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The Finance Bill 2009

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ABSTRACT

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

This year our report focuses on the Finance Bill's measures on the taxation of foreign profits, real estate investment trusts (REITs) and pensions. In addition, as last year, we consider two issues which cut across these and other topics: first the effectiveness of the process of consultation, a matter on which we were very critical last year; and second the likely impact of the proposed measures on the international competitiveness of the United Kingdom, where again we had had serious concerns last year.

Consultation

Our private sector witnesses were generally agreed that the consultation on foreign profits has been well conducted: we are however concerned that insufficient time was allowed to enable the complete provisions to be included in the Finance Bill as published. We conclude that it would have been very difficult for the Government to have consulted, even on an informal basis, on pensions. However we accept the views of our private sector witnesses that HM Treasury (HMT) and HM Revenue & Customs (HMRC) were at fault in failing to consult over the novel and contentious measures on the duties of accounting officers of large companies and on the naming and shaming of serious tax defaulters: we did not find persuasive the reasons for this put forward by officials.

Competitiveness

As for competitiveness, on foreign profits there was general agreement that the exemption for foreign profits and the changes to the Treasury consent rules were positive changes. But there was less agreement among our private sector witnesses as on how far these were outweighed by the negative impact of the debt cap rules. In our view the outstanding issues on the latter need to be resolved before the overall impact can be determined. We thought that the opinion of officials that the pension changes would have little effect on competitiveness was likely to be over-optimistic and we recommend that the effect of the changes be monitored and kept under review. The likely impact on the UK's competitiveness of the Finance Bill provisions overall is not clear. We agreed with some of our private sector witnesses that it might be narrowly positive if the concerns about the debt cap rules are resolved.

Pensions

We fully accept that the Government has to be free to make the changes it sees fit. But on the taxation of pensions, we regret that significant changes were introduced so soon after the redesign of the whole system. There seems little official recognition that this precedent has undermined simplicity, consistency and certainty or that it risks a reduction in pensions savings. We accept the views of our private sector witnesses that the highly paid may look elsewhere to invest their savings. Whilst the numbers directly affected may be relatively small, among them will be individuals who are influential in determining the pensions policy in many companies.

We accept that the Government intends that there should be a level playing field between defined benefit (DB) and defined contribution (DC) schemes, but close attention needs to be paid to the practical difficulties; we recommend that the Government should complete the consultation well before implementation in 2011. Careful consideration is also needed to avoid exceptionally high marginal rates exceeding 100% from the combination of the marginal rate of income tax and the reduction in pension tax relief on significant increases in incomes which cross the £150,000 threshold. We do not recommend alternative approaches to restricting relief.

We question whether the anti-forestalling provisions are necessary. Solutions will need to be found for all the individuals who have good reason for not making their pensions savings regularly or frequently: these include the self-employed and those retiring or made redundant. If answers cannot be found for all these groups, as a fall-back the special annual allowance should be increased significantly. Otherwise the introduction of these provisions will require the most careful consideration of all the concerns of legitimate expectation, complexity, even handedness and the practical and administrative issues raised by witnesses.

Foreign Profits

On foreign profits, we agree with witnesses from the private sector that it is difficult to assess the package while holes in the Finance Bill proposals remain; that HMT and HMRC should keep under review the possibility of moving towards a "pure" territorial system so that, were the Government to consider that the conditions had become favourable for such a move to fund a cut in the corporation tax rate, the ground work would have been done; and that it is a pity that dividend exemption, which was universally welcomed, has been marred by complicated drafting. We recommend that where appropriate there should also be consultation on the approach to drafting.

We accept the need for some restriction of interest relief. But the debt cap was the part of the proposals least welcomed by our private sector witnesses and we were not greatly reassured by the response of officials as to the case for moving away from the arm's length principle. We were also concerned about the complexity of the provisions and we recommend that the problems need to be resolved either by making changes or by persuading representative bodies that changes are not needed. We also recommend that, since there is already a gap between the coming into effect of the dividend exemption rules and the debt cap rules, the application of the latter should be delayed by a few months unless the outstanding issues can be resolved during the passage of the Finance Bill. We welcome the change in rules for Treasury consents.

Real Estate Investment Trusts

REITs were introduced after careful planning and amidst high hopes. But they have not lived up to expectations, since there are no residential REITs, nor any new ones not converted from property companies. It is difficult to conclude that this is wholly due to economic circumstances and not also to structural defects. In our view the measures in the Bill, though useful, do not go far enough and officials should take a more flexible and responsive approach. HMT and HMRC should look again at proposals by representative bodies, especially for the residential sector. The official approach seems complacent and unduly cautious and there could be reconsideration of, for example, the total entry charge, now that there is more than two years' experience of REITs' operation. The consultations when REITs were introduced originally were excellent and we recommend that advantage of this machinery should be taken to look, in the light of international experience, at what might be done.

Finance Bill 2009

CHAPTER 1: INTRODUCTION

1. This is the seventh report in a series which began in 2003 when the House of Lords Select Committee on Economic Affairs first appointed a Sub-Committee to inquire into selected aspects of that year's Finance Bill. The Finance Bill Sub-Committee's inquiries address technical issues of tax administration, clarification and simplification rather than rates or incidence of tax.

2. Each year the Economic Affairs Committee aims to publish the report drawn up by its Sub-Committee in time to enable members of the House of Commons, if they so wish, to draw on its recommendations in moving amendments to the Bill at the Report Stage. The report should also inform the Second Reading debate of the Bill in the House of Lords.

3. As in previous years the Sub-Committee selected a few topics for close examination. If it chose to examine the whole Bill, its treatment of each topic could only be cursory.

4. This year the Sub-Committee chose three topics which it considered of particular importance. It also considered two issues which cut across these matters and indeed across many other policy initiatives in the Bill which the Sub-Committee did not otherwise examine. First, how the consultative process has been carried out on these topics and whether improvements to the process could be made. Second how, for better or worse, these tax changes affect the international tax competitiveness of the United Kingdom.

5. The first topic involved the changes to the taxation of pensions. The Sub-Committee inquired into the process leading to the restriction of relief for pension contributions, effective from April 2011, and the anti-forestalling provisions in the Finance Bill, in the light of experience of the new pensions regime since its introduction in 2006. The Sub-Committee did not question the Government's right to restrict the relief in principle, nor to set the level at which the restriction is to be introduced.

6. The second topic concerned the reforms to the taxation of foreign profits, representing a move towards a more territorial system of taxing foreign subsidiaries: an exemption from tax for foreign dividends received by all companies; a restriction to the interest deduction rules by the introduction of a debt cap; consequential changes to the rules for controlled foreign companies; and the replacement of the Treasury Consent rules with a post-transaction reporting requirement.

7. The third topic related to Real Estate Investment Trusts (REITs). The Sub-Committee looked not only at the provisions in the Finance Bill, but also at the experience of the REITs regime since its introduction in 2007 and how it compares with expectations then.

8. As in previous years, the Sub-Committee conducted its inquiry by taking written and oral evidence from leading professional and business organisations and from HM Treasury (HMT) and HM Revenue & Customs (HMRC). A list of those who have contributed to the inquiry in this way is

given in Appendix 2: their evidence is in Volume II of this report. The Sub-Committee would like to thank all those who have contributed, at very short notice this year following the late Budget, to its work. Without their help this report could not have been written.

9. The Sub-Committee's findings on the two cross-cutting issues are in Chapter 2 of this report; the three chosen topics are in Chapters 3 to 5. Its conclusions and recommendations are in Chapter 6.

CHAPTER 2: GENERAL ISSUES

10. Last year our report discussed two cross-cutting issues that were common to the topics we examined and indeed went wider. We adopt the same approach this year, looking again at consultation and international competitiveness.

Consultation

11. In last year's inquiry, we confirmed that we were firmly in favour of consultation which should take place as early as possible in the development of an initiative if clarity and certainty are to be achieved. We commented unfavourably on the consultation that had taken place in the development of two of last year's initiatives: the changes to capital gains tax and to the residence and domicile rules. Given the strength of feeling amongst the private sector witnesses, our view was that something had gone wrong in the development of those initiatives. We were particularly disappointed that the progress on consultation, which we welcomed in the 2007 report, had not been maintained in the 2008 changes. So we were keen to examine how good the consultation had been this year.

Consultation on Foreign Profits

12. On the first of the topics that we examined this year, it was a general view amongst our private sector witnesses that there had been extensive consultation on the taxation of foreign profits. There were many positive comments: Mr Peter Cussons, Institute of Chartered Accountants in England & Wales (ICAEW), thought that "If we take the timeline from June 2007 when there was a discussion document put out I think by the Treasury, through to publication of the Finance Bill, as a whole I would say that the conduct of the process has been pretty well handled" (Q 2).

13. The Confederation of British Industry (CBI) expressed the view that: "This year the consultation process on Foreign Profits has been much improved compared with the situation on Residence and Domicile in 2008" (p 37). The 100 Group wrote that they "would like to formally acknowledge the extensive consultation undertaken by HMT and HMRC on these proposals and the many changes that have been made as a result, prior to the publication of the Finance Bill" (p 34).

14. The Chartered Institute of Taxation (CIOT) "commends the Government for ensuring that the foreign profits consultation process has been thorough, and in many ways, an example of how consultation should be done. The CIOT feels that significant improvements to the original proposals have been made as a result of this consultation" (p 56).

15. However, there was not unqualified praise. The ICAEW wrote: "Further consideration needs to be given to these rules, in particular the debt-cap rules" (p 2). The Institute of Directors (IoD) acknowledged that "There has also been extensive consultation on draft legislation" but added that "We do feel that the work could have gone a little faster. In particular, there was a long delay between the closing date for the first consultation, in September 2007, and publication of the next technical note, in July 2008" (p 41). The IoD continues with an acknowledgement that "officials have put a great deal of effort into consultation on the debt cap, and that work to improve the legislation has not slackened off. Proposed changes were announced on

7 April 2009, and further changes in the open letter from the Financial Secretary dated 30 April. But the fact that the Government sees the need to propose changes even at this late stage indicates that further time for consultation would be worthwhile" (p 42).

16. Mr Ashley Greenbank, Law Society of England & Wales (LSEW), expressed the view that "Overall, we found the process a little unsatisfactory … HMRC and the Treasury were very willing to meet with us when we initiated the process but we did not get invited into the process by them an awful lot. As a result we sort of dipped in and out of the process, we felt, and it did not really get moving … For the first time we had some detailed legislation after the PBR in 2008, which is what we have been consulting on ever since. The process after that has been again a bit frustrating. We have been making comments on that detailed legislation but it seems to me that the Treasury and HMRC have been stuck in terms of what the policy is … they have been very prepared to try to ameliorate what we have demonstrated are disadvantages of the debt cap, but have never been prepared really to look again at what the policy is, which is what a lot of our comments were about. Also in the process, because we have always been talking about bits of the legislation that were not there … so there has never been any real in depth consultation on the drafting itself. That is how I feel it has been unsatisfactory" (Q 27).

17. Some were concerned that some of the consultation was happening very late. The British Bankers' Association's (BBA) focus was on an exclusion from the debt cap rules for financial services. Ms Angela Knight commented "Just as we were leaving for this meeting, an email came through to the BBA with some more information for first time on the financial services exemption. The meeting with the Revenue on this is tomorrow. The Finance Bill starts its process tomorrow. For something which is complicated … this does seem extraordinarily late" (Q 50). She put the point more generally "Our concern is that whilst the consultation was good we still sit with so much uncertainty in some very key areas. Amendments that are going to be laid during the Finance Bill by government seem a little late for the proper discussion and reasoned debate on some of these issues" (Q 47).

18. The IoD discussed a particular change and were "very pleased that it was in the end possible to find a solution that allowed the exemption. It was however unfortunate that the solution was not thought of early enough to allow public consultation on its details. We wonder whether there is a lesson to be learnt for the future, about putting in the necessary effort to come up with solutions well before the deadline for finalising legislation" (p 42).

19. The CBI told us that: "An optimal consultative process would not leave extensive important material to be seen for the first time after the relevant Finance Bill has been laid before Parliament. Such sub-optimal process leaves dialogue on important matters constrained by the already unsatisfactory Finance Bill timetable" (p 38). And later in their evidence "the dialogue needs to continue at a level of intensity such that there is minimal residual uncertainty at the times the provisions come into effect" (p 39).

20. When we raised these issues with officials, Mr Mark Neale, HMT, thought that the consultation had been "successful because it led us to an outcome which balances competitiveness gains for business with protection for the Revenue … [and] because it consolidated the good relationship which the

Treasury and HM Revenue and Customs have with business generally in addressing issues of common concern" (Q 150).

21. Asked about whether the consultation could have gone faster in the early stages Ms Judith Knott, HMRC, said that the "early part of the consultation … was not in practice quite as leisurely as it may have seemed from the actual documents that were published, because what was happening during some of those periods where there was no formal publication was quite an intense process of dialogue directly with business, with a lot of meetings and discussions with groups and individual businesses as the process evolved, so that when we did go into publication we very much were not coming out with things that were fresh but things that had been discussed in evolution with business. I think it was better as a result" (Q 151).

22. In responding to the criticism that consultation on some issues, such as the exclusion for financial services from the debt cap rules, had been too late, Ms Knott said "During the consultation on the draft legislation that was published in December we did get a large number of comments in response to that legislation. We did listen to those comments and made a significant number of changes as a result. That process of listening and making the changes does take time, and in some cases, for example the financial services exclusion …, that process of dialogue extended beyond the publication of the Finance Bill" (Q 160). Asked why it had not been possible to start consultation on the draft clauses earlier, Ms Knott defended what they had done "we did start a lot earlier. In fact, I have been involved in this dialogue on foreign profits since I was in the Treasury in 2006, so it has been a long process with a number of consultation documents" (Q 161).

23. **Overall, we were left with a favourable impression of how the consultation on foreign profits has been handled and we welcome that. It was clearly not perfect in the eyes of our private sector witnesses, but it was much better than that on the two topics we looked at last year.**

24. **We accept HMRC's view that although the consultation looked a little leisurely in the early stages, there was much work going on in the background, as well as less formal consultation, so that the next document to be published would meet with more general approval.**

25. **The one area that does concern us is that there was an underestimate of how many comments would be received on the draft legislation exposed in December 2008 and how long it would take to work through these and discuss the points with consultees. This resulted in the Finance Bill being published with changes still in the pipeline.**

26. **We recommend that HMT and HMRC should review the best aspects of this consultation on foreign profits and apply it more generally. In particular, we recommend that they should consider carefully why they did not allow themselves sufficient time to incorporate a complete version of the legislation in the Finance Bill as published and should make every effort to prevent this happening again.**

Consultation on Taxation of Pensions

27. The Government has committed itself to consulting business, pension fund trustees, the insurance and pensions industries and other stakeholders on the substantive changes to the taxation of pensions to be introduced from 2011.

"The Government will use this consultation to engage with stakeholders to introduce the new system in a way that minimises administrative burdens"[1].

28. In anticipation of people forestalling these changes (i.e. entering into additional transactions between now and April 2011 in anticipation of the changes coming into effect), anti-forestalling provisions were included in the Finance Bill. We turn later to consider whether this anti-forestalling schedule is necessary. We asked our private sector witnesses about the possibility of being able to consult on the schedule, given the Government's decision to introduce it.

29. Some acknowledged the difficulty of consulting on an anti-forestalling schedule. Mr Andrew Hubbard, CIOT, put it this way "although we are very much in favour of consultation, there is an acceptance that consultation in relation to anti-forestalling measures is difficult and therefore I do not feel aggrieved in any way that there was no prior consultation on this point" (Q 86).

30. Others were less persuaded that there could not have been informal, confidential discussions. As Mr Neil Carberry, CBI, said "It may have been desirable to take views over coffee perhaps but I do not think that took place. The result, if you look at the anti-forestalling legislation, is that there are a number of areas where unlooked for consequences occur" (Q 65). In answer to the same question Ms Knight said "there is a view developing strongly that if there had been some quiet discussions or consultations, even at a high level with a few experts, some of the cliff edge adverse impact could have been resolved" (Q 65).

31. Ms Maggie Craig, Association of British Insurers, (ABI) echoed this "we do think that a few key organisations could have been consulted informally because it was obvious that this was going to be a huge issue and also, having worked through the proposals, it was obvious that they were going to be complex proposals, so I think that there could have been better consultation" (Q 135). Ms Joanne Segars, National Association of Pension Funds, (NAPF) agreed and added "The changes around the 2004 Finance Act actually seemed to be a model of the consultative process at the time, if I cast my mind back … We very much agree that it would have been helpful had the Treasury been able to pre-consult or, at least, flag in the Pre-Budget Report that these were issues that were under consideration. Now, clearly, there is an issue about people, as you have identified, 'piling' into pensions, as the Treasury call it, to meet the deadline, but we are sure that very clever people at the Treasury could have found ways round that, for example, saying that anybody who did put in extremely out-of-usual patterns of contributions between the PBR period and the Budget could have been treated as avoidance in some way; there are clearly precedents available for that" (Q 135).

32. Mr Frank Haskew, ICAEW, went further in his evidence "On the face of it you might say that there should not have been consultation on an anti-forestalling measure, but I think we are in a different league here. This is a fundamental change to a pension regime and it is such a fundamental policy shift that I think we feel that there should have been consultation on the proposal with a view to it coming in at some future date and that really there

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[1] HM Treasury: *Budget 2009, Economic and Fiscal Strategy Report and Financial Statement and Budget Report*, April 2009, HC 407, para 5.93, The Stationery Office, London.

should not have been anti-forestalling rules of this nature introduced at this time" (Q 16).

33. When these points were put to officials, Mr Neale made the point that "immediately after the Budget—indeed the day after—I convened a meeting with all the interested stakeholders to discuss the implementation of the budget measures and to get a process of consultation underway" (Q 154). On the principle of whether consultation might have been possible on the anti-forestalling schedule before the announcement and its becoming effective, his view was "as you will know, we do not consult about everything in advance of a budget. We tend not to consult about changes to tax rates or to consult about measures which could be subject to forestalling" (Q 154). He said that he found himself very much in agreement with the view expressed by Mr Hubbard. Mr David Richardson, HMRC, added later that "Consulting on the anti-forestalling provisions would be extremely difficult and largely self-defeating" (Q 221).

34. **Given the Government's decision to introduce an anti-forestalling schedule, it would have been very difficult to consult, even on an informal, confidential basis before announcement. Informal consultation is partial, not acceptable to those not involved and can put those involved in a difficult position. In last year's report we recommended "that consultation should be even-handed and open, involving as many as possible of the professional bodies and other parties which have a valid interest"[2]. We hold to that view.**

Consultation on Wider Issues

35. In oral and written evidence, our private sector witnesses commented on other provisions in the Bill where there should have been consultation. In particular, they focused on clauses 92 and 93. Clause 92 is the provision that imposes obligations upon senior accounting officers of large companies. Clause 93 is the 'naming and shaming' provision, authorising HMRC to publish information about serious tax defaulters.

36. The BBA wrote in relation to clause 92 "The BBA is dismayed that HM Government has again chosen to make a policy announcement of this nature in the Budget without attempting to consult industry in advance on the ramifications of its initiative" (p 34). And in relation to clause 93, they opined "It is not clear to the BBA that, as presently drafted, the new proposal on naming and shaming tax evaders is solely limited to evaders, as we consider it should be" (p 45).

37. The IoD commented "We are also concerned that the Government's commendable commitment to consultation is not always reflected in what happens. Two examples stand out. First, the proposals on senior accounting officers (clause 92) would certainly have benefited from advance consultation on the principle, rather than just post announcement consultation on the practicalities. Second, we note with concern the casual mention in a technical note that was published by HMRC on Budget Day, *Furnished Holiday Lettings in the European Economic Area*, that the furnished holiday letting rules are to be abolished from 2010–11 onwards … It should have been given a proper announcement in its own right and been subject to advance public

2 House of Lords Select Committee on Economic Affairs, 2nd Report, (2007–08), *The Finance Bill 2008*, HL 117-I, paragraph 33

consultation on the principle" (p 41). Mr Richard Baron for the IoD went further "[Clauses 92 and 93] are both measures on which we cannot see why there was not advance consultation on the principle" (Q 46).

38. Mr Mervyn Woods for the CBI said: "Mr Baron has already referred to at least two of the major provisions in the Bill on which there has been no consultation at all. It is firmly the CBI policy that where possible the normative process should be to consult first and legislate after and not produce material to go to the House that is incomplete and ill considered in some way, in as much as on examination of proposals in subsequent dialogue with officials it appears that answers to pretty basic questions have not been thought through and are not even immediately available" (Q 49).

39. Mr John Whiting for the CIOT put it pithily "The consultation shortcoming has been on other measures such as clause 92 and 93" (Q 86).

40. When these points were put to officials, Mr James Harra, HMRC, justified the lack of consultation in different ways for the two clauses "in the case of clause 92, … the Government had to take very difficult and urgent decisions on fiscal consolidation, and … this is why this decision was taken at the same time as [those] measures … Going to clause 93, that clause … is based on definitions that are already in legislation for the past two years, in the penalties regime, which were subject to prolonged consultation over a period of three years … Once again, consultation is underway on the practical implementation of this; and given that the first names are unlikely to be published until early 2011, there is time to sort that out and address those concerns" (Q 156).

41. **We remain of the view that consultation should be the norm and only subject to limited exceptions, such as rates, reliefs and anti-forestalling measures. In fact, in their oral evidence, HMRC specifically agreed with this. We are therefore at a loss to know why there was no consultation on the clauses setting out the duties of accounting officers of large companies and the naming and shaming clause.**

42. **We do not find persuasive the reasons put forward by officials why it was not possible to consult on these clauses. Our view is that with measures as novel and contentious as these, there should have been consultation on the principles as well as the practicalities of implementation. Even by their own criteria, we see this as a failing on the part of HMT and HMRC and we recommend that in the future there should be consultation on changes such as these. We hope that it will not be necessary to revert to this issue again in a future report.**

International Competitiveness

43. In this section we turn to the second cross-cutting issue and consider the effect on the UK's international competitiveness of the topics that we have under inquiry, but also more widely where our private sector witnesses commented. Last year we were concerned at the negative effect on the UK's competitiveness of the proposals at which we looked.

Foreign Profits

44. The Impact Assessment on the taxation of the foreign profits of companies stated that "The primary policy objective is to enhance the competitiveness

and attractiveness of the UK as a location for multinational business, while ensuring that the new regime cannot be used to undermine the UK tax base”[3].

45. We asked our private sector witnesses about the overall effect of the foreign profits package on international competitiveness. The ICAEW expressed concern “about the overall balance of the Foreign Company profit proposals and their impact on the UK’s tax competitiveness. Headquartering a multinational business in the UK, or inward investment into the UK, is likely to be less attractive in the future on account of these changes” (p 1). In particular they remained “concerned that the introduction of the worldwide debt cap, as currently proposed, will add considerable complexity to the UK tax system and affect its competitiveness” (p 1).

46. The Association of Chartered Certified Accountants (ACCA) were also “concerned that this may deter inward investment into the UK, as companies may need to gear up to maintain sufficient working capital particularly in a difficult economic climate. The major disincentive to inward investment is uncertainty and, while relieved that the proposed CFC rules have not been introduced, we remain concerned at the administrative burdens and uncertainty engendered” (p 119). The Law Society of Scotland (LSS) thought that “Coupled with the proposed increases in personal taxation these changes [the debt cap provisions] may well mean that the UK is perceived as less competitive in tax terms” (p 21).

47. The overall view of the package was summarised by Mr Cussons “Obviously dividend exemption in Schedule 14 and the repeal of Treasury consents and criminal sanctions and breach of those, both of which come in from 1 July, are extremely welcome … So what we have are two very welcome things; the start of CFC reform, on which it is too early to take a view; but in tandem, a bit like Shelley, a sort of Frankenstein monster has been created, the debt cap” which is going “to create an enormous compliance burden” (Q 3). Mr Mike Hardwick, LSEW, thought that “the main gainers are the UK multinationals, for inbound investors and for wholly domestic groups, I think [the overall effect] is negative” (Q 35).

48. The IoD, whilst warmly welcoming the dividend exemption, thought that “the UK’s competitiveness will be damaged [by the debt cap] deterring businesses from using the UK as a base and reducing opportunities for providers of professional support services. The overall effect on the tax take may therefore be negative” (p 42).

49. The BBA saw the overall position as “A competitive system for the taxation of foreign profits must be an essential cornerstone of the UK fiscal system. Overall, we think that the Finance Bill measures [on foreign profits] should give a more sensible regime and we support the direction of the proposals, provided that a satisfactory solution to the issue of the Worldwide Debt Cap can be found” (p 43).

50. Mr Whiting saw the changes on foreign profits as “generally a good move and is good progress towards increasing competitiveness” (Q 85). However he went on to qualify that by the effect of other measures and we return to that below. Ms Isobel d’Inverno, Law Society of Scotland, (LSS) said “Can I return to the competitiveness question? Our concern is that this whole

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[3] HM Treasury and HM Revenue & Customs: Budget 2009, *Impact Assessments, April 2009*

process of consultation about foreign profits having gone on for three years and still not having come to a landing, with lots of concerns about the worldwide debt cap and whether it is going to work, whether it is flawed and so on, has not done the UK any good at all in terms of being perceived as a competitive place to be located, not just on the detail of the tax legislation that we may end up with, but the whole process, the uncertainty and where it is going to be" (Q 36).

51. Mr Julian Heslop, 100 Group, was positive "In terms of the foreign profits, the 100 Group welcomes the overall package. It helps UK competitiveness" (Q 49).

52. Responding to the suggestion that the problems on the debt cap schedule have to be resolved before the Government's objectives for the foreign profits package will be achieved, Mr Neale said "we are very confident that we have a good package. As Judith [Knott] and I have said, it is important to see it as a package in the round. The government is seeking on the one hand to enhance business competitiveness, and on the other to protect revenue. The dividend exemption will give business a competitive gain. The debt cap helps to protect the Exchequer … I think [the package] provides a sensible outcome which gets that balance between competitiveness and the protection of revenue in the right place" (Q 157).

53. **Everyone agreed that exemption for foreign dividends was a very positive change; and that the changes to the Treasury consent rules were positive. Officials were confident that the foreign profits package was a good one in the round, with the debt cap provisions being necessary to protect the Exchequer.**

54. **However, our private sector witnesses, in some varied comments, were less sure that that the negative impact of the debt cap rules did not outweigh the positive effect of the dividend exemption and the Treasury consent rules. Whilst, in general, they accepted that some rules on the restriction of interest were a price worth paying for the dividend exemption, they thought that the way this restriction had been imposed would add very considerable complexity to the UK tax system and damage the UK's competitiveness.**

55. **As a minimum we recommend that the issues with the debt cap schedule need to be resolved in order that the overall package has a positive effect on competitiveness.**

Taxation of Pensions

56. We received evidence on how the changes to the taxation of pensions, both the substantive changes proposed for 2011 and the anti-forestalling provisions, would affect UK competitiveness.

57. The ACCA remained "concerned about the administrative burdens and complexity. These will be felt particularly by small businesses, but will be a concern at all levels. Major group companies have been leaving the UK as a result of the lack of certainty in fiscal legislation. Whilst the provisions impact directly upon taxpayers with incomes in excess of £150,000, the implications will be felt more widely … The smaller companies often use their pension schemes as a source of investment (up to the permitted limits) … Larger pension funds invest heavily in the stock market and this investment will inevitably be suppressed … The extra compliance would be unlikely to

benefit either the economy or our members, as the business owners may decide not to bother" (p 119).

58. Mr Trevor Johnson, Association of Taxation Technicians, (ATT) put it this way "Our view on the Schedule 35 proposals and the proposals on tax relief on pensions is that it cannot aid competitiveness within British industry. It is bound to be a disincentive to some extent" (Q 85). Mr Hubbard thought that "It may well be that those transitional provisions have quite a significant impact on people coming in to the UK but there is a lot to be done on that" (Q 85).

59. Asked about the effect on UK competitiveness of the pensions provisions Ms Craig found this very difficult to quantify. She went on "The problem with that is that in the current economic context any kind of disincentive or anything that makes high earners feel unhappy or discouraged is a problem. It is very difficult actually quantifying" (Q 128). Ms Segars agreed "the main impact would be to discourage those high earners from saving in pensions and they will look to switch out of pensions into other forms of remuneration and savings, and certainly that is the message that we are getting very clearly from NAPF members who advise this group of individuals and from large corporates" (Q 128).

60. Asked about the effect of the anti-forestalling provisions on competitiveness, Mr Richardson thought that the schedule would not "have a material impact on competitiveness. If you look at its impact, it affects a maximum group of about 230,000 people earning over £150,000; and for those people what Schedule 35 does is to say that if they continue with their regular ongoing savings that they will not be caught by Schedule 35. It is only a very small subset of the 230,000 that are affected for the two-year forestalling period; so I do not think that Schedule 35 itself will have a huge impact on competitiveness" (Q 159).

61. **We think that the opinion of officials that the changes for pensions will not materially affect competitiveness is likely to prove to be an over-optimistic assessment. As was put to us by our private sector witnesses, the people affected are likely to be the opinion formers in the business world and an adverse impact on them, particularly when coupled with the change in the highest rate of income tax, may well produce upward pressure on the cost of employing highly paid talent. This could have knock-on consequences over a much wider range of people. We recommend that the effect of these changes should be carefully monitored and kept under review to establish what impact they do have, particularly on UK competitiveness.**

The Effect of Other Issues

62. Some of our private sector witnesses gave us their views on the effect on UK competitiveness of other measures in the Finance Bill and of the Finance Bill as a whole.

63. Mr Woods commented, in the context of clause 92, that the Government was "not able or willing to have consultations ahead of the introduction of legislation creates an impression of uncertainty and instability. That is not conducive to making the UK competitively attractive from an investment point of view" (Q 49). Mr Baron said he: "would also be concerned about some other elements in the Finance Bill package … There are other elements like

the 50 per cent tax rate and the withdrawal of the benefit of personal allowances once income goes over £100,000, where we are concerned that that sort of measure can send the wrong signal … It is not just business that we are losing; it is also the business of all the ancillary services … If you can say that … the UK is a good place to be and you can rely on us remaining a reasonably low tax country, that sends out the right signals. I do not think the government with this Finance Bill is sending out the right signals" (Q 49).

64. Ms Knight said "I think the perception is also quite important and the external perception of the UK with this Finance Bill and the other measures in it is not terribly positive. That does concern me, especially in this current climate" (Q 49). Mr Heslop as part of the same discussion and having welcomed the overall package on foreign profits as helping UK competitiveness, did "not think the senior accounting officer certification eliminates that." Nevertheless, he saw the provision as "a pity. It is a sentiment thing. I do not think it is material in the scheme of the foreign profits package. I think it is an unfortunate step to introduce. If it had been consulted on in advance, it could have been brought in in quite a different way which probably would have achieved the same effect" (Q 49).

65. Mr Haskew picked up on the wider aspects of the Bill "there are certainly other parts of the Bill where similar issues are coming out in terms of complexity; for instance, the VAT changes in relation to place of supply, which are considered to be potentially quite onerous on UK companies. Going back to your point and your question on clause 92 with the duties of senior accounting officers … I think there is a question mark slowly arising as to just how uncompetitive are provisions like clause 92" (Q 3).

66. Summing up, Mr Whiting saw the overall position as "It is a case of swings and roundabouts because foreign profits … has been generally a good move and this is good progress towards increasing competitiveness. On the other hand, the measure we have just talked about [clause 92] sends a signal that we want more documentation, more procedures. Something like, inevitably, the 50% tax rate has implications, particularly when you look at its implications for trusts business … So there is a strong element of swings and roundabouts, a strong element of two steps forward and one and a half back" (Q 85).

67. Asked how they assessed the effect on UK competitiveness of the Finance Bill as a whole, and asked "Why can we not remove this impression that Britain is becoming uncompetitive", Mr Neale said "I very much hope that that impression is not out there. I do not think it is a true impression. It is very important in considering competitiveness to look not just at any particular measure or budget but at the impact of the tax system as a whole. As things stand the UK has a Corporation Tax rate of 28%, which is the lowest among the major G7 economies, and our taxes on labour also are among the lowest among the major economies … I think my answer would be that we need to look at this in the round; and looked at in the round the UK has a very competitive tax system" (Q 158).

68. **As our private sector witnesses concluded, the effect of the Finance Bill provisions is a netting of pluses and minuses. It is difficult to be sure what the end result might be. The likelihood of the overall result being positive would be considerably enhanced by a satisfactory resolution of the concerns surrounding the debt cap schedule, either by changes being made, or HMRC persuading others that changes are not necessary. If that can be achieved, then we should not be inclined to differ from the assessment of one of our witnesses of a net half step forward.**

CHAPTER 3: THE TAXATION OF PENSIONS

Context

69. A completely overhauled regime for the taxation of pensions came into effect on A day—6 April 2006. This followed productive consultations between the industry and the Inland Revenue (as it was prior to April 2005) over several years: the primary legislation was enacted in Finance Act 2004. We ourselves examined the matter in our Inquiry in 2004[4].

70. The Government said at that time that the reform of the taxation of pensions would bring simplification and increased flexibility that would ensure a transparent, consistent and flexible system that was readily understood, making it easier for people to concentrate on deciding when and how much to save for retirement[5]. Eight regimes then existing were replaced with a single universal regime for tax-privileged savings. The numerous controls in the then current regimes were replaced by two key controls, the lifetime allowance and the annual allowance.

71. The Background Note to the Overview said that simplification would provide:

- greater individual choice and flexibility—allowing everyone, for the first time, the same opportunity to make tax relieved pension savings over a lifetime,
- a transparent, consistent and flexible system that is readily understood, making it easier for people to concentrate on deciding when and how much to save for retirement,
- a reduction in the administrative burdens and regulatory cost for pension schemes, their members, operators and sponsors, and
- opportunities to save more towards a pension and retirement lump sum—the new rules will allow everyone to pay what they can afford when they can afford it[6].

72. Three years after this sweeping reform came into effect, the Chancellor of the Exchequer announced in this year's Budget Speech that he intended to "address an anomaly" that a tiny proportion at the top took a large slice of the help given to people to save. It was difficult, he said, to justify how a quarter of the cost of pensions tax relief went to the top 1 ½ % of earners. From April 2011 pension tax relief for those with incomes over £150,000 would be tapered to 20%. In the meantime there would be measures to prevent forestalling[7].

73. The Economic and Fiscal Strategy Report gave a fuller account of the restriction on relief for pension contributions for those with incomes of £150,000 and above. It said:

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4 House of Lords Select Committee on Economic Affairs, 1st Report, (2003–04), *The Finance Bill 2004*, HL 109-I, paragraphs 76–120.

5 Budget 2004 Press Notices, PN6, page 1.

6 Explanatory Notes Finance Bill 2004. Background Note to Clause 139, paragraph 7.

7 Hansard, 22 April 2009, col 244.

> "From that level of income [£150,000], the value of pensions tax relief will be tapered down until it is 20 per cent for those on incomes over £180,000 making it worth the same for each pound of contribution to pension entitlement as for a basic rate income taxpayer. This restriction applies to all contributions, including employers', but employers will continue to receive full relief on their contributions into employees' pensions through corporation tax and NICs"[8].

74. In a Written Ministerial Statement the same day the Financial Secretary to the Treasury gave fuller details. He explained that with the proposed increase in the top rate of income tax the pensions tax relief would become even more generous for the highest earners and the relief needed to be recast to maintain fairness. The Government would consult on these measures and to introduce them before 2011 would cause administrative disruption. However there was a real risk of forestalling with around £2 billion tax at risk so anti-forestalling rules were being introduced with immediate effect.

75. He added that the vast majority of taxpayers would be unaffected by the anti-forestalling rules, including all those whose income this year or in the previous two years was not over £150,000. Also unaffected would be all those who did not exceed their normal pattern of pension contributions, defined as agreements made before that day to make contributions at least quarterly, or the way in which their benefits accrued, for example as a result of normal pay and progression. Where the annual value of the contributions or benefit accrual did not exceed £20,000, individuals could increase them to that figure. In all these cases relief would continue to be due at the taxpayer's marginal rate of tax.

76. However contributions or benefit accruals outside the normal pattern above this would attract a tax charge so reducing the relief to basic rate, regardless of whether they were made by the individual, their employer or a third party. The £20,000 special annual allowance would permit individuals without a regular pension saving pattern to continue to receive relief at their marginal rate. However the Government recognised that those with less regular contributions would be affected and would welcome views on whether there were ways of ensuring that their contributions were protected within the objectives of the proposals. There would also be powers for HMRC to apply the tax charge where there were anti-avoidance schemes or to prevent income restructuring.

77. The Financial Secretary added:

> "This legislation attempts to strike a balance: preventing individuals from making large increased contributions, or increases in their benefits, to pre-empt the reduced relief available from April 2011; ensuring that those who continue with their normal pattern of pension saving, whether in defined contribution or defined benefit pension schemes, receive higher rate tax relief until the new legislation takes effect from April 2011; and minimising the burdens on pension schemes.
>
> The Government believe this measure strikes the right balance between the interests of taxpayers, savers and pension schemes"[9].

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8 HM Treasury: Budget 2009, *Economic and Fiscal Strategy Report and Financial Statement and Budget Report*, April 2009, Paragraph 5.92, HC 407, The Stationery Office, London.

9 Hansard, 22 April 2009, cols 15–17WS.

The substantive change from 2011

78. None of our private sector witnesses questioned the right of the Government to make whatever changes it wished. However they made a number of comments about the measure, particularly in the context of the new pensions regime which had been in place only since 2006.

Structure of pensions tax relief

79. There was universal concern that the substantive changes would alter significantly the structure of the regime introduced in 2006 after years of consultation, undermining its simplicity, consistency and certainty. In this way, our private sector witnesses said, the chopping and changing had led to a loss of confidence in the future of the pensions regime.

80. The structure of the tax treatment of pensions has hitherto recognised that pensions are deferred income: they are a means of saving to provide an income in retirement. Hitherto therefore relief has been given on the contributions as they are made, the income arising in the fund has been exempt, but the pensions are taxable when they are paid. This is what the National Association of Pension Funds called the EET principle (p 88). Hence the proposal, both in the substantive changes to come in in 2011, but anticipated in the anti-forestalling schedule, to restrict relief on contributions marks a very major change in the system of taxation of pensions.

81. The changes were made three years after A day in April 2006 when the simplification of the regime for taxation of pensions came into effect. All our witnesses from the private sector spoke well of the way in which the new system had worked, providing simplicity and certainty. However the ATT felt that they had not been allowed to settle down. Mr Meeson, speaking for them, said "Probably virtually every Finance Act that we have had since [2004] has made greater or lesser amendments to the basic Finance Act 2004 legislation, and none of those amendments have been in the direction of greater simplification, alas, which is an opportunity missed, I think" (Q 80).

82. That the substantial changes now being made followed so soon after the new regime came into effect was of major concern to our witnesses from the private sector. Ms Segars told us "simplicity is absolutely essential … So I think the recent changes announced in the budget mean that neither providers, employers nor individuals can have confidence that the future regime for pensions is certain if the systems are ... 'flipping' around" (Q 125).

83. Ms Craig agreed: "The issue is around consistency and stability and confidence and the problem is if you think you have a stable point and then it changes that becomes very difficult and it does undermine confidence. Absolutely we would acknowledge it only affects directly very high earners; the trouble is that those very high earners are often people who are in positions of importance and who have a great deal of say over what happens with the pension scheme for their employees … So it is that undermining of confidence [for workplace pensions] … there is this feeling that by having changed again are we now back to the point where, in the next couple of years, there will be yet another change in the next couple of years and then yet another change. It is the thin end of the wedge argument" (Q 125).

84. It was not just our witnesses from the pensions sector who were concerned that the changes could damage confidence in the UK pensions industry. For

example, Mr Haskew said "It will damage confidence in the pensions industry; I think there is absolutely no doubt that it will do so … These provisions might look a bit innocuous sometimes and may not appear to have immediate impact but over the years the cumulative damage can be very, very serious, and given that we are as a country encouraging people to make greater pension provision and given that there are other ways—you do not have to make pension provision—I think our view is that they will damage confidence in having pensions and actually investing in pensions in the long term" (Q 25). Mr Whiting suggested that property would be another alternative investment as a result of this set of measures (Q 96).

85. The CBI made the point that

> "this new regime is not a matter for the boardroom alone. It will immediately apply to between 100 and 500 senior managers in large firms and will influence the pensions decision-making of many more. In firms with DB schemes, initial CBI estimates … suggest the net effect will be to disincentivise pension saving completely.
>
> Even where there are no substantial increases to salary over the year, the total tax rate levied on pension saving by the new system, taking into account reduced tax relief, lifetime allowance charges and tax paid in retirement, will be in the region of 70–80%. This figure, when combined with a significant tax charge on the employer contribution, will make it sensible for most senior managers in firms with defined benefit schemes to leave the pension schemes, or to seek shorter-time working arrangements to avoid triggering a punitive tax regime. We are aware that many firms are already in the initial stages of looking at alternative remuneration models for long-term saving in response to this.
>
> If persisted with, CBI members believe that these changes will have three broad effects. Firstly, they will fracture the unitary nature of the company pension scheme. CBI members work very hard to align incentives within their businesses, and pension schemes are part of this. The removal of over one hundred, and possibly up to five hundred, senior managers from having a stake in the company scheme will be fundamentally damaging. Secondly, given the extent to which affected scheme members will now be incentivised to leave the scheme, CBI members feel that these measures will not raise the funds anticipated, and may even be counterproductive. Finally, these changes have opened up a new area for personal taxation—employer contributions. Our members are concerned that this will be extended in future to more taxpayers, further damaging incentives to save" (p 39).

86. Mr Carberry added "Turning to the issue of defined benefit liability, our initial analysis suggests that the changes proposed incentivise the top 100 to 500 people in our major members to leave the corporate defined benefit schemes due to marginal tax rates. Businesses in our membership have been very clear over the past few weeks that they work very hard to align incentives within their businesses and there are no longer aligned incentives between the board room table where decisions are made and the workforce on the subject of defined benefit … We have to look at it as another issue which adds to the instability of providing pensions in the UK" (Q 65).

87. A similar point was made by Ms Segars "If we disincentivise this group of people from saving in pension schemes then that impact, we believe, will be

felt much lower down the income scale. If these higher earners cannot benefit then we believe that they will be disincentivised from running pension schemes and the impact will be felt lower down the income scale" (Q 133).

88. We put these points to officials. Mr Neale said "We would certainly agree that pension saving is a long term proposition. That is why tax relief is available in recognition of the fact that citizens are locking up their savings for an extended period. But the changes announced at the Budget do not fundamentally change the existing regime; indeed, they do not change it at all for over 98 per cent of pension savers. It is still open to people to save without limit into pensions. There is still tax relief available within prescribed limits, unchanged for the huge majority of savers. The growth of funds in a pension fund remains tax free" (Q 190).

89. Mr Neale was unable to say whether the changes might be the thin end of the wedge. But he added "the changes are limited to the very small proportion of savers, about one and a half per cent with incomes of £150,000 or over, and they reflect the fact that that very small group had such strong incentives through the tax system to save that they were securing around a quarter of all the tax relief, just over £6 billion, and it is that that underpinned the changes announced by the Government" (Q 193).

90. Mr Neale thought that the danger that disincentives to pension savings by high earners would pass down the income scale was only speculation. "I have seen speculation to that effect but I think it is only speculation and, on the assumption that businesses use occupational pensions as part of their overall reward package in a measured way, I think it is too soon to jump to the conclusion that they will abandon them because of the effect on some of the higher earners in the business" (Q 203).

91. **We fully accept that the Government has to be free to introduce major changes in taxation as it sees fit, and in particular that the changes to pensions taxation reflected in part the increase in the top personal rate of tax to 50%. But we found little official recognition that making a significant change so soon after the major redesign of the whole system significantly detracted from the simplicity, consistency and certainty which are hallmarks of a good tax system. The undermining of the regime may very well set a precedent and sap confidence. Given the potential effect on savings we found this regrettable.**

92. **Nor did it appear that officials accepted that the impact of the changes on the pensions industry could undermine confidence in it. While the numbers directly affected may be relatively small, among them will be individuals who are influential in determining the pensions policy of many companies. The precedent may be seen as the thin end of the wedge in reducing relief more generally, so risking a reduction in pensions savings.**

Employers' Contributions

93. The CBI wrote that "CBI members are opposed to these changes—in particular the move to make employer contributions taxable for this group of employees. Government has already capped the tax advantages of pensions savings for high earners through the A day reforms of 2006, which introduced a lifetime cap for all pension scheme savers" (p 39). Mr Heslop

also said "The taxation of employer contributions is a dangerous extension of the tax system" (Q 65).

94. The NAPF believed that "the inclusion of employers contributions as a taxable benefit will be a disincentive for high earners to save through registered pension arrangements" (p 87). They reported that "Some large UK listed corporates and the consultants who advise them have suggested a potential change in the remuneration packages for senior executives (e.g. shares which attract capital gains tax at 18% in preference to higher salaries with reduced pension tax relief. Should such changes occur the expected revenue from the pension tax relief changes is unlikely to reach £3.1 billion" (p 89).

95. Ms Segars told us in relation to the changes generally including the inclusion of employers' contributions "the main impact would be to discourage these higher earners from saving in pensions and they will look to switch out of pensions into other forms of remuneration and savings, and certainly that is the message that we are getting very clearly from NAPF members who advise this group of individuals and from large corporates" (Q 128).

96. On the reaction to the taxation of employers' contributions, Mr Whiting said "I think there is a certain element of 'wait and see' as to exactly how. There is a very clear signal that employer contributions are being taken into account in certain areas, and again, what it comes back to is whether this is a sign of a complete shift, and a worry that it will mean a complete reappraisal as to the value of pensions provisioning" (Q 97). Mr Hubbard, after referring to their inclusion in the anti-forestalling provisions, added "But in the long term, if there were to be significant changes to the way employer pension contributions are tax-relieved within the corporate tax sphere, that would have very profound consequences. I do not see any evidence of that at the moment" (Q 97).

97. The ATT gave us an example to illustrate what they saw as an anomalous result from the inclusion of employers' contributions in the charge. They contrasted two individual directors of close companies who both had remuneration of £250,000. One was paid a very small salary and a contribution to his pension pot equal to the annual allowance: he would be liable to tax on neither the salary nor the employers' contribution. The other had a much larger salary and a smaller contribution to his pension pot. He was liable both to tax and on the salary and on the pension contribution because it exceeded the special annual allowance and was paid annually. Taking account also of NIC on the figures given, the latter paid tax of over £71,000 (p 64).

98. Mr Neale said that not to have included employers' contributions would have opened up an avenue of avoidance. He added that contributions to pensions by people with incomes above £150,000 would continue to attract relief at 20%, the same level as for basic rate taxpayers, and almost all other possible savings routes would be from taxed income. "So there remains a strong incentive to save into a pension" (Q 196).

99. **We accept that, once it was decided to restrict the relief available, employers' contributions had to be included if the purpose of the measure were to be achieved. However that does not remove the risk that the highly paid may look for other means of saving instead.**

Defined benefit and defined contribution schemes

100. The Economic and Fiscal Strategy Report made clear that there would be consultation on the valuation of defined benefit accruals. It said:

> "The Government will consult business, pension fund trustees, the insurance and pension industries, and other stakeholders to ensure that defined benefit pension schemes are treated fairly in relation to defined contribution pension schemes and personal pensions. It will want to arrive at the most appropriate method of valuing pension benefits of those with over £150,000 in defined benefit pension schemes and of valuing the related employer contributions"[10].

101. Nonetheless there was much concern among our witnesses from the private sector about defined benefit schemes and their relationship with defined contribution schemes. There was uncertainty whether defined benefits and defined contribution schemes would be treated consistently as they were under the previous regime. Ms Segars said "I think it is unclear to us … the extent to which DB and DC will now be treated differently or that the complication of DB will be such that actually it shifts the balance towards DC. I think it is a little too early to tell from our perspective whether that is going to be the case at the moment" (Q 126).

102. Ms Craig agreed and feared that "So then you start to get into issues around are they level; is there a difference? And once you get differences—if there are differences—then inevitably you get people kind of gaining across it, saying 'I will do this because of that'. I think that goes to the complexity point as well. One of the beauties of simplicity is that it makes it easier for everybody to see what they are doing" (Q 126).

103. Ms Segars added later "we know certainly where DB pensions are concerned scheme[s] are under enormous pressure" (Q 133). With specific reference to the effect of the inclusion of employers' contributions on defined benefit schemes she said "I think it is an enormous worry and … it will be a disincentive for employers to contribute particularly to DB schemes but to Defined Contribution schemes as well" (Q 134).

104. In their supplementary evidence the LSEW were concerned about the "technical issues [which] relate to the very difficult area of the valuation of DB accruals. We are concerned that the difficulties involved in this area may make the legislation difficult to operate and possibly retain unfairness between different constituencies of taxpayers" (p 31). The illustration by the CBI of the impact of very high marginal rates referred to in the next section shows how the higher tax may fall on an increase in the pension pot and not just on the annual pension contribution and reinforces the importance of these issues. Our witnesses were concerned that without a satisfactory resolution of these difficulties there could be a significant impact on the relative attractiveness of DB and DC schemes.

105. The CIOT said in relation to the anti-forestalling provisions

> "There is a distinctly unlevel playing field being proposed here, in terms of the ability for schemes to make changes to benefits or contributions. Defined benefit schemes (subject to the number of members

10 Budget 2009: *Economic and Fiscal Strategy Report and Financial Statement and Budget Report*, April 2009, paragraph 5.93, HC 407, The Stationery Office, London.

qualification) can make major changes to benefit accrual, whereas defined contribution arrangements are not able to make any increase in contributions (i.e. there is no protection unless contributions are paid at least quarterly and, for example, no protection for annual bonus sacrifice or annual AVCs). (There is also no protection for choosing different contribution rates, even if this is already permitted under the scheme rules). We would urge that this be reconsidered, to allow a much more level playing field between defined contribution and defined benefit.

Pay rises will create discrimination. For an employer-sponsored scheme where there is a contribution of 6%, a normal pay rise leading to an increased contribution will not be within these provisions, but a self-provided pension for someone who is promoted or has an increase in his profits will potentially be subject to the special allowance charge" (p 58).

106. The CIOT were also concerned about people in smaller defined benefit schemes. "Schemes with more than 50 members may enact changes to their benefits and retain protected input status, but smaller schemes may not ... We believe that the removal of the 50-member qualification would not lead to many short term benefit changes to forestall the 2011 charge" (p 58).

107. In their supplementary evidence the LSEW was concerned, in relation to the anti-forestalling provisions, that, because of the unsophisticated rules for valuing defined benefit schemes, the legislation was effectively skewed in their favour compared with defined contribution schemes. "It is ... much easier, structurally, to introduce anti-forestalling provisions for a DC scheme than it is for a DB scheme. We would note that Schedule 35 in paragraph 8 contains three different ways by which a DB scheme can escape the anti-forestalling rules. The exemptions are not limited to contributions which are quarterly or more regular, but include ongoing accruals to the fund where the rules do not alter and benefits which accrue where the rules of the scheme alter provided 50 or more individuals are affected. A DC scheme has no such exemptions. This, in our view, reflects the fact that DC schemes are easier targets than DB schemes and that the legislation is, in effect, skewed in favour of DB schemes because the issue of valuing contributions for these schemes is a far harder task than it is for DC schemes. Most notably, no members of DB schemes will suffer a special annual allowance charge in respect of their DB accrual if the scheme rules are not changed, even if their pensionable pay is doubled (e.g. on promotion) or includes bonuses whereas self-employed individuals will typically not be able to increase their contributions to personal pension schemes without triggering the tax charge" (p 30).

108. In response to these concerns, Mr Richardson said "Certainly, the intention is to be even-handed between the DB and DC schemes. There is no intention to favour one over the other. In terms of the substantive changes to take place from 2011, one of the key things that we want to consult on and one of the reasons for having a consultation period is to look at how to value benefits in relation to DB schemes, which is technically a difficult area. It is one of the things that we want to consult on carefully to ensure that we get an outcome that is fair to DB schemes and creates a level playing field" (Q 200).

109. Asked whether it would make it difficult for people running schemes if there were a long period while it was unclear, Mr Richardson said "I do not think so. The problem would have been if we had moved straight to the change

without a consultation period, where the risk would have been that either that we got it wrong or people were caught with no time to prepare. What we have done is to allow a really quite generous—if I can put it that way—consultation period of two years to make sure that we get it right, because we are committed to doing that. I suppose it creates uncertainty in the sense that we have explained that we are going to change it and we want to talk about it but I think that is the way to go about doing it, otherwise you would never make [a] change at all. If I come back to Schedule 35 in terms of the balance between DB and DC schemes, Schedule 35 is about ensuring that there is no forestalling, and exactly the same principle applies there to defined benefit and to defined contribution schemes. If you have ongoing, regular contributions that continue, then you are protected from Schedule 35 taking effect. So both for 2011 and for Schedule 35, we are committed to ensuring that there is a level playing field" (Q 202).

110. **We accept that it is certainly not the intention that the playing field between defined benefit and defined contribution schemes should be anything other than level. But that may not be easy to achieve in practice and we recommend that it should be an aspect to which considerable attention should be paid in the consultations leading to the introduction of the new substantive regime in 2011. The Government should conclude those consultations as soon as reasonably possible in order to allow people to make their plans.**

Marginal rates

111. The CBI gave a far from unlikely example of how pension saving might be discouraged by marginal tax rates exceeding 100%. They instanced "A member of a typical 1/60ths scheme with 15 years' service, who receives a large promotion and moves from being paid £180,000 pa to £240,000 pa, then the value of his pension pot, using the current approach for lifetime allowances, will increase from £450,000 at the beginning of the year to £640,000 at the end. He will then be taxed at an effective rate of 30% (50%–20%) on this increase, i.e. a tax charge of £57,000, 95% of the pay rise given to take on the new role. Given that the pay increase granted is itself subject to taxation, the marginal rate on his promotional increase would be 145%" (p 39).

112. The ATT was also concerned about high marginal rates. They told us that "Failing to link the charge in any way with the individual's income will lead to marginal tax rates in excess of 100%. We shall be proposing to Government that the charge be limited to 50% of the excess of income over £149,999" (p 60).

113. Responding to these points, Mr Richardson said that the question of marginal rates had been looked at very carefully. For the substantive changes in 2011 "there will be a taper for people when they enter the new regime, so that between £150,000 and £180,000 the benefit of relief at the higher rate will be tapered away to avoid the cliff edge of suddenly moving from having relief at the higher rate to having relief at the basic rate" (Q 204).

114. As for the anti-forestalling provision, "that is really quite different because, in essence, to be caught by Schedule 35 is an optional thing. If you are simply making your ongoing, regular contributions, you will not be caught by Schedule 35 because you get the protection that it provides. So the only people that get into [the Schedule] are those people who have decided in some way or another to change their contribution rate, which, as I say, is

essent[ially] a voluntary point. So we have not built in a taper there and, indeed, to build in a taper to Schedule 35 would rather undermine the purpose of it, to stop forestalling." He went on to say that for those who were inadvertently caught by the Schedule there would be a provision to enable a refund of pension contributions to be made (Q 204).

115. **We saw evidence which persuaded us that the combination of the marginal rate of income tax on a pay rise crossing the £150,000 mark and the restriction of relief for pension contributions which that could bring with it could lead to exceptionally high marginal rates and we were not wholly reassured by the answers we were given that officials had fully taken that point on board. We recommend that this also should be an area for particular consideration in the consultations on the substantive changes.**

An alternative approach

116. We noted that the Treasury Committee in the House of Commons had considered the issue of the taxation of pensions. They had heard concerns about the complexity of the proposals; with a suggestion from John Whiting that the annual allowance might be reduced to £150,000 and a report from Lord Turner had suggested that the only practical way was to reduce the lifetime limit. Mike Williams for HM Treasury had said that the latter could hit people much lower down the income scale, but the Committee noted that he made no comment about the annual allowance. They recommended:

> "We note that this budget marks a departure from the long-standing principle that tax relief for pension contributions should be given at an individual's highest marginal rate. We urge the Treasury to monitor the effect of this change on pension savings and to keep under review the possibility that a cap on annual contributions might be a more equitable way of reducing the percentage of tax relief that benefits the highest earners"[11].

117. The NAPF referred to the Treasury Committee report. They suggested that alternative proposals to the treatment of pension tax reliefs should be sought including a reduction in the annual and/or the lifetime allowances. They proposed that "HMT undertake a full costing analysis to examine a range of different "what if" scenarios on the revised amount of the Annual Allowance and other options. The results of such analysis should then allow a more informed judgement to be made regarding a range of future options such as a lower Annual Allowance which could potentially raise additional tax revenues from reduced pension tax relief but which still includes sufficient incentive for high earners to continue pension saving through registered pension arrangements" (p 90).

118. Ms Segars also suggested that, had they been consulted, they would have been able to come up with innovative solutions. "There are four options that spring to our minds. One would be limiting the annual allowance … and another would be reducing the lifetime allowance from the current £1.75 million for 2009–10. I think there are pros and cons in both of these … Another option … would be raising from £20,000 to a higher figure the amount that is included for assessing somebody's adjusted net adjusted

[11] House of Commons Treasury Committee, *Budget 2009*, 8th Report, (2008–09), HC 438–1, paragraph 104.

income and, therefore, the tax relief figure and the amount of tax they will pay on their employer contributions. Another more innovative way might be to look across the Atlantic and import some of the proposals that the Americans use in terms of incentivising directors to pay into pensions whereby directors receive tax relief on their employer contributions if they are in the same scheme as what they term, 'rank-and-file' employees and they are making contributions to that scheme. With auto-enrolments and mandatory employer contributions coming on stream in 2012, these things could be tied up" (Q 144).

119. Others of our witnesses also considered reducing the annual or lifetime limits. Mr Whiting (who, as we said earlier, raised the possibility with the Treasury Committee) said "That was our suggestion, being pragmatic" (Q 93). In its written evidence the CIOT said "If there is a problem with the cost of tax relief, the simple solution is surely to reduce the annual allowance, instead of trying to pretend the annual allowance is still as it was and then tax those who want to take full advantage of it. That would at least be simple" (p 58).

120. The IoD thought that "The suggestions that were made to the Treasury Select Committee simply to restrict the amount that could be contributed each year strike us as very valuable. Such an approach could be introduced promptly and could itself be the permanent solution." (p 43). Speaking for them, Mr Baron thought that the problem was that the cost of achieving the policy objectives looked very complicated and told us "If they had said, 'These are our objectives but we are happy to achieve our objectives to within five per cent, nearly achieving our precise objectives rather than having achieved our precise objectives' there would have been much more opportunity to introduce measures that would have been more practical" (Q 46). He admitted later however that "If you capped pension contributions at, say, 50,000 instead of 245,000, there would be a few people earning under £150,000 who might hit that cap and some people earning very high salaries who would still be benefiting from 40 per cent tax relief on their pension contributions, so it would not achieve exactly the same objective" (Q 67).

121. Mr Carberry told us "it would have been strongly preferable to make the changes within the framework of the 2006 regime by looking at the lifetime allowance or the annual cap" (Q 70). However at Q68 difficulties in adjusting the allowances were mentioned. Mr Baron (IoD) noted that there would still be "the problem of translating contributions into a defined benefits scheme, which is a somewhat arbitrary procedure" and Mr Heslop said that if the lifetime allowance had been adjusted "you would have to separate the contributions to date that drove you there from the new contributions. You could have done it, but it might have led to even more complexity" (Q 68). He saw no reason for changing the 2006 arrangements which had worked very well.

122. The LSEW thought that "it might be possible to restrict the annual allowance, but this has proved an extremely welcome and flexible tool for those contributing to pensions, and also for special circumstances. A simple restriction of the annual allowance might, though, present a somewhat blunt solution to the problem, but would be likely to impose a significant additional administrative burden on administrators of DB schemes" (p 30).

123. The discussion we referred to earlier by our private sector witnesses about an alternative approach to the substantive changes from 2011 involving a reduction on the annual and/or the lifetime limit ran also through to the schedule. It could be seen that such an approach would be a pragmatic response whose bluntness would need to last for only the two years until there had been time for consultation on the substantive scheme and some of the issues to which that had given rise could have been ironed out. On the other hand the same arguments about the lack of precise targeting and possible practical difficulties would apply even then.

124. Mr Richardson responded to our question on this by confirming that the possibility of a simpler alternative had been looked at. But the objective had been to restrict the higher rate relief for people earning over £150,000 who were now receiving about 25% of the relief. A restriction of the annual allowance would have an impact quite low down the income scale and a restriction of the lifetime allowance would take time to have an effect in revenue terms as well as affecting people with lower incomes. "So we did look at the alternatives because, as you rightly identify, they look simpler but they actually deliver a quite different policy and hit on people in quite a different part of the income scale" (Q 205).

125. **A number of witnesses suggested that a pragmatic and far less complex approach towards restricting relief than that adopted by the Government would have been to reduce the annual and/or lifetime allowances, either for the substantive scheme or at least in the transitional period. This could have been done within the parameters of the 2006 rules and would have required a far less significant change to the basis of the relief.**

126. **Considering the matter in greater detail however, we were persuaded that the outcome of so doing would have been to target the withdrawal of relief above basic rate quite differently from the high income individuals which Ministers intended and would affect some individuals whose income was considerably less than £150,000. With some regret therefore we do not recommend adopting a policy along these lines, despite the greater simplicity and coherence with the previous system.**

The anti-forestalling Schedule

127. We referred above to what the Financial Secretary had to say in his Written Ministerial Statement about the anti-forestalling charge. In essence there is to be an income tax charge of 20% on pension contributions and benefits accrued after Budget day on individuals whose income exceeds £150,000. Schedule 35 will provide that a person in this income range will receive full tax relief only up to the level of their existing regular pension contribution or £20,000, whichever is the higher. Any contributions above that level (up to the standard annual allowance limit) will be subject to a special tax, reducing the effective rate of tax relief to 20%.

The need for the Schedule

128. The ICAEW pointed out that "the proposed restriction on tax relief breaches the fundamental principle which underlies tax relief for pensions, which is that tax relief is given on contributions at the marginal rate but is then taxed in full (including at higher rates of income tax, where applicable) when the

amount is paid out as a pension … This principle was confirmed most recently in the changes that were made to the pension rules in the FA 2004 and introduced on 6 April 2006, which included a generous annual limit specifically to enable top up contributions to be made" (p 3). They referred in particular to a statement confirming these principles by the then Financial Secretary to the Treasury, Ruth Kelly, who, referring to the annual and lifetime allowances, said "Those allowances represent very generous levels of tax-relieved savings. They are far in excess of what 99 per cent of the population currently save or are ever likely to. However they limit the amount of tax relief that very high earners can obtain, which is fair"[12].

129. There was great concern among our private sector witnesses that the short term anti-forestalling schedule would introduce huge complexity and misunderstandings which it was difficult to justify for a relatively short transitional period. The ATT suggested that "we are not convinced that 'forestalling' the 2011 changes is a threat of sufficient magnitude to justify the existence of Schedule 35. Even if it were, we conclude that a far simpler approach would have been to introduce the substantive restriction with immediate effect" (p 62). The ICAS questioned "whether the complication is worthwhile. Against a background that it is important to encourage people to make responsible investments in pensions, we suggest that this clause and its schedule are misconceived and should be repealed … This is bad legislation and should be withdrawn until the process of consultation has been concluded and the precise rules which will apply from 6 April 2011 onwards have been enacted … The 2009 Budget report estimates that the change will deter people from making pension investment but will not increase the tax yield in the next two years. We recommend that the clause and its schedule be withdrawn" (p 121).

130. We put it to officials that, given the impression people would be able to make top-up payments as their income increased, they should be given more time to arrange their affairs before the substantive change came in. Mr Neale responded "I think it was clearly essential to have a forestalling measure to prevent people affected by the changes outlined in the Budget committing revenue to pensions that they would not otherwise have done. In designing that forestalling measure, it would have been very difficult indeed to distinguish between people doing that for avoidance reasons and people making pre-retirement top-ups." People could continue to make regular payments and one-off contributions up to £20,000 without tax penalty and would get relief at 20% above that. "So it strikes as good a balance as we can under the circumstances" (Q 206).

131. We suggested to officials that it should have been clear, after all the discussions that led to the introduction of the present rules, that one of the implications of increasing the limit on annual contributions would be more tax relief going to people with higher incomes. We asked whether that had been missed or whether the Treasury had had second thoughts. Mr Neale responded "I think it is important to set this in the context of other personal tax changes set out in the Budget, and in particular the introduction of a 50% top marginal rate, that would further increase the incentive for very high earners to save into a pension" (Q 211). He added in response to a question whether it was a knock on effect of the 50% rate "Clearly, the 50% tax rate

12 Hansard, Standing Committee A, 8 June 2004, cols 427–8.

causes you to look very carefully at whether the existing structure of incentives should continue and whether that is sustainable" (Q 212).

132. **We question whether it was necessary to have introduced an anti-forestalling provision. Ministers were well aware of the generosity of the relief for high income individuals and should not have been surprised at the proportion of the cost which was going to them. For their part, individuals had a legitimate expectation that it would be maintained. We think that the measure may have been the wrong judgement.**

Complexity

133. Our private sector witnesses commented on the complexity that Schedule 35 was introducing into the tax system. As the ICAEW wrote "We are also very concerned by the level of complexity of the provision. One only has to look at the bulk of guidance which has already been issued to realise just how difficult are these proposals, particularly for unrepresented taxpayers … complex legislation leads to significant extra costs for HMRC" (p 3). The 100 Group wrote "The 100 Group is of the view that such wide ranging and complex changes should not be introduced without broader consultation and is disappointed that this has not happened" (p 35). The NAPF thought that "In effect all the extensive planning, consultation and significant expense of the 'A' day changes will likely be lost within 3 years as tax simplification as envisaged under Finance Act 2004" (p 89). The ABI put its comment on complexity as a plea for "urgent clarification from the Government on the anti-forestalling measures" (p 87). However, in its supplementary written evidence the LSEW was less concerned and expressed the view that "[Schedule 35] is complex, but this reflects the different types of pension schemes" (p 30).

134. We asked officials whether having two sets of rules in the space of two years would not cause administrative disruption for savers, pension schemes and for HMRC. Mr Richardson responded that by stopping forestalling, Schedule 35 provided a safe window for consultation on the 2011 changes and for financial advisers, individuals and HMRC to prepare for them. To have moved directly to the substantive changes would have been extremely unattractive. He added "You are quite right though, of course, that it means that we have two sets of rules rather than one change but I think … the first change, Schedule 35, actually only impacts on a very small number of people. There are 230,000 people earning over £150,000. Something like 80% of those make pension savings below the £20,000 limit, so it is only a small subset of people that will find that Schedule 35 actually bites on them" (Q 207).

135. We also asked on a practical issue how, in particular in relation to defined benefit schemes, an individual had all the information needed to complete a self assessment return. Mr Richardson said that people who did not change their saving pattern would not get into the Schedule at all. If they did they would generally have the information they needed for their self assessment return anyway: they would not have to include their employer's contribution or benefit unless they entered into a new salary sacrifice arrangement. He thought that high earning individuals, many of whom would have advisers, would be well appraised of their contractual rights, but there were provisions to allow people to ask and receive a reply from their pension provider to the

pension rights which had been built up. "So, in terms of Schedule 35, I do not think there is a problem in terms of administrative burdens or access to information" (Q 213).

Less regular contributions

136. In the course of his Written Ministerial Statement to which we referred earlier, the Financial Secretary to the Treasury said:

> "The Government recognise that those with less regular contribution patterns may be affected and would welcome views on whether there are ways of ensuring the contributions of this group are protected in the same way as those making more regular patterns, while continuing to meet [their objectives]" [13].

137. The CIOT was typical of our private sector witnesses in saying that "the requirement that, for pensions contributions to be protected input amounts, they must have been agreed before 22 April 2009, and must have been paid at least quarterly, creates significant unfairness between those on variable earnings and those on regular earnings (since many people's pensions contributions pattern reflects their earnings pattern)" (p 58). Circumstances quoted as falling within the latter included the self employed, people who need to see the outcome at the end of the year before reaching a decision, people whose income is significantly made up of a bonus, people who spread the risk between different pension providers but contribute only annually to each, people changing jobs, and people coming into the UK.

138. The ATT suggested that "It would be better if the definition of 'protected pension input amounts' could be amended to abandon the requirement that payments be made at least quarterly. A far better approach (and one more in line with *Bennett v IRC*) would be to permit any contributions made after 22 April 2009 which are consistent with a pattern set before that date regardless of the frequency of that pattern or the equality of amounts paid over time—limited perhaps to the amount paid in the 2008/09 tax year, or to the highest amount paid in the last three years" (p 63). Mr Meeson told us that "We pointed out in our written evidence the judgement in the *Bennett* case where Mr Justice Lightman quite clearly pointed out that one can attribute regularity to a pattern of events that does not in any way necessitate doing the same thing every year; as long as one follows the same principle every year or every period that should be enough to satisfy regularity" (Q 87).

139. The ATT also were concerned about contributions close to retirement. They pointed out that "One of the features of the Finance Act 2004 pensions provisions is that the annual allowance charge does not apply in any year in which an individual is crystallising all of his pension benefits. This enables individuals (or their employers) to 'top up' a pension scheme shortly prior to retirement. The special annual allowance charge does not follow this principle, except in the very limited case of an individual retiring due to ill health—and then only if the pension scheme is occupational" (p 63). Mr Haskew suggested that there was a need to see how people who had been made redundant "can be accommodated within the new rules because I am not actually sure there is an immediately obvious test for those people" (Q 18).

13 Hansard, 22 April 2009, Col 16WS

140. The general view of our private sector witnesses was that account should be taken of the record of contributions over the years since A day and that an average figure or the best of them should be taken as establishing a pattern.

141. Alternatively if the special alternative allowance were increased significantly, there would be less need to take account of most of the cases of less regular contributions. Mr Haskew for example said "One view was that one way of at least getting rid of a lot of the problems with maybe people's annual contributions would be to up the £20,000 *de minimis* level to, say, £50,000, which looking at the Red Book would suggest that it would not necessarily cost a lot of money, but that it may at least take out a lot of people who currently have a problem with paying annual contributions. In other words, you probably have to stick with these original rules but give a higher *de minimis*, which would hopefully take quite a lot of people out of this. Another alternative is to fashion an annual payment provision extending the current quarterly or less and extend that to annual payments, probably by some sort of reference to previous years. But obviously that would add to the complication" (Q 24).

142. Ms Segars told us that she did not understand how the figure of £20,000 had been arrived at and it seemed slightly arbitrary. "In terms of the anti-forestalling legislation, again we really need to understand the Treasury's rationale for having a figure of the higher of normal contributions or £20,000 because it is quite unclear to us at the moment how that figure was arrived at". Ms Craig added "Particularly in view of the fact that we are not quite clear exactly what is going to constitute a pattern of normal contributions, we do not know where the £20,000 came from in the anti-forestalling and we are not quite clear about exactly what a pattern looks like, so you have kind of got two uncertainties and you are working with the greater of those two uncertainties, which goes back to the point about an inability to give advice" (Q 142).

143. We asked officials how the discussions were going and whether they would be able to meet the concerns about the self employed and one off cases. We also asked whether one solution might be to raise the £20,000 special annual allowance to, say, £50,000. Mr Neale responded "It is clearly an issue that concerns many stakeholders and individuals. We have received a number of representations in response to the Financial Secretary's invitation. They make a range of suggestions for addressing the issue of annual or irregular contributions, including [the] one you mentioned of raising the limit to £50,000 or to another level, and Ministers are giving very careful consideration to the range of suggestions they have received" (Q 208).

144. We were concerned by the range of issues which had arisen, the expectations raised by what had been said in 2004, the risk to pension savings, the comparative low risk of forestalling in practice, the complexities of three regimes in five years, the need for a level balance between DB and DC schemes, the need to take account of special cases and the administrative and compliance costs. As Mr Richardson had described getting within the provisions of the Schedule as optional, we asked why it should not be dropped. He responded "It is optional in that, if you leave your affairs as they were before it was introduced, you will not be caught by it. Given that Ministers have announced that in 2011 there will be a substantive change, moving the tax relief rate down from 50% to 20%, that is a huge incentive to forestall. I think it will be extremely dangerous and risky from an Exchequer

point of view to give people that opportunity. Given that there is the decision to make the fundamental change in 2011, I do not think there is realistically any responsible alternative but to have an anti-forestalling provision such as Schedule 35 in place" (Q 210).

145. **Our private sector witnesses had many concerns about the anti-forestalling provisions. The importance of these issues turns significantly on the numbers who may be affected. The HMRC view that for an individual it is optional whether to come within these provisions depends critically, and more importantly than was recognised in evidence before us, on whether an answer can be found to the various issues raised by those who have good reason for not making their pension contributions regularly, at least quarterly.**

146. **These individuals fall into two main groups. First, the self employed and others who regularly make annual or irregular contributions. Following the consultations now taking place, we think that it ought to be possible to look for an answer which protects those who have a regular pattern of behaviour, even though the actual amounts of pension saving may vary very considerably from year to year.**

147. **Second, and perhaps more difficult to define, those who have a practical reason, without any forestalling of the 2011 rules, for making a significant one-off payment into their pension pot, for example on retirement or redundancy. These individuals may well have a legitimate expectation that they could properly make a contribution up to the annual allowance and get relief at their marginal rate.**

148. **If bespoke solutions cannot be found for individuals who fall into these categories, we recommend as a fall back that the special annual allowance be increased significantly.**

149. **If answers are not found along these lines which take out from the ambit of the anti-forestalling provisions all those for whom a significant pension contribution is bona fide and not optional (to use the HMRC phrase), then we recommend that full account should be taken of all the concerns of legitimate expectation, complexity, even-handedness between DB and DC schemes, and practical and administrative issues which were raised with us and which will be on the record.**

CHAPTER 4: TAXATION OF FOREIGN PROFITS

Context

150. Dividends paid by UK resident companies are not charged to corporation tax in the hands of a receiving company. The profits out of which the dividend is paid have already been charged to UK corporation tax within the company that pays the dividend. Exempting the dividend in the hands of the receiving company therefore eliminates double taxation.

151. Dividends paid by companies that are not resident in the UK (foreign dividends) are treated differently in the hands of a receiving UK company. The dividends are charged to corporation tax. When taxing these foreign dividends, the UK tax is reduced by the amount of foreign tax already paid. In respect of portfolio dividends (on holdings of less than 10%) the foreign tax is just any withholding tax that has been imposed on the dividend. For participation holdings of more than 10%, there is an additional tax credit by reference to the underlying foreign tax paid by the company that pays the dividend.

152. The rules for determining the correct amount of credit for underlying tax are complex to apply for multinational groups as dividends can pass through several subsidiaries and countries before arriving in the UK. It is necessary to identify the profits out of which the dividend is paid; these may be in a company which is remote from the company actually paying the dividend to the UK company and accrue in a year before that in which the dividend is paid. In some double taxation computations, it is necessary to go back a number of years and this makes the calculations very complex.

153. Where profits arise in a low tax jurisdiction, a charge may be imposed on the UK parent company in respect of those profits by the Controlled Foreign Companies (CFC) regime. In broad terms, the CFC rules prevent UK companies from diverting UK profits to subsidiaries set up in tax havens. The profits of a CFC are taxed in the hands of the UK parent, subject to a number of exceptions, in particular if the CFC distributes 90% of its profits back to the UK by way of dividend.

154. The existing Treasury consent rules require a company to obtain prior Treasury consent before it can enter into certain transactions involving international restructurings and movements of capital. Transactions of this kind that are carried out without prior Treasury consent are unlawful and carry a criminal sanction, though, in practice we were told, there has never been a prosecution under this provision.

The Present Round of Consultation

155. In June 2007, HMT and HMRC published[14] a discussion document outlining proposals for: exempting dividends received by large and medium business on participation holdings; changing the CFC regime from an entity based "all or nothing" approach to a targeted, income-based regime; targeted changes to the rules for relieving interest to prevent abuse; and removing the existing Treasury consent rules and replacing them with a reporting requirement.

[14] *Taxation of companies' foreign profits*, discussion document published by HMT and HMRC, June 2007

156. Discussions continued with business and the professional bodies and, as we heard in the evidence from the private sector witnesses, there was a strong reaction against the CFC proposals.

157. In July 2008, the then Financial Secretary to the Treasury wrote an open letter reacting to the suggestion from business that it would be possible to proceed with a dividend exemption, perhaps accompanied by a form of interest restriction (a debt cap), but that other anti-avoidance measures could follow at a later stage if necessary. At that stage the Government's view was that the fiscal risks were too great to introduce a dividend exemption in this way in the 2009 Finance Bill. However, they offered further discussion on the analysis of the fiscal impact.

158. In the 2008 Pre-Budget Report, the position had moved on and the Government announced that it would "bring forward a balanced package of reforms to the taxation of foreign profits, including the introduction of an exemption for foreign dividends in Finance Bill 2009"[15]. "The new exemption will be supported by: a worldwide debt cap on interest; … extension of the unallowable purposes rule for loan relationships; … consequential changes to the CFC rules … In addition, the existing Treasury consent rules and notification requirements will be repealed and replaced with a quarterly reporting requirement for high-risk transactions with a *de minimis* limit of £100 million"[16].

159. In addition to the above proposals for Finance Bill 2009, "The Government will also continue to examine options to reform the UK's controlled foreign companies (CFC) rules"[17].

160. Draft clauses were exposed for comment in December 2008 and discussions continued. Budget 2009 announced the final form of the package:

- the exemption for foreign dividends to be extended to all companies, including small companies in respect of participation holdings;
- a debt cap which limits the tax deduction for finance expense payable by UK group companies to the external finance expense of that group as reflected in the consolidated accounts;
- some changes to the CFC rules, consequential on the introduction of the dividend exemption, any substantive changes to follow the further consultation announced at the PBR;
- the changes to the Treasury Consent rules as announced at PBR, but with a reporting requirement within six months of the transaction;
- the need for legislation in the area of loan relationships and derivative contracts to be kept under review, but the measure would not form part of Finance Bill 2009.

The changes to the taxation of dividends apply to dividends received on or after 1 July 2009. The changes to the CFC rules have effect for accounting periods starting on or after 1 July 2009. The new reporting requirement applies to transactions undertaken on or after 1 July 2009. The debt cap

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15 HM Treasury: Pre-Budget Report: *Facing global challenges: Supporting people through difficult times,* para 4.24, November 2008, Cm 7484

16 Ibid Box 4.4

17 Ibid para 4.25

applies to finance expenses payable in accounting periods beginning on or after 1 January 2010.

161. An open letter of 30 April, the date of publication of the Finance Bill, from the Financial Secretary to the Treasury outlined further changes that were needed to the provisions included in the Bill. That letter highlighted two major issues, the exclusion for financial services from the debt cap rules and the Targeted Anti-Avoidance Rules. Further consultation was promised on both these issues.

The Overall Package

162. In general, our private sector witnesses welcomed the dividend exemption and the changes to the Treasury consent rules but were concerned with the debt cap limitation, both its effect in practice and the complexity of the approach. For example, the view of the ICAEW was to "welcome the broad thrust of these provisions in the Finance Bill, but remain concerned about the balance of the Foreign Company profit proposals" (p 1).

163. The CBI was concerned that parts of the package were not reflected in the Finance Bill as published "Without all the relevant legislative text the total package cannot be assessed in the round" and "it is not clear to those outside government whether all their concerns will actually be covered at all … The longer the uncertainty continues the worse the impact." The CBI noted that concerns of a very similar nature were raised in relation to the new rules on Residence and Domicile introduced last year (p 37).

164. The CIOT echoed the comments of the CBI "Without the full picture, it is difficult to comment on whether we think the whole package will work. We do believe strongly that these rules will need continued discussion and, probably, amendment in the run up to implementation and in the light of practical experience of their operation" (p 56). Though asked if they were worried that at the time of publication of the Finance Bill further changes were already being mooted, Mr Whiting professed himself "not worried because that was a continuation of the process of consultation" (Q 111).

165. Asked why it was not possible to do all the necessary drafting before the Finance Bill was published, Ms Knott explained "We were very keen to introduce a foreign profits package this year because business is very keen to get access to the dividend exemption, so it was seen as a priority that we should introduce it this year … Generally speaking, I would say that this is not part of an increasing trend [of publishing parts of the Finance Bill incomplete] as has been suggested; but what I would say about this year in terms of foreign profits is that it reflects the extent of the dialogue and consultation we have been having and are responding to; and that sort of process takes some time, and sometime extends beyond the time" (Q 160). Ms Knott confirmed that she did not think publication of the Finance Bill with gaps in it is going to be an increasing feature (Q 162).

166. Just prior to finalising the report, the Financial Secretary to the Treasury tabled 66 amendments to the package. The changes to the dividend exemption schedule were "to correct some minor drafting problems and to remedy a matter that might otherwise be expedited in tax avoidance

schemes" [18]. The changes to the debt cap rules included many changes to the detailed drafting but also three major issues:

"(a) an exclusion from the provisions of the Schedule for groups of companies providing certain financial services;

(b) anti-avoidance measures to counter the effect of schemes designed to avoid the provisions of the Schedule; and

(c) an exclusion from the provisions of the Schedule for amounts paid to charities, designated educational establishments, health service bodies and local authorities" [19].

The changes to the CFC consequentials consist of corrections to some minor drafting problems and the addition of provisions "to regulate the interaction between the rules introduced by Schedule 15 of the Finance Bill [the debt cap] and the CFC rules, removing double taxation where it arises" [20].

It will be for our private sector witnesses to assess the effect of these changes and to what extent they meet their concerns.

167. **We remain concerned that the Finance Bill was published as work in progress, a situation that, as was explored previously, was caused by the consultation on the draft legislation taking longer than had been expected. Whilst we were reassured by the comments of officials that this is not an increasing trend, this is the second year in succession that we have had to comment on this, and this worried us.**

168. **We accept the evidence of our private sector witnesses that it is very difficult to see the package in the round when there are holes in the Finance Bill proposals. And a commitment to publish the additional legislation as soon as possible afterwards is not good enough as it reduces the time for review, particularly when the publication is close to the hearings in the Public Bill Committee.**

169. **In our view it is not good practice that the Finance Bill should be incomplete at the time of publication; this must be avoided except in the most exceptional circumstances.**

170. The CIOT also commented on the approach of the overall package "It is disappointing that, in implementing these new rules, the opportunity to move to a proper territorial system is being lost. Rather, the worldwide debt cap provisions are intended to target particular arrangements by groups which are regarded as undesirable for UK tax purposes" (p 56). In his oral evidence, Mr Whiting expanded on this "What we are really saying is that we do not think there has been a willingness to stand back and take a really radical view of how the UK tax system should operate. We have taken what we have got; how can we improve it? That is fine. I make it clear we approve and support generally the way the measures are going but we think that the opportunity has been missed to really stand back and say 'let us go into pure territoriality' … It would potentially raise a lot of money for the Treasury by

18 Explanatory Note published by HMRC 4 June 2009 on Clause 34 and Schedule 14: Corporation Tax Treatment of Company Distributions.

19 Explanatory Note published by HMRC 4 June 2009 on Clause 35 and Schedule 15: Tax Treatment of Financing Costs and Income.

20 Explanatory Note published by HMRC 4 June 2009 on Clause 36 and Schedule 16: Controlled Foreign Companies.

restricting … We would have a simpler system but we would hope that the money would be given back, and we hope it would reduce the headline rate of Corporation Tax" (Q 103).

171. In his oral evidence Mr Cussons made a similar point: some 60% of clients of PricewaterhouseCoopers present at a recent seminar "would favour moving towards a territorial system even though … that would involve further restriction of expenses because you could not expect the government to continue to give interest relief for profits wholly earned offshore that they were never taxing" (Q 10).

172. Commenting on a move to a 'pure' territorial system, Ms Knott made the point "that no country has a pure territorial system, and there is some debate as to exactly what that means … Strictly speaking, a pure territorial system would require us to only give relief for interest expense that was incurred in generating profits that would be taxable in the UK. We looked at that during the three-year consultation process we had on foreign profits … It was very clear at that stage that businesses would not have welcomed that kind of system" (Q 163). When asked whether this discussion took place in the context of a significant reduction in the rate of corporation tax, Ms Knott confirmed not, as "any decisions on how to recycle any revenue raised from that kind of measure would be a matter for the Chancellor on how to, or indeed whether to, recycle the money from such a measure" (Q 164).

173. **We were very interested in the point raised by a number of our private sector witnesses that an opportunity had been missed to move to a 'pure' territorial system, a measure likely to raise sufficient money to fund a substantial cut in the rate of corporation tax. We note the comments of officials that this would not prove attractive to business, though we can understand that reaction if the possibility of recycling the revenue to fund a cut in the CT rate were not on the table at the time.**

174. **We recommend that HMT and HMRC should keep under review the possibility of moving further towards a 'pure' territorial system so that if the Government were to decide that conditions had become favourable for such a move to fund a reduction in the CT rate, the necessary ground work would have been done.**

175. We asked some of our private sector witnesses about the changes announced recently by President Obama and whether they saw these as moving in a different direction from the UK package. Mr Cussons did "not think that the US proposals are a good model for the UK because the US is large enough in my understanding to run effectively as a siege economy … I do not think that we have that luxury because we are a much more international and smaller economy. I think therefore that we have to have a system that is attractive to inbound investment and outbound investment and I do think that the Financial Secretary is absolutely right when he has repeatedly said that he is minded to move more towards a territorial system" (Q 12).

176. Mr Heslop echoed this "There is a huge difference between the United States and the UK regrettably" (Q 63). As part of the same discussion, Mr Woods for the CBI doubted "how much of what President Obama has put forward in his budget package will survive the political process or will end up in a different format in the Volker report" (Q 63).

Dividend Exemption

177. There was a universal welcome for the principle of the dividend exemption. As the ACCA put it "The dividend exemption is welcomed and reflects commerciality" (p 119). The LSEW thought that "The adoption of an exemption system will bring the UK into line with many competitor holding company jurisdictions (such as the Netherlands and Luxembourg)" (p 13).

178. There were, however, issues surrounding this. The first was that the position of foreign branches had not been addressed. The ICAEW noted this in passing, but it was of more concern to the BBA "There is however an outstanding matter which is of particular concern to the banking industry. This is the need for a branch profits exemption along the same lines as the dividend exemption and in accordance with the territorial principle. This is of importance to the industry since a number of BBA members operate through overseas branches for regulatory reasons … HM Government should commit to a target date for aligning the treatment of foreign branches with the regime for taxing other foreign profits within 12 months" (p 43).

179. In oral evidence Ms Knight was invited to comment for the BBA on an emerging view that branches are a bad thing from a regulatory viewpoint. She responded "I do not think you can necessarily come to that conclusion at this moment … We simply say let us have a sensible tax arrangement so that a subsidiary and a branch are taxed in the same sort of way. If subsequently regulatory changes push more to subsidiarisation, that is fine. If it does not, it does not, but prejudging it with tax does not seem quite right" (Q 60).

180. Asked why foreign branches were not included as part of the package, Ms Knott stated that "we are very much aware that the BBA and the banking industry generally, would welcome an exemption for the profits of their foreign branches; but there were two sides to the story … the oil and gas sector, for example, would not welcome that kind of system because it would deny them immediate access to the losses of their overseas branches … We are likely to return to [the issue] but it will probably be after the reform of the Controlled Foreign Companies Rules, because that in itself is a significant project that will take time to get right" (Q 168).

181. The second issue concerned the detail of Schedule 14. There was widespread criticism of its complexity. The criticism was not universal, Mr Cussons commented "So it is not simple but I think it is a pretty decent bit of drafting and I think it is the right policy" (Q 5). Though he later accepted that "We could have the debate which was had with the Treasury and latterly with the Revenue, why you did not just introduce an exemption with anti-avoidance rather than the charge with the exemptions with anti-avoidance. It may be there are some foreign tax reasons why we have done it this way" (Q 6).

182. Others were less charitable in their comments. The LSS had "some concerns about the complexity of the provisions introducing this change. In particular, the Society believes it unfortunate that the legislation assumes that foreign dividends are taxable unless they fall within the exemption, rather than the other way round. It would make more sense if foreign dividends were assumed to be exempt, subject to exclusions" (p 21).

183. The LSEW echoed this "Our main reservation is that the provisions of Schedule 14 are overly complex and, as a result, some of the potential benefits, in terms of simplification and ultimately compliance cost are being lost" (p 13). Mr Greenbank emphasised this in his oral evidence "you ought

to start off with the basic default position that dividends are exempt" (Q 30). The LSEW also commented on the schedule creating a separate regime for small companies and concluded "The creation of a separate regime simply adds to the complexity of the regime, creates boundary issues and adds to the compliance costs. In our view, there should be a single regime for all companies and the small companies exemption may be a better model" (p 14).

184. The LSEW's conclusion was that "The exemptions provided by Schedule 14 are subject to numerous, at times, over-lapping exclusions, which could, in our view, be simplified without a significant degree of risk to the Exchequer" (p 14).

185. The Law Societies were not alone in their concerns over the drafting. The IoD saw the drafting as "convoluted" though did suggest that this might be driven by the need to ensure consistency with European law (p 41). The 100 Group wrote "we do not believe that this approach [of schedule 14] offers the greatest simplicity or certainty to taxpayers … We would … ask HMRC to publish its guidance on the legislation as soon as possible so that taxpayers will be given greater certainty" (p 34). The IoD was also concerned about capital distributions.

186. Responding to these points, Ms Knott acknowledged that "There have been comments on the drafting, but I am confident that the rules will be straightforward to apply in the vast majority of circumstances. It is important to make a distinction here between complexity and the length of legislation and the way it is actually applied in practice, because one can, in a sense, weigh legislation and it feels very complex and difficult, but when one applies it and operates it in practice it may well be straightforward. We believe that that is probably the case with this bit of legislation" (Q 165).

187. Ms Knott continued that they had tried to draft the schedule "the other way round and see whether that would work, but they did conclude, having done that, that this was a better approach to take. What we have in the drafting is a series of broad, overlapping exemptions. A company can come within an exemption simply by satisfying one of those broad overlapping categories. If we drafted it the other way round … essentially companies would have had to satisfy themselves that they were not caught by any of the exclusions" (Q 165). Responding to this point put a different way, she observed that "There are different views on [the drafting]. We did try to look at it from the other end of the telescope, as it were, but concluded that this was a better way" (Q 167).

188. Ms Knott justified the different rules for small companies and large companies on the basis that "we feel that is right because different considerations apply to the two groups of companies, both in terms of their commercial circumstances, and the tax regime that applies to them … Large groups of companies have much more complex commercial arrangements, and they would not have got the certainty that they would need for their arrangements within small company rules. We think it is right to have these two sets of rules for the two sets of companies" (Q 165).

189. The LSEW, with support from the LSS, raised other examples of complexity and uncertainty: "the exclusions of 'distributions of a capital nature'" means that "many distributions will have to be tested against some relatively unclear case law principles" (p 13). Responding to this, Ms Knott said that "having

looked at [the issue] and got legal advice, we do not … feel that there is a change to be made there" (Q 168).

190. There were other specific points that were raised with us by the CBI, 100 Group and the CIOT (pp 37, 35, 56): the need to address the position of joint ventures; and an issue concerning split shareholdings in subsidiaries was raised by the 100 Group (p 35). Again Ms Knott did not see the need for change in either case "We did not feel it was appropriate to give them their own exemption apart from the fact that that would have added to the complexity of the legislation; they do give rise potentially to greater risk to the Exchequer so we felt it was appropriate to have them using that general exemption" (Q 168).

191. **We are disappointed that a dividend exemption, which has been universally welcomed in principle, has been marred by dissension over the drafting. We note the view of HMRC officials that it was considered better to draft the schedule in the way that it was, and that the rules will be straightforward to apply.**

192. **Clearly it is now too late to change the approach to drafting. However, we regret that consultation on the method did not take place before actual drafting commenced. Had this happened, there might not have been the adverse criticism that we received from our private sector witnesses. It is now too late to do anything about this, other than to address the specific issues raised by our witnesses.**

193. **More generally, we recommend that wherever appropriate, and particularly where the approach to drafting is likely to prove contentious, consultation should take place on the approach to drafting as well as the substance of the provision.**

The Debt Cap

The Principle

194. This was the part of the foreign profits package which was least welcomed by our private sector witnesses. The 100 Group was sympathetic "we understand the rationale for a debt cap in the context that this formed part of a package on offer to secure the introduction of dividend exemption" (p 34).

195. However, the majority view was otherwise. The LSEW believed "that the policy underlying the worldwide debt cap is fundamentally flawed and that the Schedule should be omitted from the Bill." Their view was that "many of these anomalies [in the schedule] are inevitable consequences of the underlying principle and, as a result, these changes can never do more than paper over the cracks" (p 14).

196. The reasons the LSEW saw the debt cap as they did was that "The underlying principle of the worldwide debt cap is to restrict financing costs within a worldwide group by reference to the external financing costs of the worldwide group … The aim of the debt cap is to limit the deductions which a UK company can obtain for its financing costs by determining an amount of interest cost which is regarded as excessive … UK legislation already includes rules which are designed to have this effect … and are based on the internationally agreed arm's length standard … The debt cap is in direct conflict with those principles. One consequence of the basic policy is that a UK company is not taxed by reference to its own results. Instead, its tax

position can be materially affected by transactions which are undertaken by other members of its worldwide group in which it has no interest whatsoever. The results can be completely arbitrary: Two UK companies engaged in exactly the same transactions and making exactly the same profits from those transactions can have wildly differing tax results" (p 14).

197. The LSS joined with the LSEW in believing that "these proposals are fundamentally flawed" (p 21). The CIOT was almost as forthright in its view "that the whole debt cap principle is misconceived. The legislation is both arbitrary and discriminatory, and represents a move away from the well-established arm's length principle of taxation. It is not clear to us why these provisions are required at all in addition to the many existing rules, which are intended to restrict relief in certain situations including transfer pricing, anti-arbitrage provisions and Finance Act 1996 Schedule 9 paragraph 13" (p 56).

198. Responding to the point that the approach of the debt cap rules is fundamentally flawed, Ms Knott emphasised that "the Government does feel that some restriction to interest relief is needed as part of this overall foreign profits package, to protect the tax base and limit the risk to the Exchequer. We feel that the debt cap is an appropriate way of doing that. You mentioned the arm's length principle; in fact many countries have introduced restrictions beyond the arm's length principle, and the proposed debt cap is actually a lot simpler to operate than a lot of restrictions that other countries have introduced". Having outlined an example of the UK part of a group claiming interest relief for much more than their external worldwide interest exposure, she continued "That is what the debt cap is trying to address, those egregious cases where groups are getting relief for more than their worldwide interest in the UK. It would not be possible to address that kind of situation solely by the arm's length principle" (Q 169).

199. Later Ms Knott addressed the point that the debt cap was arbitrary in its application "I think it only appears arbitrary if you look at each company in the group in isolation. In reality, worldwide groups operate as an economic unit, and it is very artificial to look at each company in isolation. The debt cap does look at what is happening overall in the worldwide group in line with that economic reality" (Q 169).

The Outcome in Practice

200. The ICAEW "welcome the decision not to introduce the new worldwide debt cap rules before accounting periods beginning on or after 1 January 2010 so that international groups have time to reconsider their existing arrangements. This deferral provides an opportunity for further consultation so as to ensure that the identified problems with the debt cap are addressed" (p 1).

201. Mr Cussons confirmed the complexity of the schedule and expressed concern that a wholly UK group would fail the gateway test in the schedule as it is currently designed and have to grapple with the complexity of the schedule even though there is no disallowance at the end. "So you are going to have medium and large businesses all dragged through the bulk of the schedule for small revenue gain" (Q 9). He saw this as "highly unfortunate" since such groups are "not within what we understand as the avowed policy targets of the government, which is excessive debt funding by inbounds and upstream loans from foreign subsidiaries to companies headquartered here" (Q 9).

202. Mr Hardwick took us through a number of examples and expressed the Society's views:

- In the first two examples, the schedule produces the result that one would expect.
- In his third and fourth examples, one might expect a restriction but the schedule did not achieve this. From the third example he drew the conclusion that "the debt cap will be effective only at the margins and, in quite a lot of cases where there may be debt dumping going on, it will not bite" (Q 32). From the fourth example, he concluded "that, while the debt cap will be effective in some cases to limit interest on upstream loans, it will not always be effective" (Q 32).
- From examples 5 and 6 he concluded that the effect of the debt cap schedule may well depend on how a foreign parent has financed itself "I would question whether what the foreign group happens to have done outside the UK is really the right test for whether interest is disallowed in the UK" (Q 32).
- His final example drew from examples 5 and 6; he explained it thus "What it illustrates is that if you do have a foreign group which has surplus cash and it wants to make an acquisition in the UK it is better off borrowing externally than using its surplus cash. Again, I question whether that is a sensible policy result" (Q 32).

203. It was put to us that these examples of the LSEW question whether the debt cap rules achieve a sensible result in policy terms. When asked whether the LSEW had put these arguments to the Treasury and HMRC, Mr Stratton for the LSEW told us that they had "not put these exact slides but an earlier set of slides which are very similar [had been put] to the Treasury and the Revenue. We wrote a paper on our suggested design. We have not had a clear response to either. What seems to happen with the process is it just rolls onwards, so it only looks forward. It does not look at what you have presented. I cannot say that my colleagues and I know why the Treasury have stuck with this particular proposal" (Q 33).

204. Mr Baron had comparable concerns when he told us that "if you have a cash rich group with no external debt overall, you might find that you just have one internal loan and that is clobbered. It could happen simply because the group is run as a number of separate businesses each of which is allowed to do their own thing. In order to respond to that and make sure that you do not get caught by the debt cap, you would have to change the whole way in which the group's financing is arranged" (Q 53). As the IoD put it in its written evidence "The legislation's main victims will be cash rich groups that happen to have some intra-group lending. It strikes us as odd to penalise cash-rich groups that might want to invest in the UK, and to give preference to indebted groups" (p 42).

205. Ms Knott conceded that "there could be some companies that do not get through the gateway test, and have to operate the rules and find, having operated the rules that there is no restriction to their interest rate … We looked very hard at that. It was very difficult—and particularly this might apply in terms of wholly domestic groups—to come up with a gateway that was satisfactory in terms of European law which would exclude that kind of thing. But we did carve out all the small and medium size companies which tend to be the ones which are wholly domestic" (Q 172).

206. Responding to the examples which had been put forward by the LSEW and IoD, Ms Knott took us through examples 3 and 4 by way of illustration. She thought that example 3 is "a good example of the way in which the debt cap still leaves the UK rules quite generous in international terms, and it also demonstrates how the debt cap operates in quite a straightforward way … In example 4, again there is no restriction, and this shows how the debt cap will not catch every example of an upstream [loan] from a subsidiary to a parent, but again it illustrates that the debt cap rules are designed to be as straightforward as possible. It needs to strike a balance between catching every conceivable case and having something that can be operated in practice. We would need much more complex rules to capture that kind of example" (Q 171).

207. In their supplementary evidence, HMRC took us through the other examples:

> "The fifth example shows a case where the debt cap rules are intended to have an effect. The group has structured its UK investment using intra-group debt even though the group as a whole has no external debt. It is not unreasonable to limit the deductions for interest relief in the UK in this kind of situation, and to do so we need to look at the group as a whole, not just the UK part of the group …
>
> The sixth example is a variation on example 5. In this case while the debt cap rules themselves won't bite, the UK transfer pricing rules that counter the problem of thin capitalisation will still limit the amount of interest relief in respect of the debt that the UK subsidiary borrows from the foreign parent …
>
> The seventh example shows two investments in the UK, one using external debt and one using intra group debt. The examples correctly conclude there will be a disallowance in the latter case because that group has no external debt. This is a real difference between the two situations; external borrowings are a real cash cost to the group. In the right-hand example the investment in the UK could be made using equity rather than debt. However, these are very simple examples and we think it unlikely that groups will base their financing decisions solely based on the impact of the debt cap rules" (p 118).

Complexity

208. Moving on from the question of whether the debt cap rules produce a result that seems sensible, given its policy objectives, our private sector witnesses were very concerned at the complexity of the drafting. The LSS was "extremely alarmed by the huge complexity of this body of legislation" (p 21). The ICAEW remained "concerned that the introduction of the worldwide debt cap, as currently proposed, will add considerable complexity to the UK tax system". They believed "that the same policy objectives, which are to prevent the 'dumping' of debt into the UK part of worldwide operations and the penalisation of upstream loans to the UK, could equally well be achieved by tightening up the existing thin capitalisation regime and introducing targeted rules against upstream loans" (p 1).

209. The IoD saw the schedule as "an enormously complicated set of provisions to impose a debt cap, the need for which is not at all clear. The most obvious target is upstream loans, but such loans will mostly be cleared once the

dividend exemption becomes available" (p 42). The 100 Group saw the debt cap rules as "simplified since their original form, [but] they remain complex. Notwithstanding the 'gateway' test … the compliance burden and information-gathering requirements of the debt cap rules will be significant. Some complexity around the compliance burden could be reduced if the gateway test could be amended so that companies that clearly fall outside of the debt cap rules do not have to undertake a significant and detailed compliance exercise to show that this is so" (p 35).

210. We were left in no doubt by our private sector witnesses that the debt cap rules are a complex piece of legislation. Having acknowledged that, some such as Mr Heslop thought that "Our overall view on the debt cap is that we will live with it" (Q 54). Others seemed less sure, given the strength of feeling. The ICAEW doubted HMRC's figure of £8.7 million of the cost of administering the debt cap as "likely to prove extremely conservative" (p 2).

211. Responding to the charge that all this complexity could have been avoided by a different approach, Ms Knott repeated that "the thin capitalisation rules rely on the arm's length principle … it would not be possible to tackle that kind of thing [large amount of UK interest compared with worldwide interest exposure] with the arm's length principle. It tends to apply in the inward investment situation. In terms of a targeted measure for upstream loans it is something we have looked at but it would have raised a number of problems" (Q 174).

212. **We accept the need for some restriction of interest relief. But two questions arise, first as to principle and second as to drafting. Many of our witnesses thought that the debt cap, moving away from the arm's length approach, was wrong in principle. They also thought that the results were arbitrary and produced surprising results in policy terms.**

213. **We were not greatly reassured by the responses of officials, including their counter to some of the examples put forward by the LSEW. Officials pointed out that many countries had moved away from the arm's length principle and that the policy approach of the rules was governed by the need to have something that could be operated in practice.**

214. **In general, we found it surprising that the taxable profits of a UK company could be heavily influenced by transactions entered into by companies elsewhere in the worldwide group. And in their evidence, it seemed to us that officials implicitly accepted that it would not be possible to achieve the desired policy outcome within an acceptable level of complexity.**

215. **Private sector witnesses also put to us that it seems inappropriate to penalise cash-rich groups that might want to invest in the UK, and to give preference to indebted groups. In response, officials went some way to acknowledge this when they said that groups would be unlikely to base their financing decisions on the impact of the debt cap rules.**

216. **All these factors suggest to us that there may be some substance in the view of the private sector that the approach is flawed.**

217. **Our witnesses were very concerned at the complexity of the debt cap rules. Some were of the view that it would have been better to tighten**

the existing rules and introduce a targeted measure against upstream loans. Officials thought that the existing rules and an upstream loans measure would not have provided sufficient coverage and cause other problems.

218. **We are surprised and concerned that a long period of consultation left some pretty important issues unresolved. Our witnesses would not have used words like "Frankenstein monster" if they did not feel strongly about this. It is clearly too late now to change the approach of the debt cap. However, we recommend that HMRC should do what they can to reduce discontent with these provisions. We think that the problems need to be resolved, either by making changes, or persuading the representative bodies that changes are not necessary. Subject to what follows, that means that any legislative changes have to be made during the passage of the current Bill.**

The Case for Delaying Implementation

219. Draft clauses on the financial services exclusion were published only just before the whole package was due to be discussed in Committee. And as discussed above, there is still a lot of feeling about the approach and the complexity of the debt cap rules.

220. The general timing issue was commented on by the CBI. They wrote "Throughout the constructive consultations on Foreign Profits reform the CBI expressed concern that there was insufficient time to cover both Dividend Exemption and a Debt Cap in such a way as to have properly worked up legislation in the Finance Bill when laid before Parliament. Unfortunately events have proved our concerns to be well founded" (p 37).

221. The IoD put to us the idea that it would be better to delay the implementation of Schedule 15 from 1 January until 1 August 2010. That would allow for further changes to be made in Finance Bill 2010. A 1 January implementation date would mean that all legislative changes would have to be made during the passage of the current Bill. As Mr Baron for the IoD said to us: "once the legislation is, as far as the government is concerned, final, we need to stand back from it and say, 'Do we have everything in this that we do need or are there still loose ends?' and we need time to do that, we think it would be wise to at least open the window to allow this legislation to be revisited in the Finance Bill 2010 before it comes into force" (Q 64).

222. We discussed this possibility with officials. Mr Neale expressed the official view "this is a package. Business clearly wants to proceed as quickly as possible with the dividend exemption. Government ministers have always been clear that the counterpart of a dividend exemption is the debt cap. It is important to move forward with both measures together. As we have been explaining, a great deal has changed in the structuring of the debt cap as a result of the consultations we have had with business and it will be implemented in 2010" (Q 175).

223. **Given that the dividend exemption rules are to come in from 1 July 2009 whereas the debt cap rules are to apply for accounting periods beginning on or after 1 January 2010, we think that the link between these two elements has already been stretched. It seems to us that it would not be serious if the implementation of the debt cap rules were**

to be delayed by a further few months if there are issues that cannot be resolved during the passage of this year's Bill. We so recommend.

Controlled Foreign Companies

224. There were few comments from our private sector witnesses concerning CFCs. Commenting on why the CFC proposals published in June 2007 had received such an adverse reaction, Mr Heslop explained that those proposals would have taken "intellectual property income earned anywhere in the world and brought it back it back into UK tax, regardless of whether the UK had any involvement in the creation of it. For UK groups this was a very detrimental impact on competitiveness and it was worth spending any number of years to resolve that and get it right" (Q 48).

225. In general therefore, the fact that the substantive changes had been deferred was welcomed. The 100 Group would have preferred that the consequential changes in this year's Bill had "been made as part of an agreed package of changes in the more comprehensive ongoing review of the CFC regime" (p 34). On the substantive changes, the ICAEW thought there was "merit in considering, as an alternative, a tightening up of the existing ant-avoidance legislation which has as its aim to prevent artificial diversion of profits from the UK" (p 2).

226. On the measures in schedule 16, the IoD had an issue with the modification of the exempt activities exemption.

227. **There were few comments on that part of the package concerning Controlled Foreign Companies. One of our witnesses had an issue with the detail of the provisions and we hope that it will be possible for HMRC to address this and decide whether any change is necessary.**

Treasury Consents

228. There was a universal welcome for the repeal of the existing Treasury consent rules. The 100 Group thought that "Further simplification could be possible if the reporting requirements regulations enabled HMRC to adopt simplified arrangement for transactions of a recurring nature (p 35). The CBI and the BBA thought that reporting could be minimised by reintroducing the General Consents that had been part of the existing regime (pp 38, 43).

229. We explored these points with our witnesses. Mr Baron for the IoD was content to see these issues sorted out on the ground. Mr Woods for the CBI would prefer to see them enshrined in legislation. Indeed he would have preferred to see the existing legislation rewritten by dropping the criminal sanction and turn the pre-clearance process into a post-clearance report in a few words. "It could have been done much more simply than it has been and that would have addressed some of the inevitable uncertainties" (Q 61).

230. Ms Knott confirmed an intention "to include the substance of the current General Consents in regulations and a draft is due to be published on the HMRC website this week" (Q 177).

231. **The change in the rules for Treasury consents was widely welcomed. The incorporation of the substance of the General Consents in regulations will please our private sector witnesses.**

CHAPTER 5: REAL ESTATE INVESTMENT TRUSTS

Context

232. Real Estate Investment Trusts (REITs) were introduced with effect from 1 January 2007. Kate Barker's review of housing supply[21] set out the long-term lack of supply and responsiveness of housing in the UK. In response to her interim report in 2003, the Government embarked on a series of consultations with the aim of promoting greater efficiency and flexibility in the UK property investment market, which it believed would also bring benefits to the wider economy. There were a number of features of the property market which the Government believed resulted in its operating inefficiently. These included lack of choice for small investors, poor liquidity, inefficiency in the use of the commercial property, variable standards of provision in the private rented sector, high levels of debt financing, and tax distortions. The Government believed that the introduction of REITs would address all of these points, but was committed to ensuring that any reform was introduced at no cost to the Exchequer.

233. According to the Regulatory Impact Assessment published at the time of the introduction of REITs in the 2006 Finance Act, the aim was to reform the tax treatment of property investment to:

- improve the quality and quantity of finance for investment in property,
- expand access to a wider range of savings products on a stable and well regulated basis,
- ensure that a fair level of taxation continued to be paid by the property sector, and
- support structural change in the property market.

234. For companies carrying out property rental business, the provisions shift the burden of tax from the company to its shareholders. Quoted companies, at least 75% of whose business is renting property (known as the balance of business test), can become a REIT subject to various conditions and on paying an entry charge of 2% of the value of its property assets for so doing. In order to put a lower bound on the level of debt financing, there is an interest cover ratio of 1.25 which a REIT has to meet. It is then exempt from tax on its income and gains of its property rental business and pays tax only on profits and gains from other activities. However it has to distribute to its shareholders under deduction of tax 90% of its profits from its property rental business: in their hands it is treated as property income.

235. There were a number of, mainly technical, changes in both the last Finance Acts. Following that there are a few minor changes in the current Finance Bill which are intended to:

- prevent companies from restructuring with the aim of meeting the REIT requirements and conditions
- remove a barrier to entry for businesses with tied premises, and
- clarify and make consistent parts of the legislation.

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21 *Delivering stability: Securing Our Future Housing Needs*, Kate Barker, March 2004

236. Our purpose in reviewing this aspect of the Finance Bill was not only to look at the detail of the provisions in the Bill but also to consider the working of the REIT regime in the period of rather over two years in which it has been in force and to consider how it might best be taken forward.

The experience of REITs to date

237. Our witnesses from the private sector were agreed that the consultation which led to the REIT regime had been well handled, and that the scheme had worked well in the two and a half years since it was introduced for those large property investment groups which had gone into the REIT regime at the outset. There was however disappointment that there had been no new REITs, in particular covering residential property. The economic circumstances during that time had however been very difficult so that it would be unfair now to judge its success in encouraging new REITs.

238. For example, Mr Whiting said to us "I think the regime that was introduced for REITs was good, and a testament to good consultation with the industry. The system of charging the entry fee was fair, in many ways, for getting it going and, had it not been for the economic downturn, I think that we would be sitting here saying this is going well. Inevitably, REITs that have launched have not perhaps done as well economically as they had hoped and there has not been the queue of prospective REITs that we were hoping for. So we are not yet looking at an enormously successful venture but I personally, and talking to colleagues, would trace it back to economic issues rather than defects in the system" (Q 98). Similarly the ICAEW suggested that "it is probably too early to assess the success of REITs. Further, given the current depressed property climate, it is perhaps not surprising if current interest in REITs is quite low" (p 2).

239. However other witnesses thought that the economic climate had not been the only factor. Ms Rosalind Rowe, Royal Institution of Chartered Surveyors (RICS) said to us "I think the RICS very much supports the concept of a REIT. They want to see it be used effectively to correct market defaults and I think there is some concern that in the current credit crunch there are some particular snags which have arisen, which they would like to see resolved. However, I think there is one disappointment, which is while there are 20 REITs at the moment, about £30 billion market cap, there are not any residential REITs and certainly the RICS would like to see the REIT being used as one of a number of investment vehicles that could attract institutional investment into the residential regime, specifically now that we see some unwinding in the buy to let market" (Q 113).

240. Commenting on the extent to which it was the economic circumstances rather than structural issues which had led to the failure of REITs fully to meet their objectives so far, Mr Graham Roberts for the British Property Federation (BPF) told us "I think the timing was unfortunate as we were clearly approaching a peak in the property market. I think the REITs have managed to weather that storm fairly well; they have the ability to raise rights issues and in fact the majority have accessed capital recently to bolster their balance sheets. But the structural issues within the rules clearly did not think through some of the difficulties of operating in the extraordinary climate we have at the moment, where bank debt availability is so tight. And because there was the introduction of an obligatory payout of cash in the regime—the inability to pay scrip dividends, for example—it meant that there was an

obligation to pass out cash when actually preservation of cash is a natural stewardship point in most companies. So that the regulations were doing something not normal for plc behaviour; I think that is the main issue" (Q 114).

241. Ms d'Inverno told us "The inflexibility of the 90% distribution rule has not helped in the current economic climate, even for commercial REITs. It might be that a greater flexibility around that would be helpful. It is the same approach as for investment trusts where a degree of latitude is necessary to navigate through these difficult times. Also obviously, the requirement for REITs to be quoted is perhaps a bit of an impediment to them spreading more widely and the fact that other countries have unquoted REITs is something we should undoubtedly aim for" (Q 38).

242. Mr Hardwick referred to a number of difficulties arising from the fact that the rules drafted with single companies in mind had to be applied to complex groups and uncertainties caused by having notionally to divide into its exempt property rental and other business. He added "We have relatively new and quite complex legislation. The industry has devised an eight page snagging list which it has been discussing with the Revenue. The Revenue has been helpful and over time some of the problems have been solved by legislation, of which this year's legislation is one example. Others have been dealt with in guidance. There still remain others to be dealt with and it is a question of making sure that there are resources and Parliamentary time to deal with them" (Q 41).

243. We asked officials for their comments on the experience of REITs and how far they attributed the comparative lack of success to the economic circumstances and how far to structural weaknesses in the regime. In response Mr Jim Harra, HMRC, said that REITs had "been a marked success in this initial phase … There is no doubt that their performance, in common with other parts of the economy, has been hit by the current economic climate and by the credit crunch but it is not clear that that is down to structural issues with the regime" (Q 178).

244. **REITs were introduced after a great deal of careful planning between departments and the industry and there were considerable hopes for what they might achieve. Certainly there has been some success, in particular that there are 21 REITs today, including some 75% of the listed property sector. However they have failed to live up to expectations, in particular in that there are no residential REITs or new ones rather than conversion of existing property companies.**

245. **It is difficult to conclude that this partial failure is wholly due to the economic circumstances and not also in part to structural defects in the system. Moreover there has been little attempt to respond flexibly or significantly in their design to the difficult economic context. The measures suggested by our private sector witnesses could have helped.**

Finance Bill measures

246. Our witnesses from the private sector broadly welcomed the measures in the Finance Bill, but did not think that they were of as high priority as some other issues. For example the BPF said that "we have been speaking with HMRC about these 'snagging' items since 2007, and have classified them by

priority, whether they have policy implications, and whether they require primary or secondary legislative solutions or can be addressed through guidance. We welcome the fact that Schedule 34 Finance Bill addresses three such issues, albeit that they were all relatively low priority (and uncontroversial in policy terms). Unfortunately, one issue that we had identified as high priority and which had not been felt to have policy implications has not been addressed. That issue relates to the treatment for the purposes of the 'balance of business' test of cash raised from investors or lenders for the purposes of a REIT's tax exempt business. The Government has also failed to clarify its views on issues with possible policy ramifications" (p 74).

247. Likewise RICS said that "The 2009 Budget made some positive but largely technical changes to UK REITs without taking significant action to increase the use of REITs within either the commercial or residential property sectors" (p 76).

248. We asked officials if they would care to comment on the measures in the Finance Bill, their likely impact and the priority which they gave to them compared with other items under discussion which had not been included in the Bill. After he had described these measures, Mr Harra said "The Government attaches a high priority to the provisions in [the Finance Bill] but they are intended to improve the operation of the existing regime. I think it is fair to say that the Government does not accept that all of the snagging items, for example, that the industry put forward are indeed snags with the existing regime. Some of them are representations for policy change but, looking at the original purpose of this regime, which is to equalise the treatment of the investment between indirect and direct investment, we believe that it achieves that objective" (Q 179).

249. **The measures in the Finance Bill are useful and welcome and other items on the property industry's snagging list have been tackled. But no-one has claimed that they will make any significant difference either to the number of REITs or to the recovery of the property market. We think that there was scope for going further, by picking up, for example, the issue relating to the treatment of cash under the 'balance of business' test, without damaging the objectives of the scheme or risking significant tax loss.**

Measures to help REITs in the current economic circumstances

250. Given the unfortunate timing of the introduction of REITs, we wished to explore with our witnesses measures which might be especially helpful in the current economic climate. The list of measures put forward by the BPF and RICS were broadly similar (pp 75, 77). We have already mentioned some of these matters. In particular the requirement—placed on REITs alone—to distribute 90% of their taxable income in cash annually: this, they argued, should be widened to include distributions in shares, as has been done in the United States. In addition it ought to be possible to defer the payment of dividends to give greater flexibility and to balance competing needs to maintain the business and make distributions. They also suggested that the gearing restriction which required the gross profit to be at least 1.25 times the interest payable on the debt could cause particular problems in accessing credit at the present time.

251. The BPF said that they had "explained the problems that had been identified to officials, and articulated the solutions proposed, emphasising the need for swift action and the fact that they would have only minimal or temporary impact on the Exchequer. It was also made clear that all the measures proposed were either intended to be temporary reactions to current economic conditions, or compatible with the notion of REITs as low risk, high distributing vehicles for collective investment in real estate. We were extremely disappointed that the Finance Bill contains only one peripheral measure (effectively a 'snagging' issue, fixing the law permitting the issue of convertible preference shares by REITs). All our other suggestions, including the three priority measures identified above, were ignored without any satisfactory explanation" (p 75).

252. The proposals out forward by the LSS followed broadly similar lines (p 22). So did those of the LSEW. They also added "We recognise that in order to safeguard the Government's tax revenue such stock dividends would need to have been taxed in the same way as ordinary dividends, and that this might have made them unattractive to some—though not all—categories of investors" (p 16).

253. As to the gearing restriction, Ms Rowe understood why there had to be an interest restriction to prevent all the rental income being taken out tax free. But she added "However, in defining the finance cost ratio, just what costs would be looked at, they brought in quite a few other things like movements on derivatives, hedging transactions and debt break costs and again at the time of the credit crunch, when people are actually trying to revise the basis on which they are financed, they do find that they do have to pay the payments and they go through the finance cost line. So I think there are inadvertent consequences that need to be rectified" (Q 118). She thought that these recommendations were not in the Finance Bill because, although they were key priorities for REITs, they were not key priorities for the Government. "However, we would like to encourage them to reconsider" (Q 119).

254. We asked officials why these issues had not been tackled and whether Ministers might reconsider measures to help REITs in the current circumstances. Mr Neale said that REITs would benefit from the measures which the Government had taken to support businesses through the downturn. But "some of the changes [suggested] go to the fundamental design of the REITs regime. The requirement to distribute is there to protect investors and to ensure that dividends are taxed in the hands of shareholders, and the gearing requirement is equally there to protect investors and to protect revenue" (Q 180).

255. **In our view a more open-minded approach to the several proposals put forward to help REITs in the current circumstances would have been appropriate. We were not persuaded that all the proposals, such as the payment of dividends other than in cash, undermined the fundamental design of the regime. Neither would they have failed to protect investors or have had an unacceptable cost to the Exchequer. Since REITs are not currently meeting their objectives, the cost of helping them now should not be an overriding objection. We recommend that departments look again with greater sympathy at the proposals by the representative bodies.**

Longer term structural reforms: residential REITs

256. We also asked our private sector witnesses about longer term, structural reforms. The BPF suggested that "Government has so far shown an unwillingness to keep the REIT regime under active review so as to identify opportunities which might be available for expansion and development which could benefit both the property sector and the wider economy. Two particular examples are residential REITs and the role REITs might play in helping the UK emerge from the downturn" (p 75).

257. Among other things they suggested that "another specific strategic opportunity for the UK is the role REITs could play in transforming the private residential rented sector through more large scale and institutional investment and more professional management. Handled correctly, it could offer an inherently flexible and liquid route to residential investment for the public (the only real option now being buy-to-let), better quality of rented property and a new market for house builders and others to build for or sell to. Recent falls in house prices present a cyclical opportunity—as a result of higher yields—but the Government has so far failed to acknowledge this opportunity or take action" (p 76).

258. RICS also suggested that "changes should be made to the REIT regime to encourage their use in residential investment. The Government's response to the Barker Review of Housing Supply in 2005 stated that the REIT regime being implemented at the time in the UK would 'encourage increased institutional and professional investment to support the growth of new housing'[22]. Despite this desire from the Government there are currently no residential REITs in the UK" (p 78). They put forward a number of proposals to encourage increased levels of investment including changing the gearing ratio and reducing the entry cost.

259. They expanded on these issues in their supplementary memorandum in which they looked at the use of REITs to increase investment in the private rented sector. There was a need to increase housebuilding significantly if the Government's targets were to be met; a strong private rented sector could bring advantages through increasing economic flexibility and assisting regeneration. Institutional investment could improve housing quality and management (p 83).

260. They put forward a number of detailed suggestions for changes to the REIT regime to encourage investment through allowing for portfolio churn, addressing problems with the distribution requirement between residential and commercial property companies, and amending the gearing restriction to accommodate the lower net yield (p 84).

261. CIOT said that "A further barrier to the assembly of a residential property portfolio, and thus the promotion of residential REITs, is the requirement in the SDLT [Stamp Duty Land Tax] legislation to apply the SDLT rates thresholds to the aggregate value of a transaction. A bulk purchase of properties is charged to SDLT at the rate applicable to the aggregate consideration (at the maximum SDLT rate of 4% if that consideration exceeds £500,000). This compares with the position where unconnected purchases of individual properties are made, in which case the SDLT is

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[22] Memorandum of Evidence by the RICS quoting from the Government's response to Kate Barker's Review of Housing Supply, HM Treasury, December 2005, recommendation 30. (Volume II, p 76)

charged on the price of each property (at rates of 0%, 1% 3% or 4%). There is, therefore a disincentive to assemble a residential property portfolio. This is not an issue for commercial property, as the value of a typical commercial property is well above the SDLT maximum rate. The purpose of the linked transactions rule is to prevent disaggregation where a taxpayer splits up what is essentially one acquisition into several transactions to take advantage of the lower rates. However this is clearly not the case where a set of residential units is being acquired for institutional investment" (p 57).

262. Ms Rowe told us "I think now is the time to fix the structural problems because this is a kind of one chance now when prices are low but once the market picks up again there is always that concern that it will go back into the vacant possession market and therefore I think now is the time to fix things ... we came into REITs maybe just at the wrong time. Why do we not get the residential REITs right now?" (Q 120).

263. We asked officials why there were no residential REITs and whether they saw it as important to address the particular issues which had been identified. In response Mr Harra said that "One commonly cited reason [for the lack of residential REITs] is a general institutional reluctance to invest in residential property, which I think is partly historical but also partly down to the difficulty of achieving sufficient yields because of management costs and issues with leases. The industry have put forward representations for significant changes to, I think, almost every aspect of the REIT regime in the belief that that would promote residential REITs. It is not clear that they would have that effect and it is important to note, as Mark [Neale] has said, that each and every one of those features is there for an important reason" (Q 182).

264. When we pressed further and asked whether the original judgement that REITs would lead to institutional investment in private renting, which was much needed, Mr Harra added "I think it is still very early days for the regime. It has only been in operation for two full years and during that time there has also been the disruption to the property market which means that, quite apart from the regime, investment decisions around residential property have been impacted. We do keep it under review. As witnesses said, they had excellent consultation with us in the initial phase, and we maintain that with them. We do listen to representations as to how it can be improved but very significant wholesale change to the regime so soon after it has been implemented is something that would need very careful consideration" (Q 183).

265. **We note with concern the policy failure to see any residential REITs established. In our view it is not sufficient simply to blame the market and hope that in the medium term REITs will expand into the residential sector as the market turns. We believe that there are market opportunities which could be taken now in order to begin to achieve the original policy objectives, albeit at some cost, and we recommend that the detailed proposals put to us should be investigated as a priority.**

New REITs

266. There is also a dearth of new REITs, commercial as well as residential. The RICS also suggested that companies listed on the Alternative Investment Market should be eligible to become REITs: this, they said, "would be

particularly important if REITs are going to be used in the residential sector. The Government should also consider allowing unlisted REITs and the possibility of owner occupier REITs in areas where this could provide greater levels of investment—for instance hotels" (p 78).

267. In their supplementary evidence RICS added "There are currently only a very small number of residential property companies listed on public markets, giving a very small pool of potential investors. This is partly due to the cost of listing compared to the AIM or an unlisted vehicle which acts as a barrier to entry, particularly for smaller REITs focussed on a specific activity" (p 85).

268. The BPF said that "A fundamental problem which needs to be addressed in the UK is the fact that the REIT rules as originally designed served to encourage conversion to REIT status by existing listed commercial property companies, rather than to attract new entrants, because of very high entry costs. The result is that there has been very limited growth in the sector, and many new property investment ventures for which REIT status would have made sense are likely instead to be formed using offshore structures. That would be a missed opportunity" (p 75).

269. They continued: "The recent recapitalisation of the UK REITs, raising about £3 billion of additional equity, much of it from overseas, shows how UK property can attract inward investment in scale. This demonstrates a strategic opportunity, which emerges from the current downturn. REITs could have a vital role to play in recapitalising the banking sector which is undercapitalised and overexposed to commercial and residential property. Dramatic falls in property values have left banks which saw property simply as the security for their loans with unwanted primary (effectively equity) exposure to property. Their straightforward, tax efficient structure makes REITs the ideal UK resident vehicles for making property assets available to true equity investors. REITs were used in that way by the United States, Japan and other countries following the previous recessions. We hope that the Government will engage with the industry to explore the possibilities" (p 75).

270. Speaking of priorities for action and the recapitalising the banking sector Mr Roberts told us: "We have a huge opportunity to bring capital into the UK; to offer to pension funds and insurance companies a different asset class but wrapped up in a vehicle which is tax efficient. It is not an offshore vehicle, unregulated, but actually one that is within the normal framework of the Companies Act. With that new capital there is a role to play, a part only, in the recapitalisation of the banks which have massive exposure to the commercial property market … Over time that will require some capital to come in, and unlocking that will be part of the secret of actually moving on from the current issues which the banks have" (Q 120).

271. In response to a question whether REITs could play a role in recapitalising the banking sector, Mr Neale said that he had yet to receive a formal proposal from the industry but "we would certainly be very pleased to look at any suggestions the industry has on that front" (Q 185).

272. Replying to a question whether the Government wanted new entrant REITs or just the conversion of existing companies, with the suggestion that if new entrants were an aim of policy, costs could be a deterrent, Mr Neale said "We think that the REITs regime has been a success so far. Twenty-one

companies, major property businesses, have joined it, and our expectation is that more will do so as the regime matures but, as Jim [Harra] has said, it is early days in the context of a fairly turbulent market" (Q 187). He added that the entry charges were "set at the level they are partly to reflect the inherent capital gain in the property and partly to protect the Exchequer interest" (Q 188).

273. It was put to Mr Neale that the real question was whether the Government was being too cautious in protecting the Exchequer's interest if it were trying to encourage the growth of the industry. He responded "You have to strike a balance. The fact that 21 companies have already joined the regime does not suggest that we got the design wrong. Indeed, the consultation and the legislation that followed it were very widely welcomed by the industry. I think it is too early to come to the conclusion that the design is deterring new entry to the REITs regime" (Q 189).

274. **Again on the issue of the failure to see new REITs established, either residential or commercial, the official attitude appears to us to have bordered on the complacent and unduly cautious. It is indeed true that one of the aims of the introduction of the scheme was to ensure that a fair level of tax has continued to be paid by the property industry, but if other aims have not been met, it may be necessary to reconsider what is fair in this context and whether, for example, the total entry charge is too inhibiting.**

275. The BPF said that "The international experience shows that REIT regimes flourish when Governments monitor and amend them to take advantage of opportunities that can deliver benefits for investors, property users and the wider national economy. Examples are successive liberalisations in the United States starting from 1986 (prior to which the US REIT sector was fairly stagnant), and the highly activist approach of France, which has brought forward amendments on an almost annual basis, successfully supporting the growth of the French SIIC regime since its introduction" (p 75). They continued "Ultimately, there is real value in exploring what a REIT regime might be able to offer and intervening judiciously to exploit opportunities. It took the United States (who introduced REITs in 1960) a quarter of a century to see that, whereas the French (who introduced SIICs in 2003) saw it at once. We would like the UK Government to see it too and to get more excited about what REITs could offer, rather than regarding its REIT regime as set in stone and not to be tampered with" (p 76).

276. Mr Roberts added to that orally "... I think that the French experience quite surprised me, but I suppose it is the Gallic approach to Government. The regime came in very quickly, certainly behind closed doors—not in as open and transparent way as we have here, but our process took 18 months. The snagging items then should have been dealt with in successive Bills in order to encourage the market to flourish and it is that last bit which I think is missing" (Q 120).

277. Ms Rowe added "... if you look at the US legislation and if you were to look at the EU's book of legislation you will see that it is about this thick—it is massive and every year there is a new piece of legislation. If you look at the history of REITs in the US they were introduced around about 1964 and they really only took off with a change of law in the 1980s and then they really moved exponentially. What the Government has done there is to respond to the needs of the market" (Q 120).

278. **We were glad to be told that the excellent consultations which took place when the REIT scheme was being set up have been maintained. We recommend that advantage be taken of this machinery to look again, taking account of international experience, at what kind of measures would be necessary to get more REITs. If it is not premature to make significant changes to the taxation of pensions after only three years since the major reform of the system, then it can hardly be premature (as we were told) to do so well over two years after the introduction of REITs.**

CHAPTER 6: CONCLUSIONS AND RECOMMENDATIONS

General Issues

Consultation on foreign profits

279. Overall, we were left with a favourable impression of how the consultation on foreign profits has been handled and we welcome that. It was clearly not perfect in the eyes of our private sector witnesses, but it was much better than that on the two topics we looked at last year. (Paragraph 23)

280. We accept HMRC's view that although the consultation looked a little leisurely in the early stages, there was much work going on in the background, as well as less formal consultation, so that the next document to be published would meet with more general approval. (Paragraph 24)

281. The one area that does concern us is that there was an underestimate of how many comments would be received on the draft legislation exposed in December 2008 and how long it would take to work through these and discuss the points with consultees. This resulted in the Finance Bill being published with changes still in the pipeline. (Paragraph 25)

282. We **recommend** that HMT and HMRC should review the best aspects of this consultation on foreign profits and apply it more generally. In particular, we **recommend** that they should consider carefully why they did not allow themselves sufficient time to incorporate a complete version of the legislation in the Finance Bill as published and should make every effort to prevent this happening again. (Paragraph 26)

Consultation on Taxation of Pensions

283. Given the Government's decision to introduce an anti-forestalling schedule, it would have been very difficult to consult, even on an informal, confidential basis before announcement. Informal consultation is partial, not acceptable to those not involved and can put those involved in a difficult position. In last year's report we recommended "that consultation should be even-handed and open, involving as many as possible of the professional bodies and other parties which have a valid interest". We hold to that view. (Paragraph 34)

Consultation on Wider Issues

284. We remain of the view that consultation should be the norm and only subject to limited exceptions, such as rates, reliefs and anti-forestalling measures. In fact, in their oral evidence, HMRC specifically agreed with this. We are therefore at a loss to know why there was no consultation on the clauses setting out the duties of accounting officers of large companies and the naming and shaming clause. (Paragraph 41)

285. We do not find persuasive the reasons put forward by officials why it was not possible to consult on these clauses. Our view is that with measures as novel and contentious as these, there should have been consultation on the principles as well as the practicalities of implementation. Even by their own criteria, we see this as a failing on the part of HMT and HMRC and we **recommend** that in the future there should be consultation on changes such

as these. We hope that it will not be necessary to revert to this issue again in a future report. (Paragraph 42)

International Competitiveness: Foreign Profits

286. Everyone agreed that exemption for foreign dividends was a very positive change; and that the changes to the Treasury consent rules were positive. Officials were confident that the foreign profits package was a good one in the round, with the debt cap provisions being necessary to protect the Exchequer. (Paragraph 53)

287. However, our private sector witnesses, in some varied comments, were less sure that that the negative impact of the debt cap rules did not outweigh the positive effect of the dividend exemption and the Treasury consent rules. Whilst, in general, they accepted that some rules on the restriction of interest were a price worth paying for the dividend exemption, they thought that the way this restriction had been imposed would add very considerable complexity to the UK tax system and damage the UK's competitiveness. (Paragraph 54)

288. As a minimum we **recommend** that the issues with the debt cap schedule need to be resolved in order that the overall package has a positive effect on competitiveness. (Paragraph 55)

International Competitiveness: Taxation of Pensions

289. We think that the opinion of officials that the changes for pensions will not materially affect competitiveness is likely to prove to be an over-optimistic assessment. As was put to us by our private sector witnesses, the people affected are likely to be the opinion formers in the business world and an adverse impact on them, particularly when coupled with the change in the highest rate of income tax, may well produce upward pressure on the cost of employing highly paid talent. This could have knock-on consequences over a much wider range of people. We **recommend** that the effect of these changes should be carefully monitored and kept under review to establish what impact they do have, particularly on UK competitiveness. (Paragraph 61)

International Competitiveness: Other Issues

290. As our private sector witnesses concluded, the effect of the Finance Bill provisions is a netting of pluses and minuses. It is difficult to be sure what the end result might be. The likelihood of the overall result being positive would be considerably enhanced by a satisfactory resolution of the concerns surrounding the debt cap schedule, either by changes being made, or HMRC persuading others that changes are not necessary. If that can be achieved, then we should not be inclined to differ from the assessment of one of our witnesses of a net half step forward. (Paragraph 68)

Taxation of Pensions

The substantive changes from 2011: Structure of pensions tax relief

291. We fully accept that the Government has to be free to introduce major changes in taxation as it sees fit, and in particular that the changes to pensions taxation reflected in part the increase in the top personal rate of tax to 50%. But we found little official recognition that making a significant

change so soon after the major redesign of the whole system significantly detracted from the simplicity, consistency and certainty which are hallmarks of a good tax system. The undermining of the regime may very well set a precedent and sap confidence. Given the potential effect on savings we found this regrettable. (Paragraph 91)

292. Nor did it appear that officials accepted that the impact of the changes on the pensions industry could undermine confidence in it. While the numbers directly affected may be relatively small, among them will be individuals who are influential in determining the pensions policy of many companies. The precedent may be seen as the thin end of the wedge in reducing relief more generally, so risking a reduction in pensions savings. (Paragraph 92)

Employers' Contributions

293. We accept that, once it was decided to restrict the relief available, employers' contributions had to be included if the purpose of the measure were to be achieved. However that does not remove the risk that the highly paid may look for other means of saving instead. (Paragraph 99)

Defined benefit and defined contribution schemes

294. We accept that it is certainly not the intention that the playing field between defined benefit and defined contribution schemes should be anything other than level. But that may not be easy to achieve in practice and we **recommend** that it should be an aspect to which considerable attention should be paid in the consultations leading to the introduction of the new substantive regime in 2011. The Government should conclude those consultations as soon as reasonably possible in order to allow people to make their plans. (Paragraph 110)

Marginal rates

295. We saw evidence which persuaded us that the combination of the marginal rate of income tax on a pay rise crossing the £150,000 mark and the restriction of relief for pension contributions which that could bring with it could lead to exceptionally high marginal rates and we were not wholly reassured by the answers we were given that officials had fully taken that point on board. We **recommend** that this also should be an area for particular consideration in the consultations on the substantive changes. (Paragraph 115)

An alternative approach

296. A number of witnesses suggested that a pragmatic and far less complex approach towards restricting relief than that adopted by the Government would have been to reduce the annual and/or lifetime allowances, either for the substantive scheme or at least in the transitional period. This could have been done within the parameters of the 2006 rules and would have required a far less significant change to the basis of the relief. (Paragraph 125)

297. Considering the matter in greater detail however, we were persuaded that the outcome of so doing would have been to target the withdrawal of relief above basic rate quite differently from the high income individuals which Ministers intended and would affect some individuals whose income was considerably less than £150,000. With some regret therefore we do **not recommend**

adopting a policy along these lines, despite the greater simplicity and coherence with the previous system. (Paragraph 126)

The anti-forestalling Schedule: the need for the Schedule

298. We question whether it was necessary to have introduced an anti-forestalling provision. Ministers were well aware of the generosity of the relief for high income individuals and should not have been surprised at the proportion of the cost which was going to them. For their part, individuals had a legitimate expectation that it would be maintained. We think that the measure may have been the wrong judgement. (Paragraph 132)

Complexity: less regular contributions

299. Our private sector witnesses had many concerns about the anti-forestalling provisions. The importance of these issues turns significantly on the numbers who may be affected. The HMRC view that for an individual it is optional whether to come within these provisions depends critically, and more importantly than was recognised in evidence before us, on whether an answer can be found to the various issues raised by those who have good reason for not making their pension contributions regularly, at least quarterly. (Paragraph 145)

300. These individuals fall into two main groups. First, the self employed and others who regularly make annual or irregular contributions. Following the consultations now taking place, we think that it ought to be possible to look for an answer which protects those who have a regular pattern of behaviour, even though the actual amounts of pension saving may vary very considerably from year to year. (Paragraph 146)

301. Second, and perhaps more difficult to define, those who have a practical reason, without any forestalling of the 2011 rules, for making a significant one-off payment into their pension pot, for example on retirement or redundancy. These individuals may well have a legitimate expectation that they could properly make a contribution up to the annual allowance and get relief at their marginal rate. (Paragraph 147)

302. If bespoke solutions cannot be found for individuals who fall into these categories, we **recommend** as a fall back that the special annual allowance be increased significantly. (Paragraph 148)

303. If answers are not found along these lines which take out from the ambit of the anti-forestalling provisions all those for whom a significant pension contribution is bona fide and not optional (to use the HMRC phrase), then we **recommend** that full account should be taken of all the concerns of legitimate expectation, complexity, even-handedness between DB and DC schemes, and practical and administrative issues which were raised with us and which will be on the record. (Paragraph 149)

Taxation of Foreign Profits

The Overall Package

304. We remain concerned that the Finance Bill was published as work in progress, a situation that, as was explored previously, was caused by the consultation on the draft legislation taking longer than had been expected.

Whilst we were reassured by the comments of officials that this is not an increasing trend, this is the second year in succession that we have had to comment on this, and this worried us. (Paragraph 167)

305. We accept the evidence of our private sector witnesses that it is very difficult to see the package in the round when there are holes in the Finance Bill proposals. And a commitment to publish the additional legislation as soon as possible afterwards is not good enough as it reduces the time for review, particularly when the publication is close to the hearings in the Public Bill Committee. (Paragraph 168)

306. In our view it is not good practice that the Finance Bill should be incomplete at the time of publication; this must be avoided except in the most exceptional circumstances. (Paragraph 169)

307. We were very interested in the point raised by a number of our private sector witnesses that an opportunity had been missed to move to a 'pure' territorial system, a measure likely to raise sufficient money to fund a substantial cut in the rate of corporation tax. We note the comments of officials that this would not prove attractive to business, though we can understand that reaction if the possibility of recycling the revenue to fund a cut in the CT rate were not on the table at the time. (Paragraph 173)

308. We **recommend** that HMT and HMRC should keep under review the possibility of moving further towards a 'pure' territorial system so that if the Government were to decide that conditions had become favourable for such a move to fund a reduction in the CT rate, the necessary ground work would have been done. (Paragraph 174)

Dividend Exemption

309. We are disappointed that a dividend exemption, which has been universally welcomed in principle, has been marred by dissension over the drafting. We note the view of HMRC officials that it was considered better to draft the schedule in the way that it was, and that the rules will be straightforward to apply. (Paragraph 191)

310. Clearly it is now too late to change the approach to drafting. However, we regret that consultation on the method did not take place before actual drafting commenced. Had this happened, there might not have been the adverse criticism that we received from our private sector witnesses. It is now too late to do anything about this, other than to address the specific issues raised by our witnesses. (Paragraph 192)

311. More generally, we **recommend** that wherever appropriate, and particularly where the approach to drafting is likely to prove contentious, consultation should take place on the approach to drafting as well as the substance of the provision. (Paragraph 193)

The Debt Cap: The Principle; The Outcome in Practice; Complexity

312. We accept the need for some restriction of interest relief. But two questions arise, first as to principle and second as to drafting. Many of our witnesses thought that the debt cap, moving away from the arm's length approach, was wrong in principle. They also thought that the results were arbitrary and produced surprising results in policy terms. (Paragraph 212)

313. We were not greatly reassured by the responses of officials, including their counter to some of the examples put forward by the LSEW. Officials pointed out that many countries had moved away from the arm's length principle and that the policy approach of the rules was governed by the need to have something that could be operated in practice. (Paragraph 213)

314. In general, we found it surprising that the taxable profits of a UK company could be heavily influenced by transactions entered into by companies elsewhere in the worldwide group. And in their evidence, it seemed to us that officials implicitly accepted that it would not be possible to achieve the desired policy outcome within an acceptable level of complexity. (Paragraph 214)

315. Private sector witnesses also put to us that it seems inappropriate to penalise cash-rich groups that might want to invest in the UK, and to give preference to indebted groups. In response, officials went some way to acknowledge this when they said that groups would be unlikely to base their financing decisions on the impact of the debt cap rules. (Paragraph 215)

316. All these factors suggest to us that there may be some substance in the view of the private sector that the approach is flawed. (Paragraph 216)

317. Our witnesses were very concerned at the complexity of the debt cap rules. Some were of the view that it would have been better to tighten the existing rules and introduce a targeted measure against upstream loans. Officials thought that the existing rules and an upstream loans measure would not have provided sufficient coverage and cause other problems. (Paragraph 217)

318. We are surprised and concerned that a long period of consultation left some pretty important issues unresolved. Our witnesses would not have used words like "Frankenstein monster" if they did not feel strongly about this. It is clearly too late now to change the approach of the debt cap. However, we **recommend** that HMRC should do what they can to reduce discontent with these provisions. We think that the problems need to be resolved, either by making changes, or persuading the representative bodies that changes are not necessary. Subject to what follows, that means that any legislative changes have to be made during the passage of the current Bill. (Paragraph 218)

The Debt Cap: The Case for Delaying Implementation

319. Given that the dividend exemption rules are to come in from 1 July 2009 whereas the debt cap rules are to apply for accounting periods beginning on or after 1 January 2010, we think that the link between these two elements has already been stretched. It seems to us that it would not be serious if the implementation of the debt cap rules were to be delayed by a further few months if there are issues that cannot be resolved during the passage of this year's Bill. We so **recommend**. (Paragraph 223)

Controlled Foreign Companies

320. There were few comments on that part of the package concerning Controlled Foreign Companies. One of our witnesses had an issue with the detail of the provisions and we hope that it will be possible for HMRC to address this and decide whether any change is necessary. (Paragraph 227)

Treasury Consents

321. The change in the rules for Treasury consents was widely welcomed. The incorporation of the substance of the General Consents in regulations will please our private sector witnesses. (Paragraph 231)

Real Estate Investment Trusts

The experience of REITs to date

322. REITs were introduced after a great deal of careful planning between departments and the industry and there were considerable hopes for what they might achieve. Certainly there has been some success, in particular that there are 21 REITs today, including some 75% of the listed property sector. However they have failed to live up to expectations, in particular in that there are no residential REITs or new ones rather than conversion of existing property companies. (Paragraph 244)

323. It is difficult to conclude that this partial failure is wholly due to the economic circumstances and not also in part to structural defects in the system. Moreover there has been little attempt to respond flexibly or significantly in their design to the difficult economic context. The measures suggested by our private sector witnesses could have helped. (Paragraph 245)

Finance Bill Measures

324. The measures in the Finance Bill are useful and welcome and other items on the property industry's snagging list have been tackled. But no-one has claimed that they will make any significant difference either to the number of REITs or to the recovery of the property market. We think that there was scope for going further, by picking up, for example, the issue relating to the treatment of cash under the 'balance of business' test, without damaging the objectives of the scheme or risking significant tax loss. (Paragraph 249)

Measures to help REITs in the current economic circumstances

325. In our view a more open-minded approach to the several proposals put forward to help REITs in the current circumstances would have been appropriate. We were not persuaded that all the proposals, such as the payment of dividends other than in cash, undermined the fundamental design of the regime. Neither would they have failed to protect investors or have had an unacceptable cost to the Exchequer. Since REITs are not currently meeting their objectives, the cost of helping them now should not be an overriding objection. We **recommend** that departments look again with greater sympathy at the proposals by the representative bodies. (Paragraph 255)

Longer term structural reforms: residential REITs

326. We note with concern the policy failure to see any residential REITs established. In our view it is not sufficient simply to blame the market and hope that in the medium term REITs will expand into the residential sector as the market turns. We believe that there are market opportunities which could be taken now in order to begin to achieve the original policy objectives, albeit at some cost, and we **recommend** that the detailed proposals put to us should be investigated as a priority. (Paragraph 265)

New REITs

327. Again on the issue of the failure to see new REITs established, either residential or commercial, the official attitude appears to us to have bordered on the complacent and unduly cautious. It is indeed true that one of the aims of the introduction of the scheme was to ensure that a fair level of tax has continued to be paid by the property industry, but if other aims have not been met, it may be necessary to reconsider what is fair in this context and whether, for example, the total entry charge is too inhibiting. (Paragraph 274)

328. We were glad to be told that the excellent consultations which took place when the REIT scheme was being set up have been maintained. We **recommend** that advantage be taken of this machinery to look again, taking account of international experience, at what kind of measures would be necessary to get more REITs. If it is not premature to make significant changes to the taxation of pensions after only three years since the major reform of the system, then it can hardly be premature (as we were told) to do so well over two years after the introduction of REITs. (Paragraph 278)

APPENDIX 1: THE FINANCE BILL SUB-COMMITTEE

The members of the Sub-Committee which conducted the inquiry were:

Lord Barnett
Lord Best
Lord Blackwell
Lord Currie of Marylebone
Lord Eatwell
Lord Griffiths of Fforestfach
Lord MacGregor of Pulham Market
Lord Paul
Lord Powell of Bayswater
Lord Sheppard of Didgemere
Lord Vallance of Tummel (Chairman)
Lord Wakeham

Mr Leonard Beighton, CB and Dr Trevor Evans CBE JP, both retired senior officials of the Inland Revenue, were appointed as Specialist Advisers for the inquiry.

Declaration of Interests

A full list of Members' interests are recorded in the Lords Register of interests:

http://www.publications.parliament.uk/pa/ld/ldreg.htm

APPENDIX 2: LIST OF WITNESSES

The following witnesses gave evidence. Those marked * gave oral evidence.

	Association of Chartered Certified Accountants
*	Richard Baron, Institute of Directors
*	Neil Carberry, Confederation of British Industry
*	Peter Cussons, Institute of Chartered Accountants in England & Wales
*	Maggie Craig, Association of British Insurers
*	Isobel d'Inverno, Law Society of Scotland
*	Ashley Greenbank, Law Society of England & Wales
*	Mike Hardwick, Law Society of England & Wales
*	Jim Harra, HM Revenue & Customs
*	Frank Haskew, Institute of Chartered Accountants in England & Wales
*	Julian Heslop, 100 Group
*	Andrew Hubbard, Chartered Institute of Taxation
	Institute of Chartered Accountants of Scotland
*	Trevor Johnson, Association of Taxation Technicians
*	Angela Knight, British Bankers' Association
*	Judith Knott, HM Revenue & Customs
*	Andrew Meeson, Association of Taxation Technicians
*	Mark Neale, HM Treasury
*	Bill Pagan, Law Society of Scotland
*	David Richardson, HM Revenue & Customs
*	Graham Roberts, British Property Federation
*	Rosalind Rowe, Royal Institution of Chartered Surveyors
*	Joanne Segars, National Association of Pension Funds
*	Richard Stratton, Law Society of England & Wales
*	John Whiting, Chartered Institute of Taxation
*	Mervyn Woods, Confederation of British Industry

APPENDIX 3: GLOSSARY

ABI	Association of British Insurers
ACCA	Association of Chartered Certified Accountants
AIM	Alternative Investment Market
ATT	Association of Taxation Technicians
AVCs	Additional Voluntary Contribution
BBA	British Bankers' Association
BPF	British Property Federation
CBI	Confederation of British Industry
CFC	Controlled Foreign Companies
CIOT	Chartered Institute of Taxation
DB	Defined Benefit
DC	Defined Contributions
EET principle	For explanation see paragraph 80
HMRC	HM Revenue & Customs
HMT	HM Treasury
ICAEW	Institute of Chartered Accountants in England & Wales
ICAS	Institute of Chartered Accountants of Scotland
IoD	Institute of Directors
LSEW	Law Society of England & Wales
LSS	Law Society of Scotland
NAPF	National Association of Pension Funds
NICs	National Insurance Contributions
PBR	Pre-Budget Report
REITs	Real Estate Investment Trusts
RICS	Royal Institution of Chartered Surveyors
SDLT	Stamp Duty Land Tax
SIIC	les Sociétés d'Investissements Immobiliers Cotées—the French equivalent of REITs