unfairness in the new regime in that the £30,000 payment is unlikely to be of concern to wealthy taxpayers, whilst the loss of personal allowances will be of considerable concern to the less well off.
- Given the amount of money likely to be raised from these changes, it is hard to see why they have been introduced. There appears to be a perception that the changes amount to a political attack on non-domiciled individuals.
- 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.

Encouraging Enterprise

Some aspects of the consultation and research papers are outside the areas of expertise of members of the Society.

The Society would like to make the following points about the Enterprise Investment Scheme (EIS).

- The general perception is that the EIS is so complicated and includes so many restrictions that many small companies and investors decide that it is not worth making use of the reliefs.
- The complex anti-avoidance rules mean that there are a great many traps for the unwary. Actions taken by the company which seem to have no bearing on EIS can cause the relief to be withdrawn.
- Even for very small investments, professional advice is required, and the costs can be prohibitive. The costs of professional advice eat into the funds available from the investment.
- The legislation and guidance is not very accessible to the uninitiated. Without the extremely helpful advice and assistance provided by the Small Company Enterprise Centre, it would be extremely difficult for EIS investments to be made at all.
- The legislation also changes frequently and this makes it difficult for those involved in this field to keep up to date with all the requirements.
- It is not clear that the availability of the EIS changes behaviour in relation to direct investment in small companies. In general the experience of our members is that investors will take advantage of full EIS relief where it is available, but rarely make it an absolute requirement of an investment.

May 2008

Examination of Witnesses

Witnesses: MR RICHARD STRATTON, Chair of Tax Law Committee, MRS PENELOPE WILLIAMS, Chair of Capital Taxes Sub-Committee, MR EDWARD REED, Capital Taxes Sub-Committee, Law Society of England and Wales; and MS ISOBEL D'INVERNO, Convenor of the Tax Committee, Law Society of Scotland, examined.

Q209 ***Chairman:*** Welcome to our witnesses from both Law Societies, England and Wales and Scotland. I think you have done this before so we do not have to tell you too much about the preliminaries. As you know, this year our inquiry focuses on three main aspects of the Finance Bill, that is capital gains tax, residence and domicile and encouraging enterprise, and from your written evidence, for which many thanks to both societies, your main interest is going to be on the first two of those, capital gains tax and residence and domicile. I do not know if you want to make any initial statements, if you do by all means carry on. If not, we will move straight into questions.
Mr Stratton: That will be fine, thank you.

Q210 ***Chairman:*** Perhaps I can start off with consultation and ask you whether consultation on capital gains tax and the residence and domicile proposals as announced in the Pre-Budget Report could reasonably have taken place before that announcement? Also, how do we manage consultation on potentially contentious issues when there will almost certainly be winners and losers and the losers will no doubt shout loudest, possibly to the exclusion of a balanced debate or a means of finding a reasonable policy objective? How do you think the consultation should be organised in the future with that in mind?
Mr Stratton: First of all, I would like to say this is one of the most difficult questions raised so it is a good thing to deal with it first. My colleagues will doubtless have something to add to this. I think in the context it is important perhaps to differentiate between the topics that we are dealing with here. There is residence, domicile and CGT. There was a consultation on residence and domicile in 2003 which we, the Law Society of England and Wales, responded to and at that stage said we thought a statutory test for residence would be a good idea. If you consider residence as a concept, as a basis for taxing, it is a relatively isolated topic, it is not of itself that controversial and is something that you would have thought could be consulted upon on a timetable fairly straightforwardly. There would be winners and losers but one would suggest it is not such as to produce an outcry of itself. If you move then to domicile, that is a more difficult topic and it shows the problems of modern consultation. Domicile is a mixture, I would suggest, of the controversial and the technical. As we have discovered as the domicile changes have gone forward, all the very difficult technical issues have come out and the Finance Bill is addressing those but it has not managed to address them completely, so there will be further changes to be made. It is an area where it would be nice to divide the controversial part of the fairness of the tax base and who should be taxed from the technical issues. We at the Law Society believe very much in open consultation, for all parties to become involved in public consultation processes. We feel the technical aspects of domicile could have been consulted upon. Things like the £30,000 charge per annum and the framing of that charge, you could perhaps isolate and deal with separately. 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. When you get on to capital gains tax, I have to say that when you look at that, it is a simplification and a rate change; it is two things. At a technical level we would welcome simplification, but in terms of a rate change there are some things which perhaps should not have been consulted upon, and if the Government is proposing a change to the rate of tax, that is perhaps a PBR or Budget announcement, and then it goes through Parliament. So I think there are grades of consultation revealed by these different circumstances.

Q211 ***Chairman:*** Thank you very much. Is there a Scottish view on this?
Ms D'Inverno: I think we would agree broadly. 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. We really cannot see why it could not have been rolled out over a longer period. It is an enormously complicated area. Also we are quite concerned about the lower paid non-domiciled individuals, to whom this will come as an enormous shock and there will not be any time to prepare them for this change or their employers. Clearly it would be inappropriate with a change such as a change to the rate of CGT for professional bodies to be consulted about that, but in terms of looking at transitional reliefs or whatever, 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. In Scotland, because we are geographically remote, we are used to being forgotten about, but when the broad range of professional bodies are also being forgotten about, that seems a sorry state of affairs.

Q212 ***Lord Blackwell:*** Can I move on to some specific questions on CGT and enterpreneurs' relief and start with a fairly broad question which is, to what extent the changes have met the Government's objectives. They said back in 2007 that they wanted to ensure the UK had an internationally competitive capital gains tax system which responded to the changing needs of investors and promoted flexibility and competition. How well do you think in the round the changes they made, the simplification and other changes, have met that and where did they fall down?
Mr Reed: If I may attempt to answer that question, I think nobody has any quarrel at all obviously with the objective that the Government was aiming for, and indeed simplification is something which a number of people were calling for in the run up to the publication of this Finance Bill. I think I did hear a number of people requesting there be no further dramatic changes to UK tax law for a year or two to allow us all to get used to the idea. 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. The huge benefit of taper relief as I saw it was going to be that it was a relatively straightforward system in the way it eventually evolved. The main criticism of it was it did not entirely replace the old system, so we had two systems running at the same time and you had to remember what happened before 1998, then what happened after 1998 and we are pretty much still in the situation where we need to remember a number of different systems at the same time. I think in the round I am not sure we have advanced very far.

Q213 ***Lord Barnett:*** Could I just revert briefly to the answer on consultation to the Chairman? Is it not a fact that even if you had months or even years of consultation, the net result would still be that every year there would be major amendments to Finance Bills and particular new taxes introduced, and that is why Finance Bills get bigger and bigger every year?
Mr Stratton: Yes, that is true. Hopefully consultation helps with ironing out technical details and unforeseen problems. I think the main benefit of consultation is so you can see, or the Government can seen, unforeseen results of what it is proposing to do, and then may change the direction of the ship slightly to cope with that, but we are in a world where tax does change on a regular basis. It may not need to change as much as it does but it does change quite dramatically every year.

Q214 ***Lord Barnett:*** Then if I could go to the answer which has just been given on taper relief, do I take it from that you quite liked taper relief or is it the case that you just do not like change?
Mr Reed: I think the point I was trying to make was if you felt there was a flaw in the indexation system which applied beforehand, taper relief in the form in which it eventually ended up did have an advantage of simplicity and people knew where they were heading tax year by tax year. Compared to a reintroduction in effect of retirement relief, I think the answer to your question is yes.
Ms D'Inverno: Also, if I might add, the rate of tax that people generally paid on business assets was sufficiently low for no one to really bother trying to avoid it and everyone paid it quite happily, whereas if you raise it to 18% that immediately raises the spectre of people trying to navigate round it because 18% is a much higher rate for business assets. If you think back to the pre-taper relief days, people thought capital gains tax was too high and made efforts to avoid it.

Q215 ***Lord Barnett:*** But whatever the rate, there will always be professionals who are looking to seek to avoid it, will there not?
Mr Reed: I think it is the job of the professionals to deal with the law as it is in front of them, and looking at it from my perspective, when taper relief was brought in there was a significant dropping off of unusual planning, including people unnecessarily turning over their lives to go non-resident for example, and there was a significant dropping off in that and I suspect there may be an increase in that again now because the rate is significantly different.

Q216 ***Lord Barnett:*** Would you argue that simplicity in taxation, whether in this field or any other, is simply not possible?
Mr Stratton: 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.

Q217 ***Lord Paul:*** The Law Society for England and Wales sets out three detailed areas—the consequences of the repeal of sections 77-79 of the Chargeable Gains Act 1992, the vulnerable person's election and the abolition of the "kink test" and of "halving relief". These are new to the Committee, could you explain these points for us and tell us in each case how important it is that a change is made? Have you raised these points with HM Treasury and or HMRC and, if so, with what response?
Mrs Williams: These points have been raised with HMRC and we are waiting for a response on them at the moment. I have to say in the context of the other issues we are talking about today, they probably are of minor significance. We raised them in our submissions to the Committee to highlight certain deficiencies in the drafting of the legislation which we thought came about as a result of the legislation being drafted in haste. Briefly, in relation to section 77-79 the proposal is that these sections are repealed and our objection to the manner in which the repeal is set out in the legislation is that the change is set out as "Rate: consequential", and the Explanatory Notes say that the sections would serve no useful purpose in the future because with the alignment or the simplification of the capital gains tax rate to 18% for individuals and trustees there would be no point in having gains attributed to trustees. We would say there are consequences which flow from that change and they are set out in our submissions. The vulnerable person's election, the Explanatory Notes set out clearly what was intended by the change in legislation, which again is required as a result of the repeal of sections 77-79. It is our view that the legislation as drafted is deficient. We have made a proposed amendment to HMRC and we wait to see whether that is going to be adopted. Finally, the abolition of the "kink test" and of "halving relief", relates to assets held prior to 1982. The "kink test" being abolished means that all assets held prior to 1982 will now be re-based to their 1982 value and it is our view that, with halving relief being abolished, it would be appropriate for assets which would have qualified for halving relief to have an acquisition cost as at 1982 values. Halving relief was relevant if there had been a disposal of an asset which was held prior to 1982, if, when it was disposed of, there was roll-over or hold-over relief or no gain, no loss treatment. On the subsequent disposal the acquisition cost for the purposes of calculating the tax on that subsequent disposal would not have qualified for re-basing treatment because the asset would not have been held at 1982. So we say the provisions for halving relief should be amended so that that anomaly is corrected. I do not think those points will be controversial but we will wait to see whether they are adopted.

Q218 ***Lord Powell of Bayswater:*** My Lord Chairman, perhaps three points and the first comes back to the question of consultation. Was there ever a golden age in consultation when it was very good? Has it in recent years declined in quantity or quality? Or is this an annual gripe?
Mr Stratton: There is more consultation now than there has been. That as a general matter is a good thing. Some of the consultation is more opaque than other consultation in terms of, "Can you understand what the policy is behind it and the changes which are being proposed?" I do not think there has ever been a golden period which I can recall. You just find as a practitioner there is an enormous amount of it which has to be responded to all the time which is part of open government. The good news is that from a practitioner's perspective there is an openness and willingness to consult. I appeared before the Committee last year responding on the anti-avoidance sections on managed serviced companies in relation to which there had been consultation. That would not have happened in earlier years, which was a welcome development.

Q219 ***Lord Powell of Bayswater:*** It sounds as if there is not really ever going to be a state with which we are all satisfied; it is simply not achievable?
Mr Stratton: I do not think there is a perfect answer.
Ms D'Inverno: There are some consultations which seem to work much better than others. For example, 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. So there are good consultations which happen but on some of the changes just recently there has not been sufficient time for us all to take time away from our practices in order to input into them.
Mrs Williams: What is frustrating too is that there was a consultation process in relation to the residence and domicile changes and the professional bodies did feed in and make comments and representations but those were not progressed.

Q220 ***Lord Powell of Bayswater:*** The professional bodies come along and tell us all the time they want greater simplification but they also come along and tell us that because there has to be this or that provision—entrepreneurs' relief and so on coming back in—you cannot do without extra complication. Again it is very hard to see what the right answer is. If I was HMRC I think I would feel a bit persecuted by some of these comments.
Mr Stratton: That is a perfectly fair point. The taxpayer does cause complication by asking for special provisions which HMRC and the Treasury

quite often listen to and enact, and then you end up with a complex system as a result. There is no easy solution.

Q221 ***Lord Powell of Bayswater:*** One cannot have one's cake and eat it. Lastly, on the entrepreneurs' relief, was it a mistake to base it on the retirement relief? Was there a simpler way of doing it which preserved the benefit without extra complication?
Mr Reed: Not being one who designs legislation, I am not really in a position to tell you whether there was a simpler way of doing it, but retirement relief was a relief which had mainly critics and very few supporters, and it seems surprising to have pulled that out of the old books and refurbished it for the purposes of reacting to representations made by various bodies. There are specific problems with it which have not been addressed, or problems which have been taken from the old retirement relief particularly as they relate to trustees doing business, but some of the other problems such as the length of time that you had to have held an asset before you could claim retirement relief do seem to have 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.

Q222 ***Lord Powell of Bayswater:*** It is a bit of a cop out to say, "It has not been very well done but I could not suggest how it could be done better", I think if you are going to make criticism you ought to have a more constructive answer.
Ms D'Inverno: One way of approaching it might have been to retain a form of taper relief for some categories of business assets which would not have been any more complicated and would probably have been possible to introduce in a revenue neutral way. 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.
Lord Powell of Bayswater: A very fair point.
Lord MacGregor of Pulham Market: Chairman, I think we have covered most of the important points in relation to capital gains tax, so can we move on to another topic?
Chairman: By all means.

Q223 ***Lord MacGregor of Pulham Market:*** Both societies support the calls for legislation to determine when someone is UK resident to replace the practice, mainly based on case law, which underlies much of the present approach. The Law Society of England and Wales indicate that this statutory test should be introduced with effect from 6 April 2009 and that in the meantime clause 22 should be held back. I wonder if you could expand on your views on that, and I particularly take the point Mrs Williams made that there has been a long period of consultation on this particular tax and why therefore wider ranging legislation was not introduced this year and how difficult it would be to put the tests on a statutory basis?
Mrs Williams: I do not know if I can comment about why wide ranging legislation was not introduced this year, but HMRC have been provided with proposals by a number of professional bodies about the form the statutory residence test should take. Most people are agreed that a day-counting basis should be the most appropriate. The reason why we think it is better to have a statutory test rather than to be relying on the situation we have at present is because there is a lot of uncertainty. There is uncertainty in relation to the residence rules which for these purposes should be divorced from the domicile question because residence is relevant not only for people coming to the UK but also relevant to people seeking to leave the UK. A number of the recent cases which have been before the courts have considered Brits moving away from the UK and the circumstances in which they cease residence, and that seems to be the area of most uncertainty at present. We would say that clause 22, by having a night count test, really reflects the position in *Gaines-Cooper* but the question about the connections the person should have when they seek to leave and the extent to which they can retain links is still very much up in the air.

Q224 ***Chairman:*** In your written evidence both societies point out some compliance concerns, for example taxpayers of modest means who are unlikely to be aware that under the new regime they may no longer be entitled to personal allowances. If, between you, you had to prioritise these compliance concerns, which would you see as the most important and why? To what level would you like to see the *de minimis* levels increase and how do you see in practical terms HMRC actually administering these new rules?
Mrs Williams: I think there are two sets of taxpayers who are caught potentially in compliance issues. One is the low income taxpayers and their position would be amended by having the *de minimis* levels increased. We 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. The other category of people who are caught by the non-compliance concerns are in the context of deemed remittances. The rules as presently drafted catch people in a very wide range of circumstances. The definition of relevant person is very widely drawn. It is very easy to see a situation where an individual makes a gift to somebody outside

the UK, somebody defined as a relevant person, and that person brings it back into the UK at a later stage and buys services in the UK, how is the individual who made the gift to know that remittance has been made, to know the funds out of which that remittance has been made, and that calls into question how much eg spouses understand about each other's affairs. The definition of spouse is very broad and covers persons who are living together as civil partners and that too, bearing in mind there is no time limit on when the rules may be applied, would cause compliance issues.
Ms D'Inverno: 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. Unless the Citizens' Advice Bureau or people like that are going to take this up, when it really is not the most important thing they should be spending their time on, I am sure it will just be left to lie until the problems are solved by other means which is not satisfactory.

Q225 ***Chairman:*** Is that a view you share in the England and Wales camp?
Mr Stratton: Yes. We can certainly see that happening.

Q226 ***Lord MacGregor of Pulham Market:*** How can you see an HMRC way round this? They would have to have substantially increased resources and links with tax authorities in other countries. It seems to me a huge area or is that why you conclude that it is just not possible?
Ms D'Inverno: Perhaps that is one of the things they should have considered carefully before the provisions were introduced and looked into and consulted with colleagues in other countries.
Mr Reed: If you consider the microcosm of an individual client and how that client is hit by the residence rules, it is pretty demanding for one client to try to determine taxability in, say, two different countries. If you extrapolate that to Revenue authorities generally, it is going to be pretty difficult to keep track of.

Q227 ***Lord Blackwell:*** Can I pick up two specific points? One is the employment costs of the denied personal allowances, whether you think they have a significant impact on employment costs from that change, and the second relates to the deemed remittances point where we understand the government is going to bring forward amendments for the banking community to meet some of their representation. Do you think those need to be spread to cover workers in other sectors?
Ms D'Inverno: In terms of the employment costs, many employers feel a degree of responsibility towards their employees and will try and take steps to acquaint themselves with what needs to be done in order to deal with people's tax affairs properly. There are also quite a number of individuals from overseas working in this country where their employment contracts have tax equalisation clauses in them or where they are paid on a net of tax basis, so there is more for an employer to do, often with not very big sums involved. It is a lot of messing around for very little effect really. In terms of the deemed remittances, I am sure there are lots of areas where the provisions will need to be made even more complicated and the clauses will grow in order to accommodate these things to the degree where nobody will be able to understand them, apart from the professional advisers, which again means they are inaccessible to the ordinary taxpayer. That seems to be unavoidable having started from this type of approach.
Mrs Williams: On the deemed remittances point, the point has been raised with HMRC in a series of questions put to them on an open day on 2 May. None of those questions was answered at that open day because they told us that, as a result of the correspondence with the BBA, the provisions were being amended and we would expect to see the government amended legislation, they said, two weeks from that day. We are hopeful that it should be some time this week and we are hopeful that the changes will recognise the competitive need for changing that provision.

Q228 ***Lord Barnett:*** You currently support calls for legislation to determine when someone in the UK is resident in a place of practice, but you are not happy with the date of introduction. You want it delayed to 2009. Do you think that would be helpful or would it not create even more uncertainty while you are consulting over the next 12 months?
Mrs Williams: It would be fantastic if we were able to have the residence test introduced with effect for the current tax year if it was going to be acceptable for everybody. Without that consultation process having happened, it is very difficult to know that those rules would be in an acceptable form. People are moving to the UK and will be living in the UK for the current year and they need to understand the basis upon which they will be resident in that year. That is why we say we would expect legislation to be worked on during the course of the summer. Maybe it could be issued with the Pre-Budget Report and then tabled to be part of the Finance Bill for next year.
Ms D'Inverno: It surely would be possible to get round the uncertainty by for example saying to taxpayers that new rules will be coming in but during this year or the year after you will not be

disadvantaged. If the old rules suited you but gave you a better result or something like that, it would be possible to bring these things in in a more palatable way rather than springing them onto an unsuspecting public and then having to back pedal and sort them out afterwards. It is surely possible to introduce new legislation in a way that does not frighten taxpayers.
Mr Reed: We have ended up, I suppose, with two different ways of calculating again.

Q229 ***Lord Barnett:*** If it was not for the media pressure there was at the time, do you think you would support these new measures on non-doms?
Mr Stratton: There are a lot of the new measures that I would not support. There is an underlying principle of fairness in connection with a country and how much tax you pay on the basis of the connection with that country which is a reasonable principle. It became very rapidly apparent that, at the same time as introducing the safe haven of the remittance basis for which you pay £30,000 if you are extremely wealthy, the opportunity was taken to massively tighten up the old remittance rules. What was introduced on the short term timetable was an entry barrier to get into a new regime for people who did not know what the new regime was going to be when they paid the entry fee. Also, when you look at the City of London and outside the City of London, you have enormous sectors in the country where there are lots of non-domiciles resident here from the lower paid to the higher paid executive to the very wealthy. It is extremely difficult to cater for all the circumstances. I would not have supported all the changes, despite the principle.

Q230 ***Lord Paul:*** Has anybody gained from this?
Mr Stratton: I do not think so. You have probably had this said to you before. 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. If you take someone who comes here and, say, becomes resident here but under a double tax treaty they would be resident in another country because their centre of vital interest is there but they are resident under the new rule, they would end up perhaps paying tax in the UK because let us say the double tax treaty with their home country does not cover everything. They could probably set that tax off against the tax that they would pay on the same amount in their home country under the double tax treaty. They would probably end up paying exactly the same amount of money but they have to fill in two times the forms that they would have to fill in normally. You get a little bit of money maybe for the UK but not a lot and probably not enough to balance the losses. You just irritate people. While accepting the principle of fairness, the trouble is we are now in extremely sophisticated jurisdictions, so applying the principle of fairness is rather difficult.

Q231 ***Lord Paul:*** The Law Society of England and Wales has concerns around retrospection and the commitments given in the letter from the acting chairman of HMRC and the subsequent budget documentation have not been fully followed through. How significant are the issues that you mentioned? Have you pressed changes on HMRC?
Mrs Williams: The issues that we have mentioned in our written evidence are significant. We have pressed changes with HMRC. The issues particularly, as we have set out in our submissions, are in no particular order. Taking offshore income gains held through foreign trusts. The acting chairman said that accrued gains would not be taxed. The way that the rules are drafted to apply in relation to offshore income gains means that there will be tax charged by reference to gains accrued prior to 6 April 2008 if the gains when realised are not distributed in the year in which they are recognised. We think that is unfair. Also, we think it is unfair that personal companies are not covered by the rules. If the companies were in an offshore trust, accrued gains are taken out of charge. There is a point raised on alienation on which we have been constantly seeking clarification from HMRC. This will be a big point if HMRC are not able to clarify the position when assets have been settled in trust historically: whether the gains stick with the assets within the trust, or whether they were recognised but not taxable in the UK, the HMRC will clarify that prior to 6 April 2008. In the context of retroactive effect in relation to the ceased source rules, a lot of people are caught. This comes back to the non-compliance point. People set up their accounts safe in the knowledge that they were doing it in accordance with the rules that applied at that time. The rules changed and the rug was pulled from under their feet. Suddenly, they have no records to ensure that they will be compliant going forward.

Q232 ***Lord Powell of Bayswater:*** Do you have a view of how much extra revenue is likely to be raised by the amendments being introduced? Presumably an awful lot less than would have been the case if the government had stuck to its original proposals?
Mr Stratton: I do not know the answer. Obviously there was a lot of media coverage about people leaving the country under the original proposals and we have stories along the lines of somebody who was looking to repair their yacht and who was a non-domicile. That was a contract with an English shipyard. Since these rules came in, the contract was pulled because it was a provision of services in the UK, so it was a remittance.

Q233 ***Lord Powell of Bayswater:*** Your instinct would be it is probably an awful lot less than was originally estimated by HMRC?
Mr Stratton: Yes, I would be confident of that.
Ms D'Inverno: It is also necessary to bear in mind the effect on people perhaps deciding not to come to the UK and the lost revenue that results from these people not coming at all or leaving, as has been happening already.
Mr Reed: I would echo that. The rules are so widely discussed that they are being discussed inevitably in the offshore centres. They are being discussed in continental Europe and the United States. There are clearly people who are taking decisions on the basis of, firstly, the rules as they appear to be at the moment and, secondly, the sheer uncertainty of it all.

Q234 ***Lord Powell of Bayswater:*** A lot of damage and little gain?
Mr Stratton: Yes.
Mr Reed: Even if people do not necessarily depart in quite the flood that is predicted by the newspapers, there are people leaving in smaller numbers and worse there will be people who just will not come.

Q235 ***Chairman:*** Is there a view that the proposal should not have been brought in at all?
Ms D'Inverno: Certainly not in this timescale.
Mr Reed: Not so fast.
Ms D'Inverno: Perhaps not at all. I think it should be said that the Revenue are working enormously hard to try and bring in all the changes that have been suggested to them but it is a mammoth task and it is not one which should have been undertaken on the hoof in this way.
Mr Reed: Part of the problem I suspect is that because of the way the system used to work there is an awful lot that is not on the Revenue's radar screens. There is an awful lot that has been happening in relation to offshore trusts and people's assets which they simply would not know about. I have heard it said—and this is pure hearsay—that, when they were introducing the subject of offshore mortgages and how those would be treated, they made the comment that they believed it was not much of an issue. Those of us in practice know that offshore mortgages are big and reasonably common. You only have to ask HSBC.

Q236 ***Lord MacGregor of Pulham Market:*** In the context of representations and so on you raise in your paragraph 3.2.4 four particular issues that you think need to be addressed. Have you raised them with the Revenue? Have you had any response and are there any which you would particularly like to highlight for us?
Mr Stratton: Yes, we have raised these with the Revenue. As a representative body, we have not had a direct response but we understand that the Revenue are taking these up. What has happened is that the employee/employment law issues have joined the domicile discussions somewhat late, so there is a rather complex set of provisions that tax employees when they receive securities. The problem that has arisen is if you are non-domiciled when you receive the security you have to work out whether that is attributable to your UK duties or your offshore duties, assuming you work inside and outside the UK. Having said that the non-domiciled people can use a remittance basis, you have to work out when they remit the bit of their profit from the security that is non-UK income. This was not within the UK legislation at all previously. It has now been introduced on a remittance basis to be consistent with the rest of the rules and it is a question of making sure it all follows through. HMRC are pretty receptive to this, we understand, and are looking at it and are changing the rules to accommodate the particular concerns that have been raised which are essentially mechanical, just making sure that people pay the right amount of tax at the right time and know what they have to pay. It is not particularly controversial.

Q237 ***Lord MacGregor of Pulham Market:*** Does the same apply to some of the other points that you are raising? These are technical points which have to be addressed?
Mr Stratton: Yes. I saw the question, "Which would you wish to highlight for the benefit of the Committee?" I think the one that bothered me the most was the PAYE aspect because, as you may know, if you give an employee securities as an employer, you are liable to account for the PAYE on value provided. If you give them securities and they are non-domiciled, you not only have to work out when the charge arises; you have to work out if they have remitted an amount that you might be liable to account for PAYE on. It is quite a tall order. We wanted a removal of the PAYE rules so any tax due just went through on self-assessment because we did not think it was fair on employers to be burdened with a guessing game. Otherwise an employer will just have to deduct from everything.

Q238 ***Lord MacGregor of Pulham Market:*** You said at the beginning of your answers that some of these employers' concerns were coming in rather late. Do you think this is another example where things have not really been thought through and the representations from HMRC to ministers just did not cover all of these details?

Mr Stratton: It did come late. I do not think it was thought through, no. What happened with the non-domiciled rules is that, when you think of non-domiciles, you start with the ownership rules for remittance for the high net worth individual. It is a natural place to start. Then you suddenly realise there are all these lower paid migrant workers. You had not thought of them. Oh dear. There are all these people in the City of London working away and coming in and out all the time. You had not thought of them. It suddenly broadens out. I think the employment rules did come as a late realisation because of the consequential change that went through the statute, introducing a new regime. That regime has knock-on effects. I suppose the fear that we have is that there are other knock-on effects we have not yet seen in all this stuff that will just start feeding through.

Q239 ***Chairman:*** We have a few minutes left for encouraging enterprise which I know is not your mainstream topic, but perhaps I can kick off with the study done at the University of Sussex. What does that study tell us about the overall effectiveness of the EIS and VCT schemes? Should we be surprised that the positive effects of the schemes were not greater? Perhaps, given the results of the study, is it appropriate for the Exchequer to be expected to subsidise investments by sharing the high risk involved with young, growth orientated, small companies?

Mr Stratton: I have taken a look at the study by the University of Sussex. It takes a look at the various investments made against a control group, as you no doubt know. It reaches the conclusion that if you give money to a company they tend to go out and buy things with the money and spend it on employees. They reach the conclusion that if you have a tax advantage investment the company buys equipment and hires people. They go on to say that the companies do not produce any profits after doing this, as a general conclusion of this study. I suppose I was a bit disappointed by that, although not in some ways surprised because you have to bear in mind—I suppose this is a plea for this end of the market and I am always making excuses for this end of the market—that the period of the study was 1999 to 2005. That included the bubble on high tech. In 1999/2000 etc., there was quite a lot of divestment in high tech that generated profits, but there was a lot of investment which has since gone quite sour and which may just now, in many cases, be coming through the bottom of the curve to generate some more profits. That is the never ending optimism of the venture capitalist. Given the results of the study, should the Exchequer be expected to subsidise investments? I hope so. I still think it is a good thing despite the study. I think that investment in knowhow, IP development, in circumstances where there is an equity gap—without first hand knowledge, one would still expect there is an equity gap in many areas for small companies—is a useful focus and it is a focus across Europe.

Q240 ***Lord Blackwell:*** Can I ask about the complexity of these schemes? The Law Society of Scotland and Wales refer to the complex rules which we understand are there to ensure they are targeted and people do not abuse them. Equally, that makes them very difficult to use. Do you think it is possible to have these schemes that are less complex or do you think complexity is part and parcel of trying to make them work?

Mr Stratton: They do end up being complex to some extent. The trade off for complexity is not having lots of anti-avoidance provisions in. The general scheme of the rules is that they have fewer anti-avoidance provisions in but they have a longer set of rules you have to comply with. Where it might be possible to look at things is to consider loosening some of the rules, which is what is occurring in the current consultation on EIS on the connection rules. It is quite easy to trip over the connection rules and become connected and lose relief on EIS investment in circumstances that you would consider to be relatively innocent. That would be a useful thing to look at. Similarly, the control provisions are also very difficult to comply with.

Ms D'Inverno: There are lots of difficult areas. One thing that might help would be to have Inland Revenue guidance that was more accessible to the owners of small companies. At the moment it is possible to find out absolutely everything you want to know about the EIS but not to find out just in broad terms how it works and what the outline of it is. It could be tailored more towards the people involved in these companies. There are lots of difficulties with advising smaller companies because obviously the time you have to spend looking at it you cannot really charge for, because it would extinguish the investment in some cases. Sometimes you wonder whether, if some of this money was just directly given to the companies as a grant for legal and accountancy fees, that would have a better effect. The Inland Revenue Small Company Enterprise Centre is incredibly helpful. Without them the EIS would be much harder to operate, but you can always phone them and ask questions. They will help you navigate round, but the problem is that with any scheme like this the avoiders will try and design risk free, fake EIS arrangements, so it detracts from the way the scheme works for the genuine, small company.

Q241 ***Lord Barnett:*** Can I revert to the issue of effectiveness? Given the almost inevitable complexity of tax based schemes, are you opposed to the whole idea of tax based schemes and would you prefer non-tax based subsidies or do you think the government should not be involved at all?

Mr Stratton: The good thing about EIS/VCT schemes is that the principle of them is to try and put some capital into companies to be spent on businesses. I was in favour of the tax based schemes for that purpose. In the other study, Enterprise Unlocking the UK's Talent, you can see how many other schemes there are that are available to you if you are a small company. It may be best if the tax based schemes are looked at in the light of everything else. It may be better not to have so many things on the menu if you are a small company. It must get quite confusing if you are faced with possible guaranteed loans, VCT investment, EIS investment, business link, tax credits. It is an extraordinary menu. It may be the answer that, in the light of everything, you could abandon these and come up with something that is simpler, but it is important to look at it in the context of everything available to small businesses.

Q242 ***Lord MacGregor of Pulham Market:*** You are mainly talking about EIS. Do you think the same points apply to VCTs?

Mr Stratton: Yes. VCTs are in some ways harder. Some of the avoidance provisions in EIS do not apply in VCTs. There are some special return capital provisions in EIS that a VCT does not have, but a VCT has the problem that it has to balance its portfolio all the time. It has to have 70% of the money raised invested in companies of the right type. It is for ever worrying that if two or three of these companies cease to qualify the VCT itself ceases to qualify as a tax advantage vehicle. None ever has. I think that is because HMRC have done an enormous amount of work on these rules to try and make them fit and they respond every year, trying to get the rules better and better. You might look at loosening some of the VCT rules now that the limits have come down, so you have to have a large number of investments held by a VCT. You have to have 70% qualifying, which is a very significant proportion. It is a problem for follow-on investment and so that has to be taken and thought about, going forward.

Chairman: That brings us to a close. Thank you again very much for your written evidence and indeed for your clear answers to our questions.

Memorandum by the Oxford University Centre for Business Taxation

Capital Gains Tax

Why do we tax capital gains received by individuals? The main reason is that it seems fair to tax individuals who have increased their wealth through a capital gain in a similar way to those who have increased their wealth through income receipts. If we choose not to tax capital gains, then there is likely to be an avoidance problem as individuals seek to convert income into gains.

This suggests that income tax rates are a good starting point for setting tax rates on capital gains. Indeed, this was the system inherited by the Labour government in 1997.

However, the taxation of capital gains brings its own problems. These include the following.

- 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.
- Gains are typically not taxed until realisation. This has two effects. First, since the tax payment relating to a gain may be delayed, the effective tax rate on a gain is lower—ie there is a tax advantage in deferral. This would, in principle, be a reason to set higher statutory rates on capital gains than on income. Second, the realisation basis of capital gains tax creates a lock-in effect, as taxpayers seek to delay the tax payment by delaying realisation of the gain—that is by delaying the sale of the asset.
- In the case of gains made on the sale of company shares, there may be double taxation, as the underlying income generated in the company may also be subject to corporation tax. In this case, there may be a case for special treatment of such gains, in a similar way to the personal tax treatment of dividends. On the other hand, not all corporate income and gains have been or will be subject to corporation tax; where they have not, there is no need for further relief.

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.

We now turn to comments on the specific proposals in the Finance Bill which need to be considered against this background.

- The underlying rationale for taper relief was weak. As already noted, the realisation basis of capital gains already induces a "lock-in effect" which discourages a sale of an asset. By inducing taxpayers to hold assets for a longer period, taper relief exacerbated this effect. There is no economic rationale for encouraging assets to be held for a longer period. The original idea was to discourage short term speculation, but there is no obvious link between taper relief and such speculation. The reality is that taper relief has introduced its own complexities, for example, a distinction between business and other assets—a distinction which it also difficult to justify on any economic rationale. We therefore support the abolition of taper relief, though we regret the re-introduction of the distinction between business and other assets in Entrepreneur's Relief, discussed further below.
- 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. It is true that "lumpiness" in receiving gains over time could shift taxpayers temporarily into a higher tax bracket, when their overall pattern of receipts would more reasonably put them into a lower tax bracket. But this problem exists anyway as long as there are exempt gains, and can be addressed with spreading provisions. What is more important for a simple tax system is that different forms of income and gains are taxed at similar rates. With an 18% capital gains tax rate, a higher rate income tax payer now faces a clear incentive to convert income into a capital gain. The boundary between income and gains is therefore an important boundary which the HMRC has to control. Of course, with taper relief, this distinction already existed, especially for business assets. But the 18% rate does little to lessen the importance of this distinction.
- If there is to be a single rate of tax, then the choice of an 18% rate has no obvious rationale. It might be justified as being close to the basic rate of income tax of 20%, which would imply that the incentive to convert income to capital gains for basic rate tax payers is small. A rate lower than 20% could perhaps be roughly justified by the lack of an indexation allowance, though a rate higher than 20% would instead be suggested by the realisations basis of the tax. However, according to the latest statistics available (for 2004–05), total taxable gains declared by individuals amounted to £8.7 billion. Of these gains, over 60% were received by higher rate taxpayers, who face a marginal income tax rate of 40%. If there were to be only a single rate of capital gains tax, then there is a reasonable case to suggest that it should be set at 40%, rather than 18%. But a better system would allow more than one rate.

Entrepreneur's Relief

Entrepreneur's Relief will give a lifetime exemption of £1 million for the disposal of specified business assets. This includes the whole or part of a business and shares in a personal company. The business in question does not need to be new, or to be operating in a specific sector of the economy.

The economic rationale for Entrepreneur's Relief as set out is unclear. BERR's document "Enterprise: unlocking the UK's talent" lists five strategies to develop enterprise in the UK: culture, knowledge and skills, access to finance, regulatory framework, and business innovation. None of these five strategies include Entrepreneur's Relief for CGT, or indeed any other form of reducing tax on successful enterprise.

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 raises questions of fairness.

Enterprise Investment Scheme

In contrast, the EIS (and Venture Capital Schemes) are designed to ease problems of raising finance for small businesses, and therefore correspond to one of the strategies outlined in the BERR's document.

Although capital market failures are often cited as a problem for small firms, it seems that in the UK there is no evidence of any general failure, although there may be particular problems for early stage businesses to attract small amounts of risk capital (Bank of England, 2004). 79% of small businesses seeking finance are successful on their first attempt to raise external finance (IES, 2005). The principal finance gap is for new and start-up businesses rather than small businesses (Graham Review, 2004).

The Enterprise Investment Scheme, Venture Capital Trusts and the Corporate Venturing Scheme seek to meet the perceived "equity gap" for unquoted trading companies. However, it is not clear that they are well targeted, and the jury is still out on their effectiveness (see Boyns *et al* (2003); Cowling *et al* (2008)—see below for further discussion). Non-tax-based assistance is given through the Small Firms Loan Guarantee, which has been remodeled following the Graham Review to focus on firms within their first five years of business rather than small firms generally. Unlike the tax relief schemes, this is consistent with evidence that the focus should not be on size but on other characteristics.

The specific reform in the Finance Bill—the proposal to raise the limit which an individual can invest from £400,000 to £500,000 (subject to EC consent) is unobjectionable. Other limits in the EIS—for example, on the size of the company—are unaffected. It is not clear whether relaxing this limit will affect the total amount of funds invested, but there is no obvious reason why £500,000 is more or less appropriate than £400,000.

The EIS is open to investment in any small business other than those in areas of activity that are excluded (which the Finance Bill extends to shipbuilding, coal and steel for EU reasons). The rationale for the list of exclusions is unclear. The Consultation document indicates that the scheme is targeted to higher-risk trading companies. But the only way we can identify such an effect is if the list of exclusions is intended to represent lower-risk companies. This seems hard to justify.

HMRC and HMT have issued a consultation document on the EIS (March 2008). This deals with administrative issues but these issues cannot be divorced entirely from the rationale for the scheme. For example, consultees are asked whether the rules surrounding connected parties work in a way that seems at odds with the purpose of the scheme. There seems to be little economic rationale for the connected parties rules which arise through fears of abuse of the relief.

HMRC Report 44

As noted above, the EIS and VCT schemes are intended to address the "equity gap": the difficulties that small businesses have in raising external finance. Success for these schemes might therefore be reflected in:

- more small companies being created;
- companies which receive funding through the schemes investing more than they otherwise would have done; and
- additional investment proving to be worthwhile.

The Cowling *et al* (2008)/HMRC study provides an assessment of these schemes. However, it does not address the first issue raised here.

Arguably, it does not address the second question either. A broad problem with the study is that it compares the performance of companies which received EIS or VCT funding with similar companies which did not. That would be a reasonable approach if the allocation of funding were random. But that seems unlikely. If the matched companies are indeed similar, then they would be eligible for EIS or VCT funding: an important question is therefore why they did not receive any such funding. Reasons might include the fact that they did not have any suitable investment opportunities, the owners did not want to permit external suppliers of finance to become part of the business, that outside suppliers of finance were unwilling to provide finance (for unobserved reasons), or that they simply did not know about the scheme. All of these (and other possible reasons) imply that the "matched" companies cannot really be "similar".

In this context, the first results of the study are not surprising. For example, the study found that companies in receipt of EIS and VCT funds invested more, and had higher sales and employment. But it is possible to turn this around and question the direction of causation. Companies which seek to grow faster need to raise more external finance: these are also likely to be the companies which are in receipt of finance through the EIS and VCT schemes. Under this interpretation, there is no evidence of an effect of the schemes.

One possibly surprising element of the results is that investments made under EIS and VCT tend to have lower profit margins, and lower survival rates. Taken at face value, this would suggest that the schemes are not inducing very worthwhile additional investment. This could be explained if, say EIS investors have a required post-tax rate of return, equivalent to that which they could earn elsewhere. Given a required post-tax rate of return, tax relief on an EIS investment will imply that that investment requires a lower pre-tax rate of return. However, the empirical results, and this interpretation, should be treated with caution: further study on these issues would be useful.

Centre for Business Taxation

The Centre for Business Taxation was established in 2005. It is an independent research centre of Oxford University, based in the Saïd Business School, with close links to the Faculty of Law and the Department of Economics.

The Centre's primary aim is to promote effective policies for the taxation of business. It undertakes and publishes multidisciplinary research into the aims, practice and consequences of taxes which affect business. Although it engages in debate on specific policy issues, the main focus of the Centre's research is on long-term, fundamental issues in business taxation. Its findings are based on rigorous analysis, detailed empirical evidence and in-depth institutional knowledge.

The Centre provides analysis independent of government, political party or any other vested interest. The Centre has no corporate views: publications of the Centre are the responsibility of named authors. The Centre is not a consultancy: it reserves the right to publish the results of its research.

Michael Devereux is Professor of Business Taxation at Oxford University and Director of the Centre. Professor Judith Freedman is KPMG Professor of Taxation Law at Oxford University, and Director of Legal Research of the Centre.

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7 May 2008

Examination of Witnesses

Witnesses: Mr Michael P Devereux, Professor of Business Taxation, Oxford University, and Director, Oxford University Centre for Business Taxation, and Ms Judith Freedman, KPMG Professor of Taxation Law, Oxford University, and Director of Legal Research, OUCBT, examined.

Q243 ***Chairman:*** Welcome to our two witnesses from the Oxford University Centre for Business Taxation. Thank you very much for your written evidence, which we have of course read. Do you want to make any introductory statement or shall we just go straight into questions?

Mr Devereux: As you like. I think we can just go straight in.

Lord Powell of Bayswater: I am chairman of the trustees of the Said Business School Foundation, not that I intend to give them a particularly easy time as a result, but I ought to declare it.

Q244 ***Chairman:*** As you know, there are two particular topics that you have been concerned with and that we are looking at. They are capital gains tax and entrepreneurs' relief on the one hand and encouraging enterprise on the other. If I can start off with CGT, the October 2007 Pre-Budget Report said, "The Government is committed to ensuring that the UK has an internationally competitive capital gains tax system that promotes flexibility and competition and responds to the changing needs of investors. . . . [The reform] will put the CGT regime on a more sustainable footing and help investors plan for the long term." In your paper you set out a framework for approaching tax where you said that you were looking for a simple system that may not be perfect but which is reasonably fair and which does not create too many economic distortions. How far do you think it would have been possible to achieve what you are seeking within the government's aims as they have set them out?

Mr Devereux: We have not done an international comparison here so we should be quite open about that in the first place. We were approaching this from the point of UK citizens and residents as to what an appropriate way of taxing them is, also bearing in mind the effects of capital gains tax on the kinds of investment decisions they would make. In that light, we look at evidence as to the ways in which capital gains tax affects the amount and type of investment individuals may do. We also wanted to take into account the links with other forms of taxation, as we point out in the note, and to income tax in particular. That is the kind of framework that we had in mind.

Q245 ***Chairman:*** Do you believe the government is right to seek a tax regime which is internationally competitive?
Mr Devereux: 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 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.

Q246 ***Lord Barnett:*** Is it possible ever to have a truly simple tax in relation to capital gains? Is that not an aspiration that would do all accountants out of business or even KPMG perhaps, which would make your position difficult?
Ms Freedman: I would like to make clear that I am independent of KPMG. I am employed by Oxford University.
Mr Devereux: No, we do not believe there is a simple capital gains tax which would cover all of the points which people would like to make about it. Indeed, that is probably true of most taxes. I think capital gains tax is particularly complicated from that perspective. There has to be a balance in the way that it is designed.
Ms Freedman: This is a particularly complex tax because of the things that we have set out in the note which create complexities. Ideally, one would tax it in one way but pragmatically one cannot. For example, one has to have a realisation basis and that immediately complicates the tax situation.

Q247 ***Lord Barnett:*** Indexation of course has been very complex. You apparently would not want to stay with that. You recognise that it was very complex and therefore you support the idea in principle but you are looking for an administrative solution. I am not sure what kind. Can you spell that out?
Ms Freedman: 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.

Q248 ***Lord Powell of Bayswater:*** Coming on to the idea of a single rate, reading your paper I get the impression that you think the only logical single rate would be 40%, which suggests incidentally that you are not running for elective office in the City. Is that really feasible given the political context of taxation? Secondly, is not the only truly simple thing to have a single rate, possibly not 40%, and a taper for everyone over a period of 10 or 12 years or something down to zero or 10% or whatever? It seems to me that anything else is bound to be more complicated. Start with the single rate. What would you set it at?
Mr Devereux: Our basic proposition would be that there is no particular need for a single rate. If we were forced to have a single rate, we would have to have a discussion about what it would be. There would be a case for 40% and there would clearly be a case for other rates as well. The issue that we wanted to raise was one of simplicity within the system. Is it necessary to have a single rate in order for the system to be simple? The point we wanted to make primarily was that what makes a system simple is not necessarily having determined the amount of taxable income or taxable gain what rate to apply to it. Rather, it is how difficult it is to determine that amount of taxable gain. If there are possibilities of different forms of income being transferred into capital gains or vice versa, the different rates of tax that we have on income and capital gains are clearly very important. That is where the boundaries in the tax system lie and where complications in the tax system arise which the authorities have to deal with. We feel that in some ways the difficulties and complexities also arise because of the links between capital gains tax and other taxes, notably income tax, in the system rather than the single rate itself.

Q249 ***Lord Powell of Bayswater:*** You do not think all the recent anti-avoidance legislation in practice has diminished the likelihood of people being able to shift income into capital gains?

Mr Devereux: I am sure it has. The fact that those anti-avoidance provisions are there at all relates to the fact that there are boundaries in this form.
Ms Freedman: The idea would be to try to reduce those anti-avoidance provisions which cause a great deal of cost to everybody. One cannot do that unless one has a sensible, underlying tax system. Ideally one should aim for a sensible set of rates and then you could get rid of some of the anti-avoidance legislation and have a much simpler system.

Q250 ***Lord Powell of Bayswater:*** Is not the only simple system a single rate with a taper for capital gains of any sort for everyone?
Mr Devereux: I would question why we need a taper relief at all and why the tax rate that you pay on a gain should be lower the longer that you have held an asset. It is not clear to me in economic terms that that would be a sensible system.
Ms Freedman: We are not recommending 40% without indexation. Our recommendation goes hand in hand with indexation.

Q251 ***Lord Powell of Bayswater:*** The argument concerns very short term, very speculative gains and whether you simply encourage those.
Mr Devereux: The issue there is whether encouraging people to hold an asset for longer has an effect on short term speculation. More important is the way that individual investors value things happening in the future. If everybody values things happening in the future, say, a year away at very low rates, then the value of the asset will reflect that. That is not necessarily anything to do with the length of time that an asset is held. It is more to do with the discount rate which people are discounting in the future.

Q252 ***Lord Powell of Bayswater:*** If you are building up a business, you presumably take a longer term view, if you want to encourage people to build up businesses?
Mr Devereux: Indeed, but it is not clear that you need taper relief within the tax system to do that. Capital gains tax itself implies a lock in effect because the longer you hold onto an asset the further away you can defer payment.

Q253 ***Lord Powell of Bayswater:*** Is this not how the German system encourages the development of medium sized companies?
Mr Devereux: I am sorry; I am not familiar with the German system.
Ms Freedman: There are many circumstances other than tax that created the German system and we should be careful about giving too much credence to tax as a way of encouraging any particular activity. It would be much better to have a neutral tax system and let tax activities depend on commercial considerations.

Q254 ***Lord MacGregor of Pulham Market:*** Taper relief in one sense does help to deal with the indexation point and does mean at some point that you do not have to pay capital gains tax at all. You are advocating that you would prefer to have indexation but I take it you are very critical of the fact that there is now neither indexation nor taper relief in the system so that inflation gains are going to be taxed?
Mr Devereux: Indeed, yes. We would argue that there is a case for indexation. We believe there is less of a case for taper relief. In practice they are not very close.
Ms Freedman: Clearly, the lower rate is intended to be some kind of crude compensation for the lack of relief.

Q255 ***Lord MacGregor of Pulham Market:*** It is a pretty crude way of dealing with it. Can I explore further the point about people switching from income into capital because that is obviously a very real risk. Some of our evidence has suggested that the anti-avoidance rules and the need to get Revenue clearance for particular schemes will more or less deal with this problem. It sounds as if you are not convinced of that.
Ms Freedman: There are anti-avoidance rules but relying on these has its problems. You cannot get Revenue clearance in some types of case. It is not always available. The provisions for getting clearance have expanded but you cannot for example get a clearance if it is considered that you are engaged in an avoidance scheme. Who defines whether you are engaged in an avoidance scheme? That may depend on who is making that decision. Getting clearances delays things. If you want a competitive, commercial system you do not want a system in which you have to get a lot of clearances. I would have thought you would want a system where you can tell what the law is and not have to rely on going to the Revenue for a clearance.

Q256 ***Lord MacGregor of Pulham Market:*** Given the present scheme, what is your solution to the risk of people switching from income to capital gains?
Ms Freedman: We would not start from here so they would not have that opportunity to switch. Once you have built in the opportunity, you are going to have to have anti-avoidance provisions of some kind or another. You may need more. I do not have a particular idea for what might be needed but it may emerge as people in the City work things out and come up with schemes. It may be that these schemes will be disclosed and new provisions will have to be

introduced, so we will have a larger Finance Bill for you to look at next year.

Q257 ***Lord MacGregor of Pulham Market:*** With all sorts of technical responses to those press stories about avoidance or switching taking place.
Ms Freedman: Yes. There will be such responses.

Q258 ***Chairman:*** You say in your written evidence that it is difficult to justify on any economic rationale the distinction between business and non-business assets. Could you expand on that?
Mr Devereux: The starting point would be fiscal neutrality. Unless there is a particular rationale for favouring some forms of assets over others, ideally the tax system should be neutral between them. Within the context of business versus non-business, I think there would therefore be a presumption of evidence and proof required on those who would advocate a special provision for business assets. Is there some particular value in those to the economy at large relative to these other forms of assets? Broadly, it is one of fiscal neutrality and asking what particular benefits are there for business assets as opposed to other assets.

Q259 ***Chairman:*** You do not think it would be productive or more likely to be?
Mr Devereux: It may be. Some business assets are going to be more productive than others. One could ask the question why we need to give relief to all forms of business asset. One could say let us only give relief to productive business assets or those which have particular effects on the rest of the economy, rather than on the private individual who owns those assets. There are a number of ways in which one could try and identify the benefits to society generally of any particular tax measure. But it is extraordinarily hard to do so in practice and it is extraordinarily hard also to come up with a system which has the desired effect of promoting more investment in productive assets, if indeed it is believed that there is not enough investment in productive assets at the moment.

Q260 ***Lord Barnett:*** Do you think the government should not get involved in the area of encouraging enterprise at all? They are involved in enough areas. Would it be better in your view if they did not do anything?
Mr Devereux: That would be one possibility. That is not what we are advocating here particularly. There is evidence that small and particularly new businesses do on occasion face difficulties in raising finance for their investment. You might see that as a market failure and the government might want to intervene to try and improve the position of small and new businesses in that context. Starting from first principles, I would then ask what is the best way of doing that? The two things that you have been discussing, the entrepreneurs' relief and the enterprise investment scheme, approach that in different ways. The entrepreneurs' relief would give a lower rate of tax on the returns to that investment. The enterprise investment system is much more focused on the particular problem we have identified, which is lack of access to finance. There are other ways in which the government may address that question. We should identify what evidence there is that these particular schemes are having a beneficial effect. It may be that if they are not having a beneficial effect it would be better to spend that money in some other way.

Q261 ***Lord Powell of Bayswater:*** It seems to me you are saying that tax has very little role in all this and the better system is things like the small firms loan guarantee which provides help in a different way. Could you just enlarge a bit on that?
Mr Devereux: The issue there is one of focusing on the lack of access to finance and the extent to which small businesses cannot raise finance. If that is the market failure which the government is trying to correct, the question would be what is the best way of doing that. The small loans guarantee scheme seems a well targeted way of dealing with that. To some extent the investment enterprise scheme would be as well in that it is encouraging investors to make funds available for those kinds of business. Perhaps we could discuss exactly the terms and conditions of that scheme and whether it could be better targeted still. Those schemes are at least addressing what seems to be a particular failure in the market.

Q262 ***Lord Powell of Bayswater:*** You also seem to be saying that it should not just target small business; it should look at all new and start-up businesses?
Mr Devereux: The evidence we cite here suggests that it is new businesses rather than small businesses which are particularly hit by this problem. We suggest that it would be better to target new business.

Q263 ***Lord Powell of Bayswater:*** As distinguished academics, how many years do you think one would need to reach a real judgment on whether schemes like this are being effective or not?
Mr Devereux: It is possible to look at the evidence now and make judgments, as indeed the studies that you have been discussing do. There is plenty of evidence there to draw on to identify its impact.

Q264 ***Lord Powell of Bayswater:*** Quite a lot of your paper refers to needing a couple of years to reach a clear view on these schemes.

Mr Devereux: As a general principle, what we need for statistical studies is change, wherethere are differences across companies or differences over time. It is not really a fixed number of years. We need to be able to compare different kinds of companies or compare before and after tax reforms. Those are the kinds of things which help us to identify the effect of any particular measure.

Q265 ***Lord Powell of Bayswater:*** The Sussex study seems to suggest that these schemes have not been very effective in helping the companies they are intended to help. Do you agree with what the Sussex study says?
Mr Devereux: I have no quarrel with their empirical evidence. Their conclusion seems to be consistent with companies receiving this form of relief investing more and employing more people and having greater sales. One can question the policy response to that. Are these companies growing faster or having more investment because they have relief, or is it companies which are growing faster and want to do more investment getting the funds which this relief helps them to get? The direction of causation there is still open to doubt and needs further work. The other interesting thing from that study was the suggestion that companies which have used this relief tend to have lower rates of profit than companies which have not. That is what you might expect given that post tax returns on investors are more or less fixed across different kinds of investment. If you tax one investment less heavily than another, you would expect the pre tax return on the one which is less heavily taxed to be lower. That is consistent with the result which they find. Whether that means the system is not worth having is another question. It just means that we get more investment there but it is not as profitable as the investment which would otherwise have taken place.

Q266 ***Chairman:*** Sticking with the University of Sussex study, you also raised what seems to be a fairly fundamental problem that like is not being compared with like here when the study looks at companies that received EIS finance with those that did not. Can you just expand a little on that for the benefit of the Committee?
Mr Devereux: Yes. There is a large number of companies which have benefited from the scheme and a large number which have not. The paper compares those two to see what differences there are between them. The problem with that approach is that this is not a random set of firms. It is not random whether you get relief or whether you are part of the scheme or not. If you are a fast growing company in search of finance, it may well be that you are more likely to raise external finance than if you are a small company which is not seeking to expand at all. What I would like to have seen in the study is an attempt to distinguish between those two groups and to identify which companies are more likely to try to raise funds under these schemes.. Then I would do the comparisons which they have made. One can control for that statistically and make a more informed judgment on the direction of causation.

Q267 ***Chairman:*** In effect there is no study which has been done yet which would really prove the thing one way or another?
Mr Devereux: I am not aware of any studies which would answer those questions to my satisfaction.

Q268 ***Lord Powell of Bayswater:*** The government would not have dreamed this up just out of its own head. It must have been coming up with this scheme originally under pressure from business of one form or another, whether it was the CBI, the Federation of Small Businesses or something. There must be businesses out there that do believe this is a valuable thing to have and it does help them grow. Are they wrong?
Mr Devereux: We do not yet have sufficient evidence. There are always plenty of investors and other taxpayers who would welcome a reduction in the tax rate on a particular form of investment.

Q269 ***Lord Powell of Bayswater:*** It sounds as though you are quite sceptical. I get the impression that you do not think this is a particularly well designed or necessary concession to make.
Mr Devereux: Not entirely. The fact that it is targeted at the problem of lack of access to finance is a good point about the scheme. The problems with it are that it is not targeted well enough to the kinds of companies which face that problem.

Q270 ***Lord Powell of Bayswater:*** You are suggesting that a better way to do that is the small firms loan guarantee, as you said in your paper.
Mr Devereux: That seems better targeted than the EIS scheme.
Ms Freedman: There have been two studies so far, the Cambridge study earlier and this one. Neither of them has really been very encouraging. One would want more evidence and it may be that further work could be done so we should not dismiss the results without that further work perhaps.

Q271 ***Chairman:*** Can I ask you about the increase in the investment limit? In your written evidence you comment that the increase in the investment limit for EIS from £400,000 to £500,000 is unobjectionable but it is not clear whether the increase will affect the total amount of funds invested. What kind of work would need to be done up front to test whether such an increase is likely to be worthwhile? Do you know whether any such work has been done by the Treasury or HMRC?

Mr Devereux: The way I would address that in a statistical study like the University of Sussex one would be to see whether companies seem to be limited by the £400,000. How much do they raise in this scheme? If all the companies raise £400,000, it suggests that that may be a constraint. If they are raising only £200,000, then it suggests they are not under constraint. I have not seen any data on exactly how much they are raising so I do not know what the answer is, as to whether that is a constraint or not.

Chairman: May I thank you very much indeed both for your written evidence which we found very refreshing and for your open answers to our questions. You have been very helpful. Thank you.

WEDNESDAY 14 MAY 2008

Present		
	Barnett, L	Sheppard of Didgemere, L
	Blackwell, L	Valance of Tummel, L (Chairman)
	MacGregor of Pulham Market, L	Wakeham, L

Memorandum by the British Private Equity and Venture Capital Association (BVCA)

The British Private Equity and Venture Capital Association (BVCA) represents the vast majority of private equity and venture capital firms in the UK. Provisional figures show that in 2007 our members invested £32 billion in companies across Europe and North America, over £12 billion of which was in the UK.

The British private equity and venture capital industry accounts for 60% of the European market, and is core to maintaining London as the world's financial capital. Last year the industry generated £5.4 billion in fees for the City of London.

Capital Gains Tax

Capital Gains Tax and the Entrepreneurs' Relief: Clauses 6 and 7, Schedules 2 and 3

1.1 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.

1.2 The move hit not just private equity but thousands of venture capitalists, family businesses and small and medium-sized companies.

1.3 So far there is no direct evidence that the new, higher rate has led to member firms moving 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.

Entrepreneurs' Relief

1.4 The entrepreneurs' relief provides an important incentive for small businesses, and is a worthwhile attempt to encourage entrepreneurs.

1.5 However, we are concerned that it does not address the question of how to encourage serial entrepreneurship, which is at the heart of business growth and development.

1.6 For the private equity and venture capital industry, the relief changes very little.

1.7 Moreover, the requirement to have a 5% holding in a company in order to qualify for the relief is potentially divisive: in order to provide incentives to management teams, private equity firms often award equity stakes in a business, at differing levels. A Chief Executive may qualify for, say, a 5% stake in order to encourage good performance. A Finance Director (FD) might be awarded a smaller stake (say 3%), with second tier management qualifying for smaller stakes. On disposing of these holdings, the CEO would pay 10% CGT, yet the FD (and second tier management) would pay an 18% rate. Employees in Employee Share Option Schemes (ESOPs) would be in the same situation. We believe this potentially reduces the incentive which an equity stake otherwise provides.

1.8 In addition, the need to be a director of a company means that many "business angel" investors would not normally qualify for the relief.

Residence and Domicile

Residence &Domicile: Clause 22, Clause 23 and Schedule 7

2.1 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. We now have a significantly less competitive regime than previously and in the context of other changes to the business environment, we fear this represents an erosion of the UK's competitive edge.

2.2 The process around the implementation of the changes caused concern within the industry. The PBR announcement represented a major change in tax policy yet appeared hurried and consequently lacked detail. This is clearly undesirable for such a significant change to a regime which has been key to the UK's tax position for many decades. This is even more the case with the increasingly global economy and changes in mobility of capital and labour. In particular the PBR announcement covered the points in only half a page and stated that:

— Non doms who have been in the UK for more than seven out of 10 years would only be able to access the remittance basis of taxation on payment of £30,000.

— With effect from 6 April 2008 personal allowances would be withdrawn where someone was taxed on a remittance basis.

— The basis for determining residence would be changed so that any day where someone was present in the UK would be counted.

— The law would be changed to remove the existing flaws and anomalies in this area.

2.3 At the time a consultation document including draft legislation was promised for early December but this was delayed until 16 January. On publication it contained many more provisions around offshore trusts and significant retrospection which had not been apparent from the original announcement.

2.4 Whilst it had been anticipated that capital gains realised after 6 April 2008 would be exposed to UK tax based on historic cost, the provisions in relation to offshore trusts meant that remittances could be matched with gains realised since 1992. In addition where proceeds were matched with earlier gains the tax charge would be increased by 10% pa for the last six years. The rules were also such that remittances of personal possessions and gifts prior to 6 April 2008 could also subsequently be brought into charge. In addition, it became clear that:

— For US citizens the £30,000 was not creditable against US tax. US Citizens suffer US tax on their worldwide income at similar marginal rates to UK taxpayers.

— Where sums had to be remitted in order to pay the £30,000 the remittance is within charge to UK tax such that the overall cost would be £50,000 for many UK taxpayers (ie £30,000 grossed up at 40%).

— The tax was imposed on individual taxpayers such that the cost for a family would be significantly greater.

2.5 In the face of the reaction to these proposals, on 12 February, HMRC Acting Chairman Dave Hartnett issued a statement saying that there would be no retrospection and in particular:

— Those using the remittance basis would not be required to make any additional disclosures about their overseas income and gains. So long as they disclose their remittances they would not be required to provide any information on the sources of those disclosures.

— There would be no retrospection in the treatment of trusts and the tax changes would not apply to gains realised or accruing prior to the changes taking effect.

— Money brought into the UK to pay the £30,000 charge would not itself be taxable.

— It would continue to be possible to bring works of art into the UK for public display.

—The government would continue to discuss with the US authorities how to make the £30,000 charge creditable against US tax.

2.6 This statement appeared to be a hurried response to the pressure generated by the earlier announcements and the potential impact on the economy. The statement represented a significant change in stance in a number of areas—for example the indication that a remittance to pay the £30,000 would not itself be subject to UK tax and the advice that overseas gains accruing or realised prior to 6 April 2008 would not be taxed.

2.7 However, the statement still lacked detail so there was still no indication as to how the announcements would be implemented. For instance it was still not clear how the earlier realised or accruing gains would be carved out of the new regime. The authorities continued to grapple with these issues until the detailed legislation was finally published on 27 March 2008.

2.8 Had the final proposals gone as far as the draft legislation proposed, we are certain that some private equity firms would have moved their business away from London. This is a global business: the head office operations of the major houses are relatively nimble. Many houses employ a significant number of persons originating from outside the UK and already have significant operations in most European territories. Relocation is therefore a real possibility, and based on balancing various factors and objectives including tax.

2.9 We were however pleased with the Chancellor's announcement in the Budget speech that there would be no further changes for this Parliament and the next, as it was crucial for the government to provide certainty after a troubling period in relation to tax policy and the non domiciled community.

2.10 These announcements represented a welcome move forward in comparison to the debate since the PBR. Having said that the process has been difficult and there are lessons for policymakers as a result. The impact of these changes is still unclear. Whilst we do not envisage any mass movement offshore, firms take in to account many different factors when considering where to base their headquarters, and we note decisions in recent weeks about major UK corporates moving their business away from the UK. We continue to believe that the UK is an excellent place for the VC and PE houses to locate their major operations, but the balance is fine and we need to be careful not to disturb that balance.

Enterprise

Encouraging enterprise: Clause 28, Clause 29 and Schedule 11

3.1 The BVCA believes that the private equity and venture capital industry is a vital part of encouraging enterprise in the UK economy. Our members help companies to grow and develop, increase efficiency and productivity, and make asignificant contribution to UK plc:

- BVCA member firms invested in over 1,300 UK businesses last year, 1,600 across Europe. Over 75% of these investments were at levels below £2 million.
- In the last 10 years, 22% of all IPOs on the London markets were backed by private equity and venture capital.

Enterprise: Unlocking the UK's talent, and the consultative document on the Enterprise Investment Scheme

3.2 The Government strategy, *Enterprise: unlocking the UK's talent*, contained some worthwhile initiatives, including:

- £30 million to improve enterprise education.
- An increase in the amount of capital available for the Enterprise Capital Fund and the Small Firms Loan Guarantee.
- Measures to remove certain obstacles to SMEs competing for pubic procurement contracts. (Specifically, "the removal of clauses in public procurement contracts that might prevent the use of factoring and invoice discounting as a means of finance".)

3.3 Similarly, measures in the Finance Bill to raise the investor limit from £400,000 to £500,000 under the Enterprise Investment Scheme (EIS), and the raising of the individual share allowance from £100,000 to £120,000 under the Enterprise Management Incentive (EMI) were both positive, though piecemeal, moves. However, they will make no practical difference to our industry, as BVCA members are often barred from qualifying for both EIS and EMI, as well as arange of other small company tax reliefs.

3.4 We would like to see all venture capital-backed companies qualify for a series of small company tax reliefs which the Government has implemented. These companies are often denied access to such schemes on the grounds that they are deemed to be part of a wider corporate entity. Yet we believe they are exactly the sort of companies which should benefit from the reliefs.

3.5 The BVCA is concerned that the current situation unfairly disadvantages these companies against their competitors, and impedes enterprise.

3.6 Venture capital-backed companies have the potential to generate jobs during an economic downturn. Companies which receive venture capital funding have to undergo stringent assessment procedures from investment executives, and are therefore often excellent prospects for growth. Disqualifying these companies from reliefs designed to encourage growth is therefore illogical in principle and inhibiting in practice.

3.7 The schemes which our members often do not qualify for include:

- The Enterprise Investment Scheme.

— Research and Development Tax Credits.

— The Enterprise Management Incentive.

— Small Companies Tax Rate.

3.8 Amending the definition of an SME, and allowing venture capital-backed companies to qualify for the above reliefs would make a material difference to these businesses, and to the venture capital community.

3.9 In all, we estimate that these reforms would apply to fewer than 6,000 small businesses—a number which compares favourably with the 4.5 million small businesses across the whole of the UK. More details on the specific reliefs are attached in the BVCA's enterprise submission to HM Treasury.

A UK high tech fund of funds

3.10 Another area where we believe Government could do more on enterprise is around encouraging investment in to venture capital. The BVCA has for some time called on Government to establish a fund which would encourage investment in early stage technology.

3.11 The impetus for this came out of the Myners report. One of the conclusions of that report was that UK pension funds should be invested more in the PE asset class.

3.12 To compete with venture capital firms in the US, UK early technology specialists need larger fund sizes in the £100 million range to achieve critical mass.

3.13 The UK has a supportive legal and regulatory environment for early stage venture capital but an investment community that tends to shy away from it. A High Tech Fund of Funds provides away of encouraging these investors. More detail on this proposal is contained in another paper: A UK high tech fund of funds.

A Study of the Impact of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) on Company Performance (HMRC Research Report 44)

3.14 We believe that these schemes are a valuable tool in encouraging investment and enterprise. Changes in the 2006 and 2007 Finance Acts have meant that the schemes are less attractive than in the past, and that only very small companies now benefit. We understand that these changes were necessary because of EU State Aid requirements, and that EU State Aid approval has not yet been confirmed.

3.15 As the EIS/VCT impact report points out, the schemes have made a demonstrable impact in terms of capacity building in recipient companies, putting them in a good position to grow and develop successfully.

3.16 The schemes also show a positive impact in terms of productivity, although this is predictably limited in such early stage companies. Where VCTs and EIS have been used together, their impact has been more clearly felt.

3.17 Although the study indicates that the survival rate for assisted businesses is lower, we believe that this underlines the fact that the businesses which qualify are inherently more risky and are therefore in need of intervention, without which they may struggle to receive finance. We also believe that the management input provided by business angels and venture capital trust investors is an important factor which should be taken into account.

3.18 The EIS in particular should be amended as follows:

— The independence requirement prevents any company (whether alone or jointly) from having the power to secure control of an EIS/VCT investee company. This prevents companies benefiting where a venture capitalist has a majority stake in the company. We believe therefore that the definition of an SME should be changed to include VC-backed companies (see 3.7 to 3.9 above).

— EIS should also be amended to encourage the development of intellectual property in the UK, and give more flexibility for e-commerce. One of the UK's talents is the skill and innovation of its researchers, often in a university environment, and allowing intellectual property to qualify under the terms of the scheme would have a positive impact on, for example, the university spin-out sector.

— The schemes should encourage investment by directors and employees, who currently are unable to obtain income tax relief.

Other Enterprise Measures in the Budget

3.19 The BVCA was pleased with the announcement on public procurement for SMEs. We have for some time been arguing for this sort of measure. We believe it could make a significant difference to all SMEs, including those backed by our members. We are also pleased that Anne Glover, Chief Executive of Amadeus Capital and a former Chairman of the BVCA, has been asked to head a review to take this initiative forward.

3.20 Finally, we were very pleased to see the Government publish an update on the implementation of the Sainsbury Review proposals on science and innovation. These measures will help stimulate the university spin-out sector, which is a growing part of the UK's venture capital industry.

May 2008

Memorandum by the Institute for Employment Studies, University of Sussex

1. Small Company Growth, Development, CGT, Residence and Domicile

In this section we cover:

- R&D tax credits.
- Enterprise management incentives.
- Enterprise Investment Scheme and VCTs.
- Small companies tax rates.
- CGT.
- Residence and domicile.

1.1 *R&D Tax Credits*

The introduction of R&D tax credits was aimed at promoting and stimulating investment in R&D in UK companies. The outcome, and value added for the UK, is higher levels of innovation and the creation of new products and services. This would raise the technology threshold of the UK and make us more productive by shifting the start point of our production possibility frontier outwards.

- We believe this tax credit is supported in this context as we have much lower average investment (as a proportion of sales) in R&D than our foreign competitor nations.
- We also know that smaller firms are responsible for a disproportionately high share of innovation, thus intervention in this sector of the economy is likely to have an equally high return.
- We have some concerns that the wording of the qualification criteria is unclear and may exclude smaller companies that have substantial venture capital investment (and ownership). As venture capital, and equity investment more generally, is the primary source of funds for growth and technological development in smaller companies, we feel that amendments could be made to allow for this type of investment and ownership participation in smaller companies.

1.2 *Enterprise Management Incentives*

The quality of the top management team in smaller firms is crucial to their survival and growth. As smaller firms move from an entrepreneurial management model in their formative years to a more formalised structure, the requirement for an expanded and more specialist management team and model is fundamental to their ability to manage growth successfully. Research evidence has shown that the ability to bring in experienced outside managers is critical at this juncture, as it is when the founding entrepreneur exits the business.

- But smaller firms, on average, pay lower salaries than their larger counterparts. And this creates a problem when competing in the market for managerial labour as experienced managers are reluctant to move from larger firms where pecuniary and non-pecuniary benefits are typically much higher and wide ranging.
- Employee share ownership is an obvious mechanism by which top managers, and the workforce more generally, can be incentivised by aligning the interests of managers and shareholders who share in the productivity gains of their superior performance. And it mitigates some of the obvious risk for experienced, and well remunerated, managers when moving from a secure job in a larger firm to a riskier position in a smaller firm.

- There is also an issue for non-executive directors who do not spend the required amount of time working for the business. Research has showed that the addition of an outside non-executive director to a smaller company has large and quantifiable benefits (one estimate suggests an additional £250,000 in value added for the first NED).
- We would be generally supportive of a relaxing of the upper limit (currently £100,000) and a widening of eligibility criteria to allow for NEDs to qualify for employee share ownership schemes giving their importance to the growth of smaller firms.

1.3 *EIS and VCTs*

The Enterprise Investment Scheme and VCTs have recently been evaluated by an independent research team who econometrically assessed whether or not the receipt of investment funds under either, or both, schemes resulted in a identifiable upward shift in performance compared to otherwise similar firms who did not receive such investments.

- This recent evaluation concluded that either one or both schemes had made a positive contribution to performance (measured by employments, sales, and labour productivity) over and above that which would have been achieved in the absence of the two schemes. The authors concluded that whilst the quantitative gains were relatively small over the period measured, it was likely that the longer-term gains were more substantial.
- It was also the case that a high, and disproportionate, share of investment activity was directed at brand new (de novo) start-ups which was seen as a positive benefit to the economy.
- Given that EIS and VCT appear to be working well in terms of promoting a higher level of start-up activity and improving the performance of recipient companies, we are generally supportive of both schemes, although enhancements could be made.
- We would support a raising of the upper limit on investments qualifying for income tax relief to reflect the scale of investment required in growing companies and a further look at the exemption from capital gains tax after three years to ensure that "patient" money flows to smaller growing companies.

1.4 *Small Companies Tax Rates*

Smaller companies generally benefit from a favourable tax regime and this is seen as an important incentive to promote entrepreneurial activity amongst the population. As many smaller companies have limited financial acumen and external advice is costly, tax simplification is always an issue and the current regime appears quite friendly in this respect.

- We would be supportive of further consideration of the tax situation regarding equity investors in smaller companies, particularly as this may exclude many of the smaller scale venture capital funds which we are trying to promote given their obvious preference for investing in smaller scale and start-up activity.

1.5 *CGT*

The shift in CGT announced in the recent budget to a new rate of 18% is a fundamental shift which may have significant implications at a macroeconomic and microeconomic level.

- On the positive side, a tax simplification is to be generally supported as it makes the situation and environment for smaller companies and individuals in respect of tax easier to deal with.
- But we would question whether a flat rate discourages longer-term investment which, in respect of smaller companies and particularly those involved in product and service development, is a critical issue.
- There is also the potential for CGT to conflict with other policy in respect of encouraging employee share ownership if the 5% holding rule is too high given acceptable stock ownership provision for firms in respect of all managers outside the very top team.
- Our general feeling is that the new rate is a rather blunt instrument which, whilst not likely to cause huge changes to the UK business environment, might result in lower levels of business angel activity, and cause problems for particular types of smaller companies such as family firms and serial entrepreneurs.

1.6 *Residence and Domicile*

— We feel that the residence and domicile regime requirement that individuals who are effectively resident in the UK should pay tax as is right and proper.
— We also do not believe that the intended burden of the tax will unduly affect the financial position of those the legislation is meant to capture.
— But we have serious concerns that the regime will have unintended consequences on individuals and families who should not fall within the scope of this regime and that the detail of the regime needs to be looked at and changed to exempt them.
— The obvious solution is to incorporate an income cap into the regime thus exempting less wealthy, and unintended individuals from the regime. An alternative would be a sliding scale, but this would have major issues surrounding disclosure and present a considerable burden on individuals.

May 2008

Examination of Witnesses

Witnesses: Mr Simon Walker, Chief Executive, Mr Philip Shuttleworth, Chairman, Tax Committee, British Private Equity and Venture Capital Association and Mr Marc Cowling, Institute of Employment Studies, University of Sussex, examined.

Q272 ***Chairman:*** Welcome to our witnesses from the British Private Equity and Venture Capital Association and from the University of Sussex. As you know, this year our inquiry is concentrating on three aspects of the Finance Bill—Capital Gains Tax, residence and domicile and encouraging enterprise. Thank you for your very useful written evidence. No doubt this afternoon we will be concentrating on the third of our topics, encouraging enterprise, but if we have room at the end of the day there may be one or two questions that we can put to you on the other two topics as well. We can either have an introductory remark from you if you want to, or we can go straight into questions—whichever you prefer.
Mr Walker: Could I just have a brief introductory comment if I may? The British Private Equity and Venture Capital Association has its membership ranging from the very largest private equity houses to the smallest venture capital companies. The UK is very much dominant in European private equity and venture capital and has had really big international players based here for ten years doing deals out of the UK with great benefit flowing back to London, and indeed the regions of Britain, over that period. One point that I will make is that global finance is highly mobile and that it is terribly important that we are competitive, but above all our central message would be that certainty and predictability are certainly vital because all our investors, from the largest private equity house to the smallest venture capital firm, are long term in their plans and so tend to lock up their investments for ten years or more, so that element of predictability is the one thing that we stress above all others.

Q273 ***Chairman:*** Perhaps I can start off on the topic of encouraging enterprise. Given that the Treasury issued a consultative document on the EIS and the other related documents on the Budget Day, do you find it surprising that the change to the EIS limit was made in advance of a wider consideration of these publications? Would it not have been more sensible to stand back and assess where all that might be taking us and then introduce a broader package if that seemed desirable?
Mr Walker: I can certainly see the arguments for that. I would say that every little bit helps but I certainly see the point at which you are driving. Our main concern is that our members are largely barred from participating in EIS or indeed EMI because companies eligible for them are not allowed to be backed by funds because that means that they are part of a wider corporate entity. Our members would very much like to use EIS far more than they do but in fact they are barred because that wider ownership of funds backing for the venture capital prohibits their qualifying for EIS. So our argument would that we would like to see all venture capital backed companies qualifying for small company tax reliefs. The fact that there is some funding from a large fund should not block that.
Mr Cowling: It was certainly quite strange to me. I was not given notice that the document was being published at that point. Certainly I would argue that the nuances in the evaluation that I and my colleagues undertook, which could significantly enhance proposals for development of EIS, I would have expected to have been asked about potential avenues for development prior to that document being published.

Q274 ***Lord Blackwell:*** Simon, you mentioned a number of schemes that your members are blocked from because of the corporate backing rather than the individual subscriber. Does that argument apply not only to the EIS but to the other schemes you mentioned, and is there an argument, do you think, that those restrictions should be removed and that

your members should be allowed to apply for those schemes?
Mr Walker: That is very much what we would like to see. They apply also to EMI, to research and development tax credits and to small companies' tax rates, re the definition of small companies that have a fund backing them as SMEs in terms of European concepts of state aid. My understanding is that the Treasury is not unsympathetic to our view but that there are arguments about whether the European Commission will allow us to qualify because an entity is prohibited from being an SME if it is backed by a larger fund that is deemed to be able to control it.
Mr Shuttleworth: I think the other concern is the independence tests which restrict the use of these schemes in venture backed companies. Essentially that is aimed at large companies disaggregating their subsidiaries and also obtaining these reliefs, and companies which are part of the venture capital portfolio are very different than a range of subsidiaries in a large corporate. So we think the relief should apply and, as Simon says, I think that is generally the view of Treasury and we have proposals to amend the wording to make these reliefs apply, about which we are talking to the Treasury at the moment.

Q275 ***Lord Blackwell:*** So just to be clear, leaving aside the EU restrictions on this, do you think it is possible to create a definition which would differentiate companies within a large fund from companies which are disaggregated subsidiaries of a group?
Mr Shuttleworth: Yes. Actually in the last few weeks we have developed some wording about which we are talking to the Treasury almost as we speak.

Q276 ***Lord Barnett:*** You did say that every little bit helps but does it in this case of EIS? Your members seem to do quite well without any external incentive. Are you not really arguing for or would you not really prefer no allowances at all anywhere and a reduction in basic taxes?
Mr Walker: 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, and in particular pension funds in this country do not invest in British venture capital. So with some venture capital firms 90% 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.

Q277 ***Lord Barnett:*** I am not clear on this. As I understand it, the venture capitalists looking for a small company investment tend to want to see a yield on it within a very short space of time usually; I gather they like to make their profits within a couple of years and not ten—is that the case?
Mr Walker: I think they are fatalistic, are they not?
Mr Shuttleworth: Yes, I think the time span is more like five years for the gestation period for both early stage and late stage investments.

Q278 ***Lord Wakeham:*** You said pension funds but pension funds do not pay tax anyway, do they? So I am not sure how the tax would change on them. You also put forward some changes which in your view should be made to the EIS. Could you tell us what you think they are?
Mr Shuttleworth: There is both EIS and EMI and both of those actually are not aimed at the taxation of the institutional investor. EIS is aimed at Business Angel Investment and the situation that often arises is that at a very early stage of venture investment an institution, a venture capital house will co-invest alongside a Business Angel and that is a very important part of the dynamic of the investment. So restricting EIS relief and those Business Angel Investors at that point in the company's growth actually restricts the venture capital investment at a critical time. Just also to talk about EMI schemes, they are not aimed at the institutional investor; what EMI is essentially trying to do is attract talent into young, early stage companies and attract talent away from large corporates with pretty secure jobs and quite a high salary, and not having EMI applicable to venture capital investment prevents talent going into that sector.

Q279 ***Lord MacGregor of Pulham Market:*** I would like to ask you something about the University of Sussex study because we have had quite a bit of discussion with earlier witnesses about this and I think the impression we have been given is that the study's findings were that the impact on capacity building on profitability and survival rates was really rather disappointing and rather low, and has led some people to question whether there is real value in having considerable tax incentives so that the Exchequer shares the higher risk involved with young growth-orientated companies. Just reading the evidence that we have had from the University of Sussex today it seems that perhaps we have been given a slightly wrong impression because you seem to want to continue to encourage these schemes. We also had one piece of evidence suggesting that perhaps one reason for not having better results,

certainly in the EIS up to now, and perhaps in the area of VCTs, was that a lot of these investments were made in dot.com companies about seven or eight years ago, and we all know what happened to some of them and therefore it is a bit misleading. So I would like to have all three of your comments on that study and on the argument that some have put that perhaps tax paying relief should be better directed elsewhere. In other words, I know that BVCA have quite a lot of evidence of the impact of VCTs and I would like to hear something from you about that.
Mr Cowling: In terms of the study it is very consistent with general enterprise policy. Around about 10% of the stock of firms within the UK would be technology-orientated, involving the creation of new products and services, *et cetera*. That adds value to the UK economy as a whole and obviously enhances our ability to produce more goods and services given the same amount of resources. It is certainly true that small, and particularly technology, firms are responsible for a disproportionately high share of growth and innovation and that would be the growth in employment, productivity and innovation. They have problems with funding through conventional sources—small businesses typically prefer debt finance. Probably two-thirds of all small business owners would have a strong dislike of equity for control reasons. So in a sense you have to work, at least in the short term, with the third that are generally supportive of bringing in equity capital and the managerial expertise that goes with that, because it is not just finance that you are talking about, it is human capital. Particularly small technology firms are very much built in the shape of the founding entrepreneur, but in a growth scenario you need formal management expertise, maybe if you are developing international markets, etcetera, and those are the things that Business Angels bring. I see wider public benefits from having an EIS kind of tax incentive-based scheme, and the public benefit far exceeds the private benefit—the potential for knowledge, technology spill-overs from supportive activity. The thing that is less clear in all of this—certainly in terms of the changes in the maximum finance investment—is that we are still unclear where the equity gap lies. There is a broad base of evidence that suggests that there is an equity gap, i.e. small, innovative companies and growth-limited companies cannot get access to equity funding in that volume. But we are still not clear where the low and upper bounds are here. The simple fact is that although BVCA represents the majority of venture capital industry in the UK, compared to informal investment activity it is a very small share of total equity investment in smaller companies. So to shut off that route, particularly for start-up companies, is potentially dangerous for the UK economy. In terms of the actual findings of the report, on average 20% of VCTs and EIS invest in brand new start-ups and my guess is that it is unlikely that any more than 10% of those businesses would have started up without that supportive investment. So it is new activity with very, very low deadweight by general small business scheme parameters. Turning to the results, it is only the negative results on profit margins, not profit in absolute terms, so what you are getting is the classic standard economic textbook growth, short term growth profits trade-off, where you are going through a process of change with new investment maybe moving to some new markets through a strong kind of R & D investment phase. So it is hard to keep margins up to that point while you are ploughing money into growth and the kind of uncertainty in the company. Aside from that it appears—although quantitatively the results are quite small—that the firms are doing all the things you would want these firms to be doing. They are building up fixed assets, i.e. additional capacity which is gearing up for future growth, even though they are actually securing growth in the relatively short run post-investment. My guess is that if I followed these firms for five more years then the results would be quantitatively significant, even though they are statistically significant at the moment. So it is just where they are on the growth curve.

Q280 ***Lord MacGregor of Pulham Market:*** What do BVCA say about that aspect?
Mr Walker: I would go along with the points that were made. As Marc's report says, immature companies tend to have lower profitability so to some extent the rather gloomier figures could be a reflection of that rather than anything else. I do think you are absolutely right to emphasise the high tech aspects and the problems that there are from the high tech bust a few years ago which have marred the statistics and which have marred something else that we are concerned about, which is the idea of a UK high tech fund of funds that the government did put its toe in the water on—unfortunately at about that time in the year 2000/2001—and one of the things we would like to suggest is that that perhaps might be tried again where there is some cornerstone funding perhaps allied to universities and certainly intellectually driven work where the UK has such a strong comparative advantage.
Mr Shuttleworth: I think the question is: is it a good use of taxpayers' money? If you look at, for example, the EIS scheme, do not forget that alongside taxpayers' money is, for example, the Business Angels' greater investment. They are pretty shrewd guys and it is not as though it is an investment which does not go through rigorous processes and rigorous due diligence and selection and I think essentially that limits the downside.

Q281 ***Lord MacGregor of Pulham Market:*** Do you think therefore that the changes in the 2006 and 2007 Finance Acts, which reduced the attractiveness, particularly for VCTs were—I know mainly EU influenced—actually in the wrong direction for achieving the kinds of results you are looking for?
Mr Walker: I think so. I think they are made less attractive to invest and from our perspective that has to be a bad thing.
Mr Shuttleworth: Yes and therefore restricted. VCTs are more restricted in size of companies they can invest in. I think the equity with the funding gap is pretty substantial—you cannot put a precise figure on it. It probably goes beyond the VCT limit, in my view. Yes, definitely.

Q282 ***Chairman:*** Can we come back to the University of Sussex Study just for a moment? There are a couple of methodological points that we would like to put to you, where perhaps you can put our minds at rest. The study looks at companies receiving EIS finance and those that did not, and it has been put to us that the approach adopted would be a reasonable one only if the allocation of funding were random. Is it not quite likely that there will be reasons for the differences between the companies' fortunes which are unconnected with the provision of EIS or VCT finance?
Mr Cowling: I guess there are a couple of points. Randomised experiments are great but no one will pay for them, and just randomly dishing out money is not a route government has taken in any response initiative. But in a more practical sense the obvious thing that was missing was that we had no knowledge of strategy or human capital within the businesses, which clearly have very strong correlates of growth, etcetera. The fact that the panel data method used had 80,000 otherwise identical companies—same age, sector, size, *et cetera*—at the point of investment, and we had a time series element to it. So for those firms that were not brand new at the point of investment we had knowledge of their activity, their performance prior to investment. So that method deals with the looking across firms at a given point in time and also changes within a company over time. That method was chosen to deal with those issues.

Q283 ***Lord Blackwell:*** Another point on the methodology is the question of cause and effect, whether in fact the linkage between capacity building and seeking EIS finance the other way round, that it is only those firms that are looking to increase capacity which seek EIS finance. Is that a valid criticism or have you control for that?
Mr Cowling: Potentially it could be but then another argument would say that it is only the poor companies that cannot get funding through normal channels or even generate sufficient internal funds. So you could argue that selection may exist, but it could go both ways—they could be the worst bunch of companies or potentially the best, as you are implying. Again, this method captures that—we collect twin companies at the point of investment, so that kind of mitigates that issue to some degree.

Q284 ***Lord Blackwell:*** Are there similar studies in other countries that you have looked at, which have the same or different results that you could use to calibrate out?
Mr Cowling: No. In fact this is why it is fantastic for us that this was the first of its kind and most EU countries were waiting for this to see where to go with their policy. There have been a couple of studies in places like Australia looking at smaller programmes. The general finding is that lots of interventions in this arena are too small scale and they are not attracting enough investors and investment.

Q285 ***Lord Barnett:*** Given the low take up would you reckon it is value for money or whether we should scrap it altogether?
Mr Shuttleworth: The take up of EIS and some of the schemes?

Q286 ***Lord Barnett:*** Yes.
Mr Shuttleworth: Our point is that EIS, research and development, tax credits, EMI, small companies' rates and avoiding paying tax by instalment, all those for me are saying that small companies are denied venture backed investments. So to some extent it is a theoretical question in the context of venture capital investment—in most cases they do not apply anyway. And that is what we want to see.
Mr Walker: I think our members would love to have the opportunity to try them out and at the moment we do not, and to that extent I do not think the system is being tested properly because some of those investors who would prompt much more activity are not able to do so because they would fall foul of those control requirements.
Chairman: Lord Sheppard, do you have anything else on encouraging enterprise that you want to ask?
Lord Sheppard of Didgemere: No. I was interested in your papers which made me think—I have been involved in venture capital in some way or other for more than 25 years and I found the papers very interesting to that extent.

Q287 ***Lord MacGregor of Pulham Market:*** What do you think the next stage is in determining whether these schemes are worthwhile and whether changes should be made? Or do you think that you have sufficient evidence at the moment to suggest that (a) EIS is going to apply to venture capital more generally; and (b) that the levels are too low and we

know that already. Or do you think we need more evidence to prove it?
Mr Shuttleworth: We conducted a survey of our members last year to ask them, of the various schemes aimed at smaller companies what are the schemes that are most powerful, and very strongly EIS and EMI were the most important areas that we would like access to. But, yes, our next step is to get access to those reliefs and intuitively it must be right that companies that are at that stage in growth, if they are capable of passing the rigorous venture capital investment tests with due diligence then they must have high potential; but it is also the case that they still are very fragile and if it is the case that they also need EIS investment alongside with Business Angels at that point it is just a great shame that that does not happen.

Q288 ***Lord Wakeham:*** I can well understand your members saying, "Here is a tax relief that some people get and we do not, and we would like some of it if we could," and every taxpayer would like to be in that same position. But looked at from the public point of view what I am really still not absolutely clear about in my own mind is whether there is a great deal of activity actually happening which would not happen if it was not there. The more you tell me how well these are researched, they only do it with good projects, the less I am persuaded they would not happen anyway, and with the same amount of taxpayers' relief given across the board in a reduced way of tax that would be a better way of spending the money. That is obviously a bit controversial, but that is the heart of what I wanted to say.
Mr Shuttleworth: I think the feedback from our members is that not having the EIS relief there for some of their marginal investments means that it discourages their investment in a particular project.

Q289 ***Chairman:*** We have probably come to the end of our questions on encouraging enterprise and perhaps we can spend a little time on the other two topics that the Committee is looking at, starting off with Capital Gains Tax and entrepreneurs' relief. Perhaps I should kick off with that. The October 2007 Pre-Budget Report said: "The government is committed to ensuring that the UK has an internationally competitive Capital Gains Tax system that promotes flexibility and competition, and responds to the changing needs of investors. The reform will put the CGT regime on a more sustainable footing and help investors plan for the long term." I assume from your written comments that the British Private Equity and Venture Capital Association might question the government's stated commitment to an internationally competitive Capital Gains Tax system. How far do you think that this has been eroded by the changes in the system announced in the Pre-Budget Report? Do you believe that it has been eroded even after account is taken of the entrepreneurs' relief? And given that we have an annual Budget and Finance Bill, how can the certainty and stability for which you are looking be ensured?
Mr Walker: I think our view was that it has been very considerably eroded, but perhaps not fatally. It has dropped us way down the competitiveness table because investors choosing where they might put their money—and international finance is highly mobile, as you know—now see us lagging behind countries like Italy and the United States that have lower Capital Gains Tax rates, not to mention Belgium, Holland and Switzerland that do not have Capital Gains Tax. So from that point of view we think that there is a considerable drop. It is when it was allied to some of the other problems at that time—I was in New York earlier this year and one of the big investment banks there said to me, "We just feel that the welcome mat is being withdrawn." It is a succession of measures that seem to be saying to big foreign capital, "We do not want you in London any more; we are not the destination of choice," and for our industry, the private equity, we absolutely are at the moment. We were completely dominant in Europe, London; we have companies like KKR that were here for ten years doing business all over Europe before they actually bought anything in the United Kingdom. And the flow on to the London and the UK economy has to be good. So to us what would be important would be to say we are now in a position of stability for the future; we may have had that argument but it is behind us and there will not be any more messing around with Capital Gains Tax perhaps in the way that there had been assurances on the non-dom regime. One of the things we applauded about tax change was simplification, which has to be a good idea in principle, and of course entrepreneurs' relief went in exactly the opposite direction. It is a bit better—again, it is little to some of our members who felt very disadvantaged. But of particular worry to us is that the lifetime cap on entrepreneurs' relief actually discourages serial entrepreneurs, and above all we need people who start one business, float it perhaps and then start another, perhaps in a completely different area, and the idea that you are actually discouraging people from doing that seems to us an unintended consequence.

Q290 ***Chairman:*** Is there anything that you want to say on that from the University of Sussex?
Mr Cowling: I think the jury is still out on the relative quality of serial entrepreneurs or portfolio entrepreneurs as opposed to de novo entrepreneurs. So I think there needs to be more research in that area.

Q291 ***Lord Sheppard of Didgemere:*** I was going to query whether you really thought that the difference between 10 and 18% would stop a serious serial entrepreneur?
Mr Walker: No, I do not think it will stop a serious serial entrepreneur, but I think it is a disincentive and when perhaps tied in with other qualifications to the entrepreneurs' relief—for example the requirement to have 5% of a company in order to qualify for relief, so if you have one, two, three or 4% you do not, which might well be the position in many smaller companies—you actually have more perverse incentives where the person at the top is actually doing relatively well compared to his or her colleagues. So I think that there is a mix of mis-planning—if there is such a word—that came about as a result of the whole process by which this was done, and then repaired subsequently. I am certainly not saying that there will not be any serial entrepreneurs but I think it is a marginal disincentive.

Q292 ***Lord Barnett:*** You said in your paper that last year there was £12 billion invested in the UK out of the £32 billion invested in Europe and North America and out of that the City of London got £5.4 billion in fees. It sounds as though you do not need incentive for the City of London; on that basis they seem to be getting a very fair percentage.
Mr Walker: The £5.4 billion is total fees coming into lawyers, accountants and others.

Q293 ***Lord Barnett:*** I know about where the fees go!
Mr Walker: Often from activity undertaken in other countries, so that could well be from work conducted from London throughout Europe by private equity. Incidentally, we should have said that over a billion of that is not actually done in London itself but done in regional centres because legal fees are so much lower there.

Q294 ***Lord Barnett:*** Of course there is a huge difference in venture capitalists between KKR and some of the smaller ones. I do not know whether KKR are members of yours?
Mr Walker: They are indeed.

Q295 ***Lord Barnett:*** Quite major members! But you say in paragraph 1.6 that for the private equity and venture capital industry the relief changes very little as far as the entrepreneurs' relief and certainly as far as KKR is concerned—it would be a bit small. Although there are, I assume, amongst your members some smaller ones as well.
Mr Walker: There are.

Q296 ***Lord Barnett:*** You are unhappy at the 5% point to get the entrepreneurs' relief?
Mr Walker: Yes, we are.

Q297 ***Lord Barnett:*** Would you want that eliminated altogether? You quote that a finance director may have only 3%. Would you want it to compel or be eliminated or what?
Mr Walker: My suggestion would be that 1% might be an appropriate level where there was a requirement to have a stake in the company, but it seems to me that the finance director, the marketing director, the other key individuals—and also possibly some of the non-executive directors—it might be appropriate to extent this. We are not talking very large differential sums.
Chairman: Perhaps we could move on to our final topic, residence and domicile. Lord Wakeham.

Q298 ***Lord Wakeham:*** You were saying that the process around the implementation of the changes to residence and domicile have caused concern within the industry, and you helpfully set out the various stages in the process. Could you tell us which parts of the process you see as least satisfactory and what changes you would like to see made? Also should consultation have taken place before the announcement?
Mr Walker: We would see the introduction of the changes to the non-domicile regime as having been a real shambles. The announcement was made in early November; we were promised a consultation paper in December, which was then delayed until January 16, at which point new provisions were introduced covering offshore trusts, retrospectivity and disclosure. Then on 12 February there was a change from that and an indication that there would not be retrospectivity, but there were no details actually until 27 March, which is a week before the end of the tax year, meaning that professional advisers could not give proper advice until then. Our biggest concerns actually related to the offshore trusts and the retrospectivity regime. We did a survey of our members of buy-out houses, I should make clear, rather than small venture capital, and we found that 52% were non-domicile with the individuals and 40% used offshore trusts—we actually included those figures in a submission to the Treasury over that period. So it was of major concern to our industry, and I believe that had there not been a move back on those points that we would have seen a significant outflow of private equity from the UK—we were in no doubt about that.

Q299 ***Lord Wakeham:*** You have said—and you are not the first witnesses to have said it—that there was a shambles in the introduction. Others have attributed that to the political circumstances in which it came in; would you share that view? Why was there a shambles, in other words?

Mr Walker: I can see how a case can be made; I do not know if it is really for me to make it. It seems to me that after a long period of consideration but actually minimal consultation tax policy was made on the hoof over a very short period, and it seems to me that the mistakes of that were considerable. A contrast for me, for example, is what has happened over the *Arctic Systems* case—husband and wife income splitting—where the whole measure, which was one also dear to HMRC's heart, is being deferred for a year in order to give time for the legislation to be properly framed and for proper advice to be given over the whole situation.

Q300 ***Lord MacGregor of Pulham Market:*** Your submission and also what you have just said indicates that some of your major concerns have finally been met in the process. Can I ask you three questions in relation to that? Do you think that has largely removed the damage to the UK's competitive position on this? Do you have remaining concerns and, if so, what? And in particular a lot of our witnesses have referred to the threshold of the £2000 issue in relation to personal allowances, etcetera. I do not know whether that really concerns your members or not, but I would be interested to know whether you share those concerns—as to how it is workable, etcetera.

Mr Walker: I think they are significantly removed but not entirely because we are in a highly competitive situation in that area too. I was on a telephone conference call last week to my opposite numbers in Italy and France, in private equity associations, both of whom were referring to their governments' efforts to woo private equity over there. In the case of the new Italian Government there is an Economics Minister with a background in private equity who thinks that Milan could be turned into a centre as well. In the case of France the Finance Minister, who was for many years a successful business lawyer in the States, is apparently looking at a possible non-dom regime over there, a way of making Paris more attractive for internationally mobile capital. So we are 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. One consolation I think we do take is the Chancellor's assurance that for this Parliament and the next Parliament there will be no further tampering with the non-dom regime. That at least appears to convey stability. So that gives us something.

Q301 ***Lord MacGregor of Pulham Market:*** Remaining concerns and the threshold?

Mr Walker: I do not think that the threshold is critical for our members.

Lord MacGregor of Pulham Market: I thought that was probably the case!

Chairman: That brings our questions to an end, so thank you very much for spending your time here this afternoon, for your written submissions and for answering our questions so clearly.

Supplementary memorandum by the BVCA

I am writing to you about the BVCA's campaign to increase support for enterprise in the UK economy, and how the Government can provide a more supportive environment for our young companies to grow and develop.

Last week the BVCA gave evidence to your Committee, where we argued in particular for a removal of the distortions which currently mean that small companies owned by venture capital firms do not qualify for a series of tax reliefs available to other small and medium-sized enterprises.

The BVCA believes that the private equity and venture capital industry is a vital part of encouraging enterprise in the UK economy. Our members help companies to grow and develop, increase efficiency and productivity, and make a significant contribution to UK plc. In the last 10 years, 22% of all IPOs on the London markets were backed by private equity and venture capital. And venture capital backs tomorrow's big companies. Vodafone, for example, benefitted from venture capital funding in its early days.

Yet currently, the Enterprise Management Incentive, the Enterprise Investment Scheme, the Small Companies Tax Rate, and R&D Tax Credits are not available to any small company owned by a venture capital firm. Yet companies which manage to win venture capital funding are often the very best prospects for growth.

Such companies have to undergo stringent assessment procedures from experienced investors, who then put in place clear business plans for development. We believe that the Government ought to support such businesses, as they can make a positive contribution to Britain's future economic prosperity, particularly at a time when we face slowdown in the economy Disqualifying these companies from reliefs designed to encourage growth, and which are available to all other small companies, is therefore illogical in principle and inhibiting in practice.

23 May 2008

MONDAY 19 MAY 2008

Present	Barnett, L	Sheppard of Didgemere, L
	MacGregor of Pulham Market, L	Vallance of Tummel, L (Chairman)
	Paul, L	Wakeham, L
	Powell of Bayswater, L	

Memorandum by HM Treasury and HM Revenue & Customs

Capital Gains Tax and Entrepreneurs' Relief

The Pre-Budget Report, announced a major reform of the capital gains tax regime, which is introduced by **clause 6** and **Schedule 2**. Under the new rules, every individual has a £9,600 tax-free annual exempt amount (AEA) and any gains exceeding this annual allowance are subject to capital gains tax at a headline rate of 18%.

The new rate and allowance structure is complemented by a focused tax relief for entrepreneurs, introduced by clause 7 and Schedule 3. This is available on the disposal of shares in a trading company, provided the person making the disposal is an officer or employee of the company and has a minimum 5% stake in the company, or on the disposal of a trading business. Entrepreneurs' relief reduces the effective tax rate to just 10% for the first £1 million of qualifying gains made over a lifetime.

These changes deliver on the Government's objectives to support business and enterprise and to keep the tax system as simple and as fair as possible.

Residence and Domicile

Budget 2007 confirmed that the remittance basis of taxation will continue for non-domiciled and non ordinarily resident UK residents. The detailed proposals are included in the legislation introduced by clauses 22, 23 and Schedule 7 of the Finance Bill.

This legislation provides for:

— adults using the remittance basis of tax, who have been resident in the UK for longer than seven out of the past 10 tax years, will be subject to an annual tax charge of £30,000 a year as regards the foreign income and gains they leave outside the UK, unless their unremitted foreign income and gains are less than £2,000 a year;

— people using the remittance basis of taxation will no longer be entitled to personal allowances, or the AEA for capital gains tax, unless they have unremitted foreign income and gains of less than £2,000 a year;

— the residence rules will be changed so that any day when a person spends midnight—at the end of the day—in the UK counts towards establishing UK residence; and

— loopholes and anomalies in the remittance basis rules will be removed.

This followed a period of consultation, including the issuing of a HM Treasury consultation document in December 2007 and draft legislation on 18 January 2008. As a result of that consultation various changes to the detail of the proposals were announced at the Budget and are included in the legislation.

At the Budget, the Government also gave a commitment that the rules for the remittance basis of taxation would not be revisited for the remainder of this or the next Parliament.

Encouraging Enterprise

The Budget also announced an increase in the maximum amount of investment in qualifying companies in respect of which an individual can obtain Enterprise Investment Scheme (EIS) income tax relief from £400,000 to £500,000, which is introduced by clause 28 of the Finance Bill. The increase will only apply once it has been brought into effect by Treasury order following approval by the European Commission.

The Commission is currently considering the UK's application for approval of all three tax-based venture capital schemes—the EIS, Venture Capital Trusts (VCTs) and the Corporate Venturing Scheme (CVS), and the changes made by clause 29 and Schedule 11 are designed to help secure approval. These changes add shipbuilding and coal and steel production to the list of activities that investee companies under the Corporate Venturing Scheme (CVS), Enterprise Investment Scheme (EIS), and Venture Capital Trusts scheme (VCTs) are excluded from carrying out to any substantial extent.

The Enterprise Strategy sets out how the Government will encourage further business start up and growth. Focusing on small and medium sized businesses, the strategy outlines a new framework for Government action and details five enablers of Enterprise (Culture, Knowledge and Skills, Finance, Innovation and Regulatory framework).

The EIS consultation document is part of a process of consulting users of the scheme to improve its operation in practice. The document largely focuses on operational and definitional issues. It has been welcomed by stakeholders.

To improve the evidence base underpinning these schemes, HMRC commissioned the Institute of Employment Studies (IES) to undertake an econometric study to find out whether investment raised through the introduction of the EIS and the VCT scheme has had an impact on UK company performance. HMRC published the results on 12 March 2008.

21 April 2008

Examination of Witnesses

Witnesses: MR MARK NEALE, Managing Director, Budget, Tax and Welfare, HM Treasury, MR GEOFFREY LLOYD, Director, Corporation Tax and VAT and MR DAVID RICHARDSON, Director, Charity, Assets and Residence, HM Revenue and Customs, examined.

Q302 ***Chairman:*** Good afternoon and welcome to our witnesses from the Treasury and Revenue and Customs. Thank you for spending some time with us this afternoon. As you know, this year our inquiry focuses on three aspects of the Finance Bill—capital gains tax, residence and domicile and encouraging enterprise. Thank you for your written evidence. As you know, we have already heard from a wide range of professional, business and academic witnesses but your appearance is a crucial part of our inquiry. I do not know if you have any initial statement you want to make?
Mr Neale: I do not think so.

Q303 ***Chairman:*** In which case we will move straight into questions and we will start off with consultation. It has been put to us by the representative bodies that the consultation on both capital gains tax and residence and domicile were very poorly handled and fell far short of the good practice they have seen on other topics. How far do you think that criticism is fair in each of the two instances?
Mr Neale: The first thing to say is that both for HM Treasury and HM Revenue & Customs consultation is a key part of getting tax policy and delivery right, and I think I can say 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—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.
Chairman: Let us go into a bit more detail. Lord Barnett?

Q304 ***Lord Barnett:*** Of course one understands that the people who have been consulted will often feel there is a lack of consultation when you do not agree with them but some of our witnesses made specific points. They said there was a lack of clear and consistent policy statements from the outset and a lack of openness from the beginning and, more importantly and I am sure you will agree with this, there was a lack of coherence and communication between the Treasury and the Revenue.
Mr Neale: I do not agree with the last bit. You have dealt quite a charge sheet there. 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, 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. I am interested to read what many of those who have given evidence to you have said, and one of the things which emerges quite graphically from some of the evidence you have heard is there is a tension between people who say, "This consultation is creating uncertainty, we want answers quickly", on the one hand, and others of your witnesses who say, "This consultation was too quick and did not allow enough time to explore issues" on the other. Inherent in any consultation is that tension between uncertainty, which consultation always creates, on the one hand, and fully exploring the detailed issues on the other.

Q305 ***Lord Barnett:*** Of course there is often a difference, is there not, between the Treasury and HMRC, in the sense that the Treasury would be more concerned with the amount of tax raised or not raised, whilst the Revenue would be concerned with the way it all works.
Mr Neale: 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. We cannot have a successful policy which HMRC cannot satisfactorily deliver, any more than we can have successful delivery of a policy that is not properly thought through and developed. So we work together extremely closely.

Q306 ***Chairman:*** Do the Revenue want to comment on that?
Mr Richardson: On capital gains tax and residence and domicile certainly the teams from both sides of the Treasury and HMRC worked very closely together and I think achieved a lot in the time. Certainly one of the things I noticed is that a number of people giving evidence to you have recognised that, on various issues we listened very carefully and responded, so I took heart from some of those comments.

Q307 ***Lord Sheppard of Didgemere:*** Do you think one of the things which caused some of the complaints or comments we have received about residence and domicile was that talks had been going on at least since 2002, and maybe before then in some cases, and yet the final outcome did not bear one to one with some of those debates.
Mr Neale: It was a review which was begun in 2002, you are absolutely right, and I think that bears out what I was saying about the tension between certainty and getting to the bottom of all the issues. There were certain people who would have liked us to wrap it up sooner than we did; equally there were people who would have liked us to delay implementation of the measures further in order to explore in greater depth some of the issues which emerged when we consulted.

Q308 ***Lord Paul:*** It has been put to us that after the announcement on capital gains tax it was difficult for the professional bodies to get into the consultation process. It was said that four trade bodies were consulted but not more widely. Is this correct and, if so, why was this?
Mr Neale: I read that and I was fairly mystified. We have very close relationships with the professional bodies and their associations. We certainly talked to them about capital gains tax and they have all got my telephone number, so I am not aware we failed to adequately consult them. I do not know if HMRC colleagues want to comment?
Mr Richardson: I have to say I was puzzled as well. 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. Also the PBR documentation set out a contact number and there is nobody who contacted us we did not respond to and talk to about their issues.

Q309 ***Lord Paul:*** Did you consult with the accountants and the lawyers?
Mr Richardson: We certainly met with the ICAEW and we met with some of the big four accountancy firms and some of the law firms.

Q310 ***Lord Powell of Bayswater:*** A couple of years ago this Committee was quite critical of the consultation on inheritance tax and trusts, and I guess in the light of the weight of the evidence we have had this year we are going to be critical again on consultation. Presumably you have given some thought to this and why you get the criticism. Have you got some ideas which you are willing to put forward to the professions and the various groups as to how consultation could be improved? Is this something high up on your agenda?
Mr Neale: It is very high up on our agenda. We attach a huge amount of importance to effective consultation and we are in constant dialogue with the professional associations about it. I went to an event only a couple of weeks ago at the Chartered Institute of Taxation to talk about how we consult and we do learn from each consultation that we undertake. Not every consultation is the same, we try to tailor consultations to the issue and the circumstances, but as I explained at that event there are constraints on consultation. As I have said, we do not tend to consult on changing tax rates because it is very clear what the winners and the losers will say. There are sometimes issues to do with forestalling, if we expose our hand too soon, and there is the issue I have

already talked about of balancing certainty on the one hand and getting underneath some of the detailed issues on the other. But we learn from the consultations we undertake and we do have a very good dialogue with the professional bodies about how we go about it.

Q311 ***Lord Powell of Bayswater:*** We all understand the constraints, indeed in my recollection Chancellors do not always consult Prime Ministers about changes in tax rates, but the complaint is so widespread amongst the witnesses we have heard that I would have thought an initiative from Treasury and HMRC to go out and say, "Look, here are some ways in which consultation could be improved", always bearing in mind you cannot consult about tax rates, would be very well received and perhaps avoid the slightly painful sessions we have had this year.
Mr Neale: We can certainly look at that but we do have a very good, continuing dialogue, as I have said. We meet the professional associations on a very regular basis, consultation is almost always one of the issues we discuss with them, and I have seen, I am pleased to say, from some of the evidence you have received that many of your witnesses have commented very favourably on a lot of the consultation we have undertaken recently, for example on foreign profits, aviation and tax managed service companies. Clearly we can and will improve but HM Treasury and HMRC get it right much more often than we get it wrong.

Q312 ***Lord Wakeham:*** I do not want to ask the same question again in another form but one of the things we did say to a number of our witnesses was, would they come forward with proposals to you about how they think the consultation process can be improved, and I take it from the answer you have given that you would obviously read what they have to say and study what they have to say and if you think it is sensible you would go along that way. I wonder if I can ask you a slightly different question and that is this: at least one witness, as I recall, said that they felt when they had actually got to the minister they did not think the minister had quite got the briefing they would have liked them to have had. In other words, that the ministers understood the Inland Revenue's point of view very clearly and were there to defend it, but they felt, and I am not saying they were right, that the ministers had not really understood the points that some of the associations and professional people were putting. Do you think the process works well right the way through?
Mr Neale: I will let Geoff and David comment but I would certainly regard it as part of our duty to serve ministers to ensure that they have a full and fair account of the views of the people we had been consulting on issues. That is the whole point of consultation.

Q313 ***Lord Wakeham:*** Many of us round here have been Treasury ministers in our time, so we are not unaware of the process, but this was a comment which worried me when I heard them say that, that they felt they had not quite appreciated some of the points.
Mr Neale: I hope they will come back to us and let us know where they think that was the case, but I would certainly, speaking for the Treasury, regard it as fundamental to our professional duty to ministers to ensure they had an absolutely clear account of where people saw difficulties with proposed legislation.

Q314 ***Lord MacGregor of Pulham Market:*** Mr Neale, you said the proposals were properly thought through and developed when you were talking about the relationship with HMRC, but I cannot remember a case when there was so much criticism of the detail and practical working as there was on the residence and domicile proposals. We know changes are still to come in the Finance Bill quite late and I suspect that will not be the end of the matter. It does seem much of the consultation you had was ignored. How did you get it so badly wrong? I know you made some changes in January, that was well received, but there were still a lot of practical problems. Why was it that ministers were not advised of the practical problems which have emerged?
Mr Neale: I am not sure I agree with you that we got it wrong. We had some clear policy objectives which were set out first in the Pre-Budget Report of 2007 and then in a consultation document on the taxation of non-domiciled residents in December 2007. We then published some draft legislation precisely in order to test whether we were carrying those policy intentions into law effectively. You are absolutely right to say that that caused many people to raise issues with us. That is the purpose of consultation. The legislation took us into some quite complex territory, particularly in relation to offshore trusts, and we considered very carefully and ministers considered very carefully the representations and issues raised with us and responded to them.
Mr Richardson: Really just to echo that. As has been mentioned, a number of your Lordships have been Treasury ministers and will know the devil is in the detail very often in tax. Certainly in the area of residence and domicile that is very true. Therefore, as Mark says, a good part of the consultation was in order to get some of that technical detail right, and some of it did not deliver the policy objectives, and no doubt we will come on to that later in more detail. But that was the point of the consultation, which was to enable us to get these details right and I hope we have done that now.

Q315 ***Lord MacGregor of Pulham Market:*** We will come on to that obviously, but I must say it is not so much the devil is in the detail, I think some of the original proposals were deeply flawed and that is why you have had to make so many changes. It has been put to us that the relationship between HMRC and the Treasury is not working well and it might be better to bring the policy formulation process back into the Treasury and recombine the HMRC parts within the Treasury. How do you respond to that?
Mr Neale: 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 & 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. Clearly you could draw the lines in slightly different places but I think the key to this is not really where you draw the line but a really constructive and harmonious partnership between the two organisations, and that is certainly what we, who lead the policy partnership on either side, try and ensure we have.

Q316 ***Chairman:*** Let us move on to the three particular issues we have been considering, starting with capital gains tax and entrepreneurs' relief. You set out the aims of the CGT reform package as being international competitiveness, flexibility and sustainability. We have been told that certainly as announced in the PBR and even with the subsequent introduction of the entrepreneurs' relief that the tax is not internationally competitive. Would you care to comment on whether the tax as it has turned out has met your aim?
Mr Neale: It 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% 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.

Q317 ***Chairman:*** Coming on to sustainability, it has been suggested to us that given the extent and frequency of changes, the encouragement possibly of speculative rather than long-term gains and the denial of legitimate expectations and so forth, all that has engendered a lack of confidence in the system as a whole and therefore in the sustainability of the system. How do you feel about that?
Mr Neale: 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. As I have mentioned, there is a slightly different regime for entrepreneurs disposing of businesses. I certainly do not agree that this promotes speculative investment or gains, it is a regime that is neutral as between the holding of one kind of asset or another and is neutral as between the time periods over which assets are held, and that should mean people will hold whatever assets it is economically sensible to hold and hold them for as long as it is economically sensible to do so.

Q318 ***Lord Barnett:*** Is not sustainability actually an impossible aim given your knowledge of the history of changes every year in Finance Bills because of errors in previous Finance Bills?
Mr Neale: 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.

Q319 ***Lord Barnett:*** Taking this suggestion that legitimate expectations have been denied, why were there not what might be seen as fairer transitional provisions, for example with grandfathering?
Mr Neale: 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%, 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%.

Q320 ***Lord Barnett:*** How did you come to choose 18% incidentally, rather than 15 or 20?
Mr Neale: We wanted to arrive at a rate which was both simple and internationally competitive.

Q321 ***Lord Barnett:*** So it was not to do with revenue?
Mr Neale: It was to do with arriving at a rate that was internationally competitive.

Q322 ***Lord Barnett:*** There were some six months before the changes came into effect. Some taxpayers managed to take advantage of the disposals in order to obtain the benefits which were not available to everyone. Would it not have been more reasonable to

allow a deemed disposal at 5 April 2008 for those who wanted it?
Mr Richardson: 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% rate.

Q323 ***Lord Barnett:*** Is it not a fact that the way you did it, as far as taxpayers were concerned, depended on the quality of their professional adviser rather than the law?
Mr Richardson: 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% which is historically a very low rate for capital gains tax in this country and is internationally competitive, as Mr Neale has said.

Q324 ***Lord Sheppard of Didgemere:*** Following on the specific point which came up from a number of people who spoke to us and following on from what the Chairman has been saying, the elimination of the frozen indexation which came in in 1998 seems to have been criticised by a lot of people and regretted by a lot of people.
Mr Richardson: As you say, indexation was frozen in 1998 for the period March 1982 to April 1998. That was some time ago and therefore the number of assets being disposed of now to which that frozen indexation applies is relatively small and continually declining. The last statistics that we published showed that something like 17% of disposals had frozen indexation attached to them. That frozen indexation was a cause of part of the complication in the capital gains tax system in particular because it made pooling of shares much more complicated. You can have shares of the same sort purchased at different times. The simplest arrangement is if you have a single pool but once you have indexation, taper relief and so on you end up with lots of different pools and quite complicated arrangements. Therefore, the combination of the fact that there are relatively few assets now to which it applies and the fact that it was causing complication pointed to removing it. The situation this time round is very different from when taper relief was introduced and indexation was frozen. At that point all of the assets up to the point when taper relief was introduced had indexation attached to them. So it was not like now when you only have 17% or less. It was 100% of the assets which had indexation attaching to them. The second difference was that taper relief did not take effect immediately. You had to hold your assets for a period of time before you got the benefit of the taper relief, whereas the proposals that we have now introduce the 18% immediately. Given those considerations, it is a different situation and therefore ministers took the view that indexation should be abolished.

Q325 ***Lord Sheppard of Didgemere:*** Although I agree that time would have eliminated a lot of the frozen indexation, on the other hand, a lot of people would have second houses which would have gone on during that period so it could apply to them.
Mr Richardson: There will obviously be some people that indexation would have applied to and now does not but equally there are a lot of people who will find an 18% rate lower than the rate that they would have been paying otherwise.

Q326 ***Lord Paul:*** We have received mixed messages as to whether the major aim of simplification has been achieved. Some think that there can be no real simplification until the rules for computing the size of the gain or loss are simplified. In this respect therefore the current changes make little difference. How do you see the overall position and how would you respond to the sceptics?
Mr Richardson: There are a number of witnesses you have taken evidence from who have been quite clear that the changes are simplification and that is certainly our view as well. If you look at what has been removed, taper relief on business assets, a different taper relief for non-business assets, indexation and some weird and wonderful things like the kink test, halving relief and so on, all of those have complicated rules attached to them and the interaction of them made it even more complicated. Pooling is probably one of the most obvious examples which is now much simpler. It is certainly the case that there is simplification out of what has happened. We now have entrepreneurs' relief which we did not have before and by definition introducing a new relief means a new bit of complexity, but that relief is very focused. There are a lot of people to whom it is not relevant and therefore they do not have to deal with that. For those it is targeted at, we have tried to make it as simple as we can. I suspect we will come on to that in more detail. 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.

Q327 ***Lord Powell of Bayswater:*** The kink test always sounds a bit salacious to me so I will not pursue it any further. We did hear some evidence from the insurance industry that their products were disadvantaged by comparison with other financial products. Have you been able to take account of their representations and make changes or are you intending to do so, or are they just whingeing?
Mr Neale: We had a very good dialogue with the Association of British Insurers as well as insurance businesses. It is important to emphasise that the capital gains tax changes did not alter at all the basis on which insurance bonds are taxed. No holder of an insurance bond is gaining or losing as a result of the capital gains tax changes. The issues the industry raised with us were essentially around the relative position of insurance bonds against other investments. When we looked into this, it became clear that very much depended on the precise circumstances of taxpayers, both when they acquired the bond and when they surrendered it, and whether they were primarily seeking income or capital gains. We came to the conclusion in the end, after a very good discussion, that it would not be sensible to make changes to the law.

Q328 ***Lord Powell of Bayswater:*** Did they appear to accept this conclusion?
Mr Neale: I am not saying that they were happy about that outcome but they have I think accepted it.

Q329 ***Lord Wakeham:*** Many years ago when I first got involved with tax matters, the whole question of trying to turn income into capital gains was a great source of activity for a lot of people. Do not the new proposals bring that back a bit? Are you worried about that and, if so, what are you proposing to do about it?
Mr Richardson: That is an interesting question. Arbitrage is always an issue when you have two different tax rates and it is something that needs considering carefully from the tax evasion point of view. It is worth saying that this is not something that is new compared to the old system because with the old system business assets gave you a ten% or a 24% rate for a business or a non-business asset compared to the normal 40% rate. We have had those issues right up to the current day as well as in the past when we had a single rate of capital gains tax. We gave some very careful thought when these provisions were proposed and discussed, as to whether we ought to accompany them with some form anti-avoidance legislation in addition to what is there at the moment. Our feeling was that that was not necessary at the present time for a number of reasons. One, there is quite a large amount of anti-avoidance legislation in the statute book already around capital gains tax and conversion of income into capital. Secondly, we now have quite a developed body of case law which has developed over a period of time in relation to avoidance, when it works and when it does not. Thirdly, the really new thing we have had in recent years are the disclosure provisions. Those have been very successful in terms of alerting us to schemes very early on so you can take legislation to deal with that. I know that is an issue that your Lordships looked at a couple of years ago in this Committee. 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.

Q330 ***Lord MacGregor of Pulham Market:*** You will have seen in today's press that there has been a big drop in the number of insurance bonds being taken out. Do you think that is as a consequence of this new matter?
Mr Neale: I think it is too soon to tell. There has been a big fall in the take-up of a range of investments as a result of the disruption in the financial markets and I do not think we can confidently attribute that to the CGT changes, no.

Q331 ***Lord MacGregor of Pulham Market:*** It has been suggested that simplification is easier to achieve when changes are made on a revenue neutral basis. Given the experience of this initiative, would you agree with this and, secondly, how confident can you be of the estimates of the yield from these changes and of the cost of the entrepreneurs' relief?
Mr Neale: The Chancellor certainly sees simplification as an important part of a continuing strategy for the evolution of the tax system. I am not sure that revenue neutrality in itself makes simplification easier to achieve because revenue neutrality does not necessarily mean there are no winners and no losers, but simply that the winners and the losers cancel each other out. In the circumstance where there are losers, there will clearly be representations about measures including simplification measures. As to your second point, yes, we are confident about the costings that appeared in the Budget document.

Q332 ***Lord Wakeham:*** Over the years you make estimates of what you think is going to happen. Is there ever any audit done of those estimates

afterwards, as to whether they were reasonably right or not and has any of that ever been published?
Mr Neale: Very much so. We update our forecasts of tax revenues in every Budget and Pre-Budget Report and we are subjected to very vigorous scrutiny on divergences between our forecasts and the revenues that come in.

Q333 ***Lord Wakeham:*** Is that published regularly?
Mr Neale: Yes, very much so.

Q334 ***Lord Wakeham:*** I put a question down to you about the amount of saving that the entrepreneurial relief was going to give and I think the answer came that it was something like £200 million. I do not have any evidence to know but I was slightly sceptical as to whether that was right or not. Will I know one day?
Mr Neale: I would hope so. What will be clear is whether the revenue from capital gains tax matches our forecasts for it or not.

Q335 ***Chairman:*** Why was the entrepreneurs' relief based on the former retirement relief? We have had a number of representations that a relief based on the business assets tapering provisions would have been more familiar for practitioners and HMRC staff and might have been simpler, more comprehensive and would have avoided many of the problems associated with retirement relief. Why did you go down that route?
Mr Richardson: The thing to recognise here is that entrepreneurs' relief has been introduced for entrepreneurs. It is a new relief. It is not a disguised form of taper relief. It has a different target. The objective of entrepreneurs' relief is to ensure that entrepreneurs selling their businesses get relief and that is obviously something quite different from taper relief. There is some cross over but taper relief went an awful lot wider than that. That is why simply using taper relief again would not have been appropriate. The reason that we have based it on retirement relief is that the target for retirement relief was, generally speaking, the target we were trying to achieve with entrepreneurs' relief. It was about entrepreneurs selling their businesses. There is some familiarity with the legislation. It was on the statute book for more than 30 years and there is a small amount of case law which attaches to it to clarify some of the issues where there was some doubt in the early days of retirement relief. Rather than starting with a completely blank sheet of paper, it seemed a sensible place to start. What we have done though is to strip out some of the complexities attached to the old retirement relief. There were provisions in retirement relief around age and ill health which caused problems of interpretation which have gone and equally the rather complicated provisions around qualifying periods. 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.

Q336 ***Chairman:*** There were a number of consequences of going down this route, some of which seemed a little odd. For example, why have you excluded many employee shareholdings from the scope of entrepreneurs' relief? Why is it that the requirement to hold at least 5% of the shares in a company has been put in there? It seems a little skewed in that the person at the top of a team might very well get relief whereas other key individuals playing an active role but with a smaller stake would not. Is that reasonable?
Mr Richardson: This comes back to the purpose of the relief which was to relieve entrepreneurs rather than simply any shareholder or employee. It is a difference in the focus of this relief from taper relief. Obviously employees can qualify for entrepreneur relief if they hold 5% or more. Where one draws the line in terms of deciding what the appropriate percentage should be is a policy issue and a matter for ministers. It is an area that I cannot go into other than to observe that 5% was the figure that was in the old retirement relief, which is where it is borrowed from. In relation to an employee, it is worth reflecting that employees that have shares in all-employee tax approved share schemes are still unlikely to have to pay capital gains tax. If you look at the two schemes, Share Incentive Plans are in effect capital gains free while shares are in the plan because of the rebasing when shares come out of the plan. And with Save As You Earn share schemes, the average amount of gains that people have is something like £2,300 and therefore well within the £9,600 annual exempt amount which is available to everyone.

Q337 ***Chairman:*** Why is there different treatment of companies, partnerships including limited liability partnerships and sole traders in the approach?
Mr Richardson: That is obviously a recognition of the fact that sole traders, partnerships and companies are all slightly different.

Q338 ***Chairman:*** Can they not all be entrepreneurial?
Mr Richardson: They are different organisations, different structures and different legal entities. They need slightly different rules in order to match the circumstances. 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. If that is a sole trader, they will be disposing of something which they directly own and that is how the relief works for sole traders. If you take companies, it focuses on the individuals selling some of their shares in the business. The fundamental point is the same but

obviously it operates in a slightly different way, depending on the particular legal and organisational structure.

Q339 ***Chairman:*** The government has promised to consider the case for disregarding rent received before 6 April 2008. Do you think that is going to lead to a positive outcome?
Mr Richardson: This is a detailed point in relation to what are described as associated transactions. The Financial Secretary in committee said that she would consider that point and that is a matter for ministers. I have no doubt that she will consider it very carefully with due seriousness. For me to prejudge the outcome would be to go beyond my role.

Q340 ***Lord Barnett:*** Whether or not retirement relief is based on the old relief, the fact is that many who have substantially more than the 5% in a business but are unable to sell and then retire will currently no longer be able to get the 10% relief. Is that correct or are you proposing to change that?
Mr Richardson: Can you repeat the question? I did not quite follow.

Q341 ***Lord Barnett:*** Somebody has to have more than 5% and be a director or an employee to get the benefit of the entrepreneurs' relief but it is possible, is it not, that they were not able to sell before they retired and if they sold just after they retired they would not get the relief, would they?
Mr Richardson: If you will forgive me, I will have to revert to letting you have a note on that.

Q342 ***Lord Barnett:*** Under the Act as is now proposed, you have to be either a director or an employee and have more than 5%, but it is possible that somebody can only sell after they have retired and they would no longer be eligible, even if it was only a matter of weeks. Is that not correct?
Mr Richardson: I confess I am not absolutely sure of the facts. I do not want to mislead you so if you are happy to have a note I am more than happy to provide one.

Q343 ***Lord Sheppard of Didgemere:*** It has been suggested to us that serial entrepreneurs have been insufficiently helped by the entrepreneurs' relief because of the £1million etc. Can we have your views on that?
Mr Richardson: Yes. Obviously the entrepreneurs' relief is a lifetime allowance and therefore differs from retirement relief, which was connected with retirement or ill health. So it does recognise the concept of serial entrepreneurs and that was certainly the intention of the design. The setting of that limit at £1 million is a policy matter and a judgment for ministers in deciding what level to set it at. That is the level that they chose. What I think is worth observing is that £1 million is not an insignificant amount of money. For those who exceed the £1 million limit, the tax rate is 18% which is historically a very low figure for capital gains tax. The £1 million, like all limits in provisions in tax legislation, will be kept under review.

Q344 ***Lord Sheppard of Didgemere:*** I suppose it is a political question so the answer is, "Pass", but why was the response to the entrepreneur section that you have just described, where a lot of other special cases were made and rejected? Presumably you can say that was a case for special pleading.
Mr Richardson: I think you have answered my question for me. The design of the policy is a matter for ministers. The entrepreneurs' relief and the issue about people selling in particular small businesses and so on was by far the strongest point that was put to ministers and one that they were very keen to address because of wanting to encourage businesses and entrepreneurs.

Q345 ***Chairman:*** Can we move on to residence and domicile? The question I am going to ask we touched on a little when we considered consultation but I would like to press you a bit further on it. The changes do seem to be on shifting sands. Why did so may changes have to be made between January and the Budget announcement? Why are the Finance Bill provisions still subject to so much amendment? It suggests that things were not thought out fully before you started.
Mr Richardson: Over the years this area of the tax code has tended to be one where any suggestion of changes to the rules has rather generated headlines and controversy is something that has been attached to this for as long as I can remember. It was therefore important to consult on the detail after the Pre-Budget Report to try to get that right. As I observed earlier on, this is an area of tax code that is particularly difficult and tricky. We were very keen to consult on the detail of all of that. The Treasury put out a consultative document in December around the principles and 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 most striking example there was around disclosure where there were a number of stories circulating quite quickly that the clauses were asking people to return details of their worldwide income. Clearly they were not but that took hold quite quickly as a view. The second thing that came out quite quickly from those responses to the clauses was that there were some detailed circumstances which the clauses did not address. Probably an example of that would be the

importation of works of art for public display. The third category of issues that came out quickly in people's responses was bringing to our attention the fact 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. The area that was most clear was around the provisions on trusts. The impact was clearly out of line with the policy intent of ministers. We acted very quickly as a result of that because there were all sorts of stories circulating which were not what ministers wanted to achieve. Dave Hartnett, the chairman of HMRC, put out a clarificatory letter in February which covered those points which I have just referred to. In the Budget 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—moving some of the *de minimis* limits for instance from £1,000 to £2,000 and so on. The Finance Bill being the next stage, 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. We wanted to take the opportunity of the extra time up to the Finance Bill Committee to make sure we got them right. It would be nice to have everything in the Finance Bill but getting it right is more important and that is the process that we are going through at the moment, to get all of that fine detail correct and ready for when it is discussed in Committee in the House of Commons.

Q346 ***Chairman:*** Does not all that suggest that some earlier consultation, at least on this topic, would have been desirable?
Mr Richardson: I am sure any official would always say they would like more time to do anything. We had sufficient time to do what we had been asked. One of the key issues in relation to this subject is the degree of uncertainty caused by the very long review that had taken place in relation to residence and domicile. There was a keenness to see a line drawn under the review. Once it had got past the PBR stage and the final proposals from that review being in the public domain, to allow that to run on for a long period of time and not deal with it in this Finance Bill would have been quite unhelpful. Ministers took the view that it was much better to work quickly and ensure that we got all the details right this time round in order to provide individuals and businesses with the certainty that they were looking for.

Q347 ***Lord Paul:*** It has been suggested to us that if changes like this are to be made there is the need for a proper economic analysis of the consequences to see whether there is a net benefit to the UK. You will probably have seen that it has been put to us that overall these changes may well prove to be an own goal for the UK. Was a full economic analysis done? What is the Treasury's assessment of the net effect of those changes taken over all taxes and expenditure in the UK by the people affected by these proposals?
Mr Neale: Yes. The Treasury always looks at the economic impact of tax changes because economic efficiency is one of our objectives for the tax system. It is not always easy to provide for economic assessment because you are very often looking at people's behaviour or response to a change, which is not always predictable. 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 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.

Q348 ***Lord Powell of Bayswater:*** These proposals have been around for ever. I remember them coming up in the 1980s twice and in the 1990s. Why this time?
Mr Neale: Because a review had been initiated and it was important to draw it to a conclusion.

Q349 ***Lord Powell of Bayswater:*** It had no political motives at all?
Mr Neale: It was important to draw that review to a conclusion.
Lord Powell of Bayswater: There were political motives.

Q350 ***Lord Sheppard of Didgemere:*** The City thought it had reached a conclusion. The expression put to us was that it had been deliberately put into the long grass by yourselves.
Mr Neale: A review was initiated. That was well known. I remember in the run up to the PBR there was a great deal of press speculation about the taxation of non-domiciled citizens and ministers took the view that it was important to bring the review and the uncertainty to a conclusion.

Q351 ***Lord Paul:*** Has it stopped the uncertainty?
Mr Neale: Yes.

Q352 ***Lord Paul:*** I do not think so. That is not the view we are getting.

Mr Neale: Ministers made it very clear that the proposals for taxation of non-domiciles were ones that they expected to last for the rest of this Parliament and the next.

Q353 ***Lord Powell of Bayswater:*** Quite apart from the notice of the changes, coming on to the substance of them, quite a lot of concern was expressed to us that the tax affairs of people affected are going to become more complicated which runs against the government's general purpose of simplification. Obviously different classes of people are going to find their affairs affected in different ways. My question is about what I call the most wealthy. Are they going to find that their affairs become really quite a lot more complex?
Mr Richardson: It very much depends on the circumstances. It is very difficult to give a single answer. It will obviously depend on what income, investments and so on any particular individual has. 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. We have responded to issues that have been raised with us around the £30,000 charge, about ensuring that money brought in to pay it does not count as a remittance and also we are working to ensure that, for US citizens, the £30,000 will be creditable in the US. The wealthy staying on the remittance basis will have to apply the new, tighter remittance rules. That seems fair. The old remittance basis had a number of loopholes like a leaking sieve in many respects. To tighten that up seems a reasonable thing to do and it was something ministers wanted to do. Yes, they are tighter but that is not unreasonable. 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.

Q354 ***Lord Powell of Bayswater:*** You mentioned fairness. Was it very fair both to slap on the £30,000 charge and to take away their personal allowances?
Mr Richardson: They are two different policies. The removal of the personal allowance which obviously applies to everybody was a recognition of the fact that people on the remittance basis have a chunk of income which is not remitted to the UK but is essentially tax free. The personal allowance is also a tax free amount and to allow people to have both seems unduly fair. I do not think that is any different for the wealthy who are paying £30,000. The £30,000 equates to about £80,000-worth of income. The likelihood is that they will probably have a significant amount of income above £80,000.

Q355 ***Lord Wakeham:*** What about at the other end of the spectrum, the person who might have foreign income of more than £2,000, which could easily be just the letting of his house back home? How do you think this is going to operate in practice? Do you envisage them claiming the remittance basis? Who will be responsible for ensuring that they do not receive the personal allowances? Who is going to make the choice? How are they going to make the choice? The whole process seems to me to need a lot of Inland Revenue staffing operations to do. I just wondered whether you had got it right. Can you justify the £2,000? I know it has gone up from £1,000 to £2,000 but even so give us your rationale for that.
Mr Richardson: There are a lot of questions here, which I will take in turn. First of all, the general point is that like the wealthy it will very much depend on the individuals' circumstances as to what the effect of the changes will be. There is the £2,000 *de minimis* which is equivalent to, if somebody has a foreign bank account with a 5% 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. If you take the group of people whose unremitted foreign income is over £2,000, if they want to stay on the remittance basis, they will lose their personal allowances. That will work through the self-assessment system. It will be up to them when they fill in their self-assessment returns to indicate that they want to claim the remittance basis. They will be expected to declare any income that they admit to the UK. We are having a look at whether we can use the pay as you earn system to remove people's personal allowances so that they do not have to go through that self-assessment year after year. We cannot do that for this tax year. People already have their tax codes and we do not always have the information about whether or not they are non-domiciled. Once we have discovered that somebody is non-domiciled and they are not remitting income to the UK, it ought to be possible to simply incorporate that in their tax code going forwards. You asked how we expect people to decide whether or not to claim the remittance basis or to keep their personal allowance. That is a matter for them. I 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? We will be providing guidance to people to help them make that comparison. That is something which we have started work on and that will be available after the clauses are brought into the statute book. You asked about HMRC resources. For me, the issue is 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 will be updating the current leaflet IR20 on residence, and we are looking to provide a new, comprehensive guide to the new rules. All of these I would expect to be available during the course of this tax year. We are working with stakeholders to make sure that we accommodate those groups. We have started talking to the Low Income Tax Reform Group around making sure that we get publicity material that works for some of those lower income groups. Migrant workers are one of those. We are looking at how we can ensure that the publicity material and information are available at the points of contact that some of those people have. The key to making all of this work is around getting the publicity and guidance right. We have a team working on that. Beyond that, on the processing of self-assessment returns and compliance issues, HMRC deals with about 30 million taxpayers. The additional work in terms of processing self-assessment returns from those who until now did not have to file them and the compliance issues around that are very much at the margin. As part of the work we are doing at the moment we will look in more detail precisely at the resource costs but I would not expect them to be significant.

Q356 ***Lord Wakeham:*** Does not the very length and the complication of the answer make the question even more valid at the end than at the beginning? Surely there must have been discussion as to whether or not it would have been better only to deny personal allowances for those who pay the £30,000 charge? It seems a fantastic story and it is not going to worry the Inland Revenue.
Mr Richardson: I am sorry if I did myself no good by giving you a long answer. I was trying to be helpful.

Q357 ***Lord Wakeham:*** It was a very good answer but to me it confirmed that this thing is very complicated and the argument for increasing the *de minimis* level is pretty strong, I would have thought.
Mr Richardson: I do not think so. In reality it is quite simple for most people. I was trying to run through answers to the whole sequence of questions that you asked me. The issue about the removal of the personal allowance is a political policy issue, but it is against the background that the remittance basis gives people the opportunity to have tax free income—personal allowances do the same—and the fairness of allowing people to have both of those regimes. £2,000 is the *de minimis* which will take out a large body of those people at the lower end of the scale. It equates to £40,000 in offshore income in a bank account. Although some choose to present it as complicated, I think it is nowhere near as complicated as some people might suggest.

Q358 ***Lord Paul:*** Would it have been simpler if, instead of 30,000, you had decided to charge 32,000 and save more complication?
Mr Richardson: The removal of the personal allowance applies to anybody who wants to use the remittance basis from year one, whereas the £30,000 charge is in relation to the wealthy after seven years. It is a slightly different set of people involved.

Q359 ***Lord MacGregor of Pulham Market:*** Mr Neale, in answer to an earlier question about the relationship and liaison between HMRC and the Treasury, highlighted the deliverability as being crucially important. The more we listen to all of our witnesses and the more I listen to that answer, I find deliverability extremely difficult to be happy about. I think there will be a huge amount of unintentional evasion, for all the publicity you put out. How are you going to do the monitoring and checks that a lot of these migrants are being truthful in their self-assessment forms or what they have told their employers? Are you going to have liaison with all the tax authorities in the rest of the EU? What happens when, half-way through the year or even later, they suddenly realise that this remittance issue may apply to the individuals and then find that their allowances are taken away which they did not expect at the beginning of the year or their employers did not expect? What role do you expect employers to play? Is that not the main way in which this will be misconstrued and they will have to do a lot of the paperwork themselves. The mind boggles at the complication of the whole thing.
Mr Richardson: As far as compliance is concerned, we use risk assessment to determine where to deploy our resources and we will do that in this area as we do anywhere else. Self-assessment relies in the first instance on the honesty of the individual. Most individuals are honest. I would expect, if we provide the appropriate guidance explaining the rules, that most people would comply with the law. That is how

it has been and I do not see any reason why that should be any different with this group of individuals.

Q360 ***Lord MacGregor of Pulham Market:*** In the UK you have the means of checking where you suspect somebody is not giving proper and full information and the means of checking on their background or whatever. How are you going to do that in relation to the A8 countries and all those sorts of areas? Are you going to go back to their tax authorities and ask them to do the checking for you? How is it going to work?

Mr Richardson: There are a number of things we do in order to risk assess. People's general lifestyles compared with the income they disclose are one issue. Within Europe we now have the European Savings Directive which requires Member States to exchange information on savings accounts in one country held by a resident of another country. That is an automatic exchange of information. Double taxation agreements we have with Member States will have contained in them exchange of information. If in an individual case we felt there was something we wanted to know about, there are provisions for asking. Using all of that information, we will take an assessment on whether there is a case that we want people to answer.

Q361 ***Lord MacGregor of Pulham Market:*** Turning to the middle income executives, I have already asked you where you feel that the burden will fall in relation to the *de minimis* threshold people, but it has been suggested in relation to middle income executives as well that much of the compliance burden will in practice fall on their UK employers. Do you agree? If so, has any assessment been done on the scale of the compliance burden for employers, how much it will cost them, etc?

Mr Richardson: 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. I am aware that some employers with foreign executives here choose to provide assistance to them. Indeed, some of them have tax equalisation arrangements to ensure they are not worse off working in one country or another. That is a matter for them. That is not something that the tax system imposes on them. How burdensome providing assistance might be would depend on the complexity of their individual employees' affairs. It is quite hard to generalise. What we do know with foreign executives working over here is that they tend overwhelmingly to be here for fewer than seven years. They are unlikely to come into the £30,000 regime. The key issues affecting them will be the loss of the personal allowances if they have unremitted overseas income of more than £2,000, which I would imagine is quite likely in relation to that class of person. 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. If they choose to remit income into the UK, obviously that will be assessable under the remittance basis but the level of complexity very much depends on the affairs of a particular individual.

Q362 ***Chairman:*** There is a clutch of other detailed issues that have been put to us as a concern, including the position of those who are in full time education in the UK and stay on to work afterwards, who may come up against the seven year limit; the implications for all-employee share schemes, various impacts of the new remittance rules, differences in the treatment of offshore companies compared with offshore trusts and direct holdings by individuals; some concerns about the rules for mixed funds; grandfathering rules for offshore mortgages and so on. You will see others in the written evidence which no doubt you have had a look at. It was suggested that either the policy justification for those changes needs to be set out or, if they are just drafting glitches, that they need to be corrected. What is being done to address detailed issues of that sort?

Mr Richardson: We have noted all the points that have been coming up in your evidence and that people have given us. There is a variety of technical points there. Obviously decisions on those matters are for ministers. They have all been brought to the attention of ministers. It will be their decision to take on what they want to do about them. There is probably little more than I can rightly say at the present time on those points.

Q363 ***Lord Barnett:*** Can I ask whether any or many have already applied to drop their claims for non-domicile?

Mr Richardson: There is no evidence of that whatsoever at the moment. I am not aware of that.

Q364 ***Lord Barnett:*** You are not aware of any?

Mr Richardson: I am personally not aware of any. That is not to say that there are not some, but I think it means that there is certainly not any significant number.

Q365 ***Lord Barnett:*** The Chancellor recently indicated he might be inclined to offer some relief where it might be damaging to UK interests. If it is shown that some parts of this measure on non-dom were seen to be damaging, is that being considered as a possibility?

Mr Neale: We do not expect this measure to be damaging to UK interests.

Q366 ***Lord Barnett:*** How about the seven year limit? Is there any possibility of increasing that?
Mr Neale: As I said in response to an earlier question, we do not expect there to be any material or adverse economic impact from this measure.

Q367 ***Lord Sheppard of Didgemere:*** Have the universities put a case to you about the seven year rule and the effect of that on the number of overseas students we get, which as you know the universities depend on financially in this country?
Mr Richardson: I am not sure whether it has been put to us by universities. We are certainly aware of the issue. All these issues are ones that we have logged and they will be considered by ministers. I do not think this is a territory that I can stray onto.

Q368 ***Lord Sheppard of Didgemere:*** Is the question of the complexity of the changes in this area and therefore the possibility of anomalies arising going to cause a problem with the Chancellor's statement that he would not want to revisit the position on domicile and residence for some period of time? I forget how long it is.
Mr Richardson: I need to be careful here in giving a helpful answer that I do not in some way undermine the statement that the Chancellor made, because it is an extremely important statement and a real statement about future intent that I know has been very much welcomed by the outside. What the Budget press notice says is that the rules in this area will not be substantially revisited for the rest of this Parliament or the next Parliament. That wording is there to recognise the possibility that there might be some minor, technical anomalies that would need correcting. That flexibility is there but I must stress that the statement is very real about there being no substantive changes. That commitment is very important, but there is that flexibility there in the event that there were some minor, technical anomaly that was discovered.

Q369 ***Lord Powell of Bayswater:*** There was a universal view that it would have been better to have a comprehensive legislative definition of UK residence rather than continue to rely on case law precedent and HMRC practice. Could you explain why a legislative definition was not included with these provisions?
Mr Richardson: We are getting back to policy matters and ministerial issues. In a sense, the existing rules have stood the test of time. They have been with us for an awfully long time and have worked reasonably well. That said, I am certainly aware that some representative bodies have suggested that a statutory test would be useful. I am not aware that there is a consensus on what that statutory test should be. 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.

Q370 ***Lord Powell of Bayswater:*** It can hardly be taken out this year. I accept that but do you think it is a candidate for future consideration? I am not asking you to commit ministers to doing it; I am just asking if you think it is a candidate for it.
Mr Richardson: 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.

Q371 ***Lord Wakeham:*** Do you think there is a serious argument to be considered as to whether there should be a change? I appreciate that you are not going to make the decision but, as a minister, in the time honoured way, I would need quite a lot of persuading to change it; but there are those who say there is a good case for changing it.
Mr Richardson: I need to be careful not to get drawn in a sense. There are clearly a number of representative bodies that think it is a good thing. But I am not clear that there is a consensus as to what they would want. Therefore, one would need to tease out what each of them wanted in order to comment if it was a realistic way forward.

Q372 ***Chairman:*** Shall we move on to encouraging enterprise? Can you explain to us why the increase in the EIS investment limit to £500,000 was made at a time when you published a number of consultative documents in this area? Would it not have been more sensible to stand back and assess where all this might be taking us and then introduce a broader package if it seemed desirable?
Mr Neale: The change to the EIS was not 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. It was against that background that ministers took the decision to increase the limit as part of a wider package of measures.

Q373 ***Chairman:*** Was there an economic case for that increase to be published?
Mr Neale: I am not clear whether we have published an economic case. We will send you a note about that.

Q374 ***Chairman:*** You may be able to tell us now whether there is an economic case for increase made.
Mr Neale: We certainly looked at the economic case for doing so, yes.

Q375 ***Chairman:*** You will send us it?
Mr Neale: I will send you a note.

Q376 ***Lord Wakeham:*** Some of our private sector witnesses have indicated that there might be a case for abolishing the venture capital reliefs to reduce taxes across the board. I wonder what your view is of the assessment of the balance between the two targeted schemes of this kind and using the money for lower rates of tax?
Mr Neale: It is 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.

Q377 ***Lord Wakeham:*** Most of us here have tried that in our time in the Treasury. It has been going on since God was a boy, trying to introduce these things, and none of them has worked very well. I wondered why you thought this new one was going to work better.
Mr Neale: 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.
Lord Sheppard of Didgemere: Could I make a plea that if you do decide to make a change you consult fully and that you are sure of what the implications are for the people in that sector? Otherwise, if you suddenly put it in, there would be quite a surprise. I know you have said you have no plans but if you do can you have full consultation?

Q378 ***Lord MacGregor of Pulham Market:*** Some of the evidence we have received suggested that one of the problems with the EIS and VCT schemes—particularly the EIS scheme—is that they are too complex and put a lot of people off. Therefore the take-up is not as strong as it might be and the objectives are less than desired in achieving take-up. I am aware that you have a document consulting on the rules and processes governing the EIS. How far do you think it is possible to remove the complexity given the need to target abuse?
Mr Lloyd: We do have a very large number of satisfied users with the scheme as it stands. We have had some 14,000 companies invest since the scheme came into existence.

Q379 ***Lord MacGregor of Pulham Market:*** Is that both schemes?
Mr Lloyd: I am talking now about the EIS scheme. In relation to the EIS scheme for example last year 1,500 companies benefited from investment in the scheme. We do put a lot of effort in HMRC into making sure that the rules are administered satisfactorily. We invest in very clear guidance both in our formal guidance internally which is published on the website and with a brief guide to the scheme which runs to ten pages. Only a couple of weeks ago, I visited one of the two specialist units that we have set up to deal specifically with this scheme, called the Small Companies Enterprise Centre. There is one of these in Cardiff and one in Maidstone. We have dedicated resource there that deals with telephone inquiries from prospective companies and their advisers. We operate an advance assurance regime, in some cases giving a turn around to the requests for advanced assurance very quickly indeed if the need is urgent in order to assist companies wishing to access the scheme. As you have mentioned, we have now at Budget time issued a consultative document which is aimed at inviting views on pinch points within the regime. We know that there will be representations being made on that. Some of the written evidence that you have received for this inquiry takes the form of a comprehensive reply to the questions that we have put in the con-doc. We are looking forward to seeing the ways that we can ameliorate the scheme. In short, yes, I think we can make it work. We can make it work well and it is very popular.

Q380 ***Lord MacGregor of Pulham Market:*** Does that suggest that the evidence you are getting from the people who come to consult you and get advice suggests that it is not as complex as is sometimes made out and therefore the take-up is really quite satisfactory?
Mr Lloyd: Of course people will always be looking at the boundaries of the scheme and areas where, in order to target it most closely, there is a particular condition that is part of the rules, whether it is a condition about the ownership or the length of time one has before the money is invested. Without doubt some of those areas do give rise to pinch points in particular cases and it is precisely because of that that we are consulting on whether changes of that nature can be made within the overall ambit of the scheme.

Q381 ***Lord MacGregor of Pulham Market:*** You have talked about the EIS scheme. Have you anything to say along the same lines about the VCT scheme?
Mr Lloyd: We are consulting initially on the Enterprise Investment Scheme but a number of the conditions that apply in relation to the EIS are equivalent to conditions that apply for the Venture Capital Trust Scheme. Therefore, we do expect to hear representations in relation to both as a result of the consultation. I should also say that, as you are aware, both of these schemes are currently before the European Commission for state aid approval and we need to make sure that any *desiderata* that come out of

the consultation are compatible with securing the approval for those schemes which is currently before the Commission.

Q382 ***Lord Barnett:*** It has been suggested to us that the target for the reliefs should be much broader based, including new and start up businesses rather than just small companies. What is your view on that?
Mr Neale: I come back to the underlying rationale here which is to target market failures and the small, entrepreneurial businesses that would otherwise struggle to gain access to finance. I have seen some of the representations from the BVCA but almost by definition, where private equity is interested in investing, the finance is there.

Q383 ***Lord Barnett:*** We have also had representations, admittedly from representatives of venture capital organisations, but I gather they are discussing with you the possibility of the BVCA principles being included?
Mr Neale: We certainly have a dialogue with them but I underline that this is a measure targeted at specific market failures.

Q384 ***Lord Sheppard of Didgemere:*** Do you want to comment on the work done by the University of Sussex and published by HMRC? It is really about damning of the impact of VCT and EIS.
Mr Lloyd: I did not see the study as damning. Nor indeed were we surprised by the results of the study. They do draw out the differences between the effect on performance of those companies that are supported and those that are not. Not surprisingly, the companies that have looked at support under EIS and VCT have been shown as associated with growth of the business in terms of investment, employment and sales. On the other hand, by the very nature of the companies at which those reliefs are targeted, the greater risk that is inherent in those businesses will have its effect in terms of the profitability, the profit margins and the survivability of the companies. To that extent, the results are not surprising. Also, as the report brings out, there are inherent difficulties in assembling a perfect control group in relation to this sort of work. The university did a good job in identifying a control group that was as well matched as it could be with the EIS and VCT supported companies, with all factors other than the support as far as possible being eliminated. Clearly, you cannot eliminate for some factors which the data will not show. For example, the appetite for risk on the part of the entrepreneur or indeed extraneous funding. The results can only be taken so far and they have not been sufficient for us to be able to demonstrate causality or value for money, but they are consistent with addressing the market failure in the way that Mark described previously.

Q385 ***Lord Wakeham:*** I wonder whether there is a case for a further study of the effectiveness of these schemes? We have had comments that the reduction in 2006 of the size of a qualifying company was a retrograde step. It is suggested there ought to be a study of the EIS investment levels pre and post the 2006 changes, in other words whether the work done by the University of Sussex ought to be expanded further than it has been already.
Mr Lloyd: We do indeed publish the amounts of investment into the schemes on an annual basis; we publish those on the website. We have information on the EIS up until 2006-07 and the results for the next year will be published later this year in the normal way, so that data is available for all to see and all to monitor how the schemes are operating.

Q386 ***Lord Wakeham:*** From your point of view, do you think there is a need for any further study of the effectiveness of these schemes?
Mr Lloyd: We have just got the results of the study recently, and we will be looking at the database which is underlying that over the summer. As the study said, there may be a case for looking at a longer time series in order to get a better handle on the effect of the scheme. But I come back to the point about the inherent weakness in relation to demonstrating categorically cause and effect in relation to these schemes. Yes, we are looking at whether a further study can be a valuable one but we need to bear in mind it will not necessarily give us a conclusive result.

Q387 ***Lord MacGregor of Pulham Market:*** Mr Lloyd, you referred earlier to the consultations with the European Commission, can you tell us the progress on that and how restrictive you think this process might be in developing those schemes as you might like to do it?
Mr Lloyd: I am confident the schemes we have notified to the Commission will receive approval under the rules. Inevitably the process is somewhat drawn out and we still do not have that approval, but we have been speaking to the Commission throughout and we have informed them of the increasing investor limits which is the subject of the Finance Bill measure, and we are confident that approval will be given.

Q388 ***Chairman:*** Any more questions members would like to put? Any more comments you would like to put to us which we have not covered? In which case, thank you again for spending your time with us and for your evidence which will be a useful contribution to our report.
Mr Neale: Thank you very much.

Supplementary memorandum from HM Treasury

I write to clarify two Points Treasury and HMRC officials were not able to address when they gave oral evidence to the Finance Bill Sub-Committee last week.

First, Lord Barnett asked (at Qs 341 – 2) whether an individual who held more than a 5% holding in a company but had retired from being a director or employee would be able to claim entrepreneurs' relief. The position is as follows.

Entrepreneurs' relief may be available where an individual disposes of shares in a trading company (or the holding company of a trading group) provided that the individual making the disposal is an employee or officer of the company, and has at least 5% ofthe ordinary share capital of the company which confers at least 5% of the voting rights.

All of these qualifying conditions must be met for a period of 12 months ending either:

— on the date of disposal of the shares; or

— if earlier, on the date the company ceased to be a trading company or the holding company of a trading group.

Where an individual retires—that is, he or she ceases to be an employee or officer of the company (or the group)—before the disposal of the shares, he or she will not qualify for entrepreneurs' relief unless:

— the company ceases to qualify as a trading company (or ceases to qualify as a holding company of a trading group) on or before the individual's retirement; and

— the individual was an officer or employee throughout the 12 month qualifying period referred to in the second bullet point above.

In this case relief may be available, if all other qualifying conditions are met, even though the individual is not an officer or employee of the company at the time he or she disposes of the shares.

Secondly, the Chairman asked (at Q373) whether an economic case had been published for the increase in the enterprise investment scheme investment limit. While no economic case was published, the Treasury considered a variety of factors such as potential cost and impact, before making this policy change.

I hope this clarifies these points, but do please let me know if you need any further information.

28 May 2008

Memorandum by The Association of Investment Companies (AIC)

1. The AIC welcomes the opportunity to comment on the Finance Bill 2008 and related issues. Our specific interest is the Government's policy on enterprise and reforms to the VCT regime. We have a particular insight into these issues as we represent Venture Capital Trusts (VCTs) which invest exclusively in smaller growing businesses.

2. Smaller businesses are inherently risky (they have a high failure rate, for example) but they are important employers and can evolve into large, economically significant, companies. This creates a strong justification for the Government to try and create an environment that supports their development—in particular developing policies that address market failures which impede their successful growth.

3. Small firms may struggle to deliver their full potential where they cannot raise investment funds despite offering a potentially attractive commercial proposition. This situation might arise where they lack the resources, profile and a track record to attract mainstream investors. VCTs are designed to address this market failure.

4. VCTs are able to target smaller, riskier businesses with investment funds because the relative risk of their investment portfolio is reduced by tax incentives for the end investor. These incentives are targeted on retail investors and enable them to benefit from income tax relief when purchasing newly issued shares and also to receive dividends, and capital gains on disposals of shares, tax-free.

5. The specific details of the VCT scheme are complex and have been subject to various changes over recent years (which mean that individual VCTs launched in different years have to operate under slightly different rules from one another). With this in mind, the AIC has prepared a fact sheet exploring the main features of VCTs and how the rules have evolved. It can be accessed through the link below:
http://www.theaic.co.uk/files/factsheets/AICVCTFactsheet.pdf

6. The AIC has 96 VCTs in membership (out of an industry total of 126). VCTs manage some £2.8 billion in assets and the AIC's members represent approximately 90% of that total.

7. It is perhaps worth noting that the AIC is distinct from the BVCA (which represents fund managers) as our members are the VCTs themselves (personified by their independent Board). Our mission is to help our members deliver greater value for shareholders over the longer term. However, the interests of VCTs and their managers are closely aligned and we often work together to support the interests of the sector.

8. **Enterprise: unlocking the UK's talent**

9. The Government has correctly identified the promotion of an enterprise economy as an important priority. Although markets and private enterprise are fundamental to delivering growth and economic prosperity, they do not operate effectively in all circumstances. The Government can therefore play a valuable role in identifying ways to overcome market failures to help stimulate levels of economic activity within the UK.

10. HM Treasury and BERR have identified five areas where government activity could help enable enterprise: culture; knowledge and skills; access to finance; regulatory framework; and business innovation. This overall framework is helpful in identifying key themes for possible government intervention. VCTs play an important role in supporting this agenda.

11. **Knowledge and skills:** VCTs inject business expertise into smaller companies which may have management teams that are relatively inexperienced or incomplete. As part of their investment agreement, VCTs will often appoint a representative (from either the fund manager or the board of the VCT itself) to the board of the investee company. These are experienced individuals able to offer valuable skills for the smaller company. The skills provided will depend on the needs of the investee company. Often they will simply involve general commercial insight and expertise. In other instances they may relate to the specific sector the company is operating in. So, for example, a VCT specialising in, say, healthcare, may provide experience related to that market.

12. The investee company benefits from this arrangement through increased knowledge and expertise within its management team. This should help it develop its overall commercial proposition and negotiate specific business challenges more successfully. The VCT benefits because the input will help deliver a stronger investment performance and reduce the risk of failure.

13. **Access to Finance:** Clearly, the provision of finance is the critical role for a VCT. They have become an important source of funding—with some £2.8billion of assets under management within the sector. Their role could become even more significant over the next few years as slowing economic growth and withdrawal of bank lending facilities restrict other sources of development financing.

14. VCTs do not focus on start ups (although some do provide funding at that level). More often, they invest in companies which have been established for a little while but need funds to move to the next stage of their development. Each tranche of investment by an individual VCT is usually between £250,000 and £1 million. However, particularly for companies with a high rate of cash consumption, VCTs are also invaluable as they can also be a source of follow-on funding, which is often critical to support the ongoing development of a business.

15. Investee companies will often have exhausted traditional funding sources for immature businesses (friends and family, re-mortgages, bank overdrafts, business angels etc) before a VCT gets involved. However, because of their inherent risk or the level of their funding requirement, they may not be able to secure permanent bank finance or equity investment from traditional private equity. VCTs fill an important gap for companies with assets up to £15 million (although, it should be noted, that newer VCTs are only allowed to invest in companies with assets of up to £7 million).

16. The majority of VCT investee companies are unquoted. However, a significant proportion of the sector (around 25%) is dedicated to investing in newly issued AIM-quoted company shares. The move to a public quote is an important developmental stage for growing companies. However, smaller companies only seeking to raise moderate amounts of capital may struggle to secure the attention of large institutional investors, who typically invest in much larger issuers. Traditional institutions may not have sufficient appetite for risk to want involvement in these relatively small stocks (which are also often quite illiquid). The VCT sector has traditionally played an important role in purchasing shares of smaller companies which come to AIM (or equivalent investment exchanges) and so provide access to capital for these developing businesses.

17. **Business innovation:** Innovative business propositions are, by their nature, inherently risky. They may rely on an unproven technology or business model. They may also not have a tested market. Whatever the reason, innovative companies do face difficulties, particularly in raising finance. VCTs have become an important supporter of these companies. They have also developed formal links which support the development of innovative companies. Most significantly, a number have developed strong links with centres of innovation, such as academic institutions. As the VCT market has matured, VCT boards and their managers have become

increasingly experienced in identifying innovative businesses with commercial potential and helping them develop.

18. All aspects of the role played by VCTs in supporting the enterprise agenda should be fully recognised by the Government and broader policy community.

19. **Impact of the Enterprise Investment Scheme and Venture Capital Trusts**

20. This research paper provides useful evidence of the impact of VCTs and supports continued public policy support for the VCT scheme.

21. It finds that VCTs are invested in companies seeking to increase their level of capital investment (often a characteristic of companies which are seeking to deliver growth). They also invest in companies which support higher levels of job creation and sales turnover than other smaller businesses. The employment effect, while small overall, is particularly encouraging from a public policy perspective.

22. However, the research also indicates that VCT invested companies may have lower survival rates and lower profit margins than other small businesses. The AIC believes that there may be some difficulty with these conclusions.

23. For example, it is not clear that the public data (on which this study was based) has the capacity to provide a true picture of survivability as it focussed on whether or not investee companies continued to trade independently. It may not have recognised cases where a company owned by a VCT is sold to a trade buyer and agglomerated into a larger group. This company would no longer be trading independently but this is not a failure of VCT investment. The VCT has supported an ongoing commercial activity which provides continuing economic activity and supports growth and employment creation. It would be useful if further research could explore the impact of these situations on the survival rates of VCT backed-businesses.

24. It may also be useful for further research to provide more insight into the report's conclusions on profitability. The basis upon which this conclusion was constructed is not entirely clear and it may be that further research will provide more useful insight into the role that VCT funding can play. Again there may be some difficulties with the public information available.

25. While there is room for further research to clarify these points, this study provides valuable support for the VCT scheme. After all, market failures in the provision of finance are more likely where the commercial proposition is challenging. This might well involve circumstances where an innovative business requires high levels of investment in fixed assets before it is able to develop its business model which makes attaining profitability is more challenging. The study indicates that VCT investment is correlated with companies of this type. These are most likely to face a funding gap.

26. Also, even if survivability is slightly higher than the research indicates, it is understandable that VCTs may be investing in companies with a higher failure rate than the wider market. They are targeted on young, growth-orientated companies yet to make a profit which are investing to support an unproven commercial proposition. Such companies are inherently risky and more likely than others to fail.

27. We also anticipate that the majority of firms that VCTs have successfully invested in are still in the relatively early stages of their commercial development. This is likely to mean that the greatest impact of VCT investment is likely to emerge in the future. VCTs support precisely the sort of companies with funding needs which may be difficult for the mainstream market to satisfy, but also have the potential to deliver strong benefits when they mature.

28. It is also significant that the research highlights different characteristics of VCT investee companies in comparison with those supported by the Enterprise Investment Scheme. This confirms the AIC's view that the Government should support a range schemes targeted on enterprise as this will help develop different parts of the small business community.

29. **Maintaining the ability of VCTs to support the enterprise agenda**

30. Critical to ensuring the continuing effectiveness of the VCT sector will be minimising the amount and complexity of unnecessary regulation it is subject to.

31. Much of the current regulatory burden stems from the tax-favoured status of VCTs. As the Government is providing attractive tax benefits for investors which represent a direct cost to the Exchequer, regulation is needed to ensure that VCT funds are targeted on appropriate investee companies and to protect the scheme from abuse. However, recent years have seen the number of rules governing VCTs increase. Particularly

notable are the introduction of new regulations which the European Commission has required the UK Government to introduce because of State Aid considerations.

32. "State Aid" driven measures include, for example, the prohibition on future investment by VCTs in coal, steel and shipbuilding activities (introduced under Clause 29/Schedule 11 of the Finance Bill 2008). This restriction has been required by the Commission as part of the ongoing process of securing State Aid approval for the scheme. This individual provision is unlikely to have a seriously detrimental impact on the VCT sector. To date very few VCTs are involved with these sectors. Even without the new prohibition future interest would remain limited as, by their very nature, these industries are relatively established and operate on a scale which does not fall within the likely scope of VCT investment. However, this does create an additional rule to be monitored and complied with, for no real purpose.

33. More significant are the rules (introduced via the 2007 Finance Act) which prevent newly raised VCT funds from being invested in companies with over 50 employees and in companies which have previously received £2 million from tax-favoured investment vehicles in the previous 12 months. These rules are unhelpful and will limit the investment flexibility of new VCT funds. The 2007 requirements will also increase ongoing compliance costs where the VCT has raised funds in different years, under different rules, and have to maintain and monitor separate investment pools.

34. The UK Government has successfully managed to limit the impact of introducing these rules (for example, by ensuring they only apply to new funds raised and not the entire VCT industry). We also recognise that it has had to accept these restrictions to protect the scheme and achieve State Aid approval. We anticipate that Commission approval—conditional on these reforms—is likely to be forthcoming later this year. Successfully securing this approval will be an important success for the UK Government as it will secure the status of the VCT scheme.

35. However, once the State Aid process has been completed, it will be important to consider what scope there might be to change the framework through which the Commission considers this issue. In particular, the AIC is keen to work with HM Treasury/HMRC to establish what scope there may be to enable allowable State Aid (particularly in relation to VCTs) to be administered more simply. The formal opportunity for this will arise in 2009, when the Commission reviews its, "Community Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium-Sized Enterprises" (the so-called SARC Guidelines).

36. We are engaging with HM Treasury and HMRC to establish how the industry can work with the Government to input successfully into this review. We have been very encouraged by the Government's appetite to work with the industry to build the evidence-base and to inform the Commission's view of the limits of allowable State Aid and the conditions which should be placed upon it. Once the current Commission process has been completed we are confident that we will be able to move forward on this agenda.

37. We are also keen to discuss with HM Treasury and HMRC the current regulatory requirements to establish if there are any areas where deregulation or increased flexibility might be introduced in advance of making progress at the European level. This might include, for example, exploring if there is scope to amend the rules to increase the flexibility which VCTs have to invest in commercial propositions where innovative e-commerce approaches are involved.

38. This debate is in its earliest stage (and the priority is to secure Commission approval for the VCT scheme as it stands). However we look forward to engaging in discussions with the Government as the agenda moves forward.

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