HOUSE OF LORDS

Select Committee on Economic Affairs

3rd Report of Session 2008–09

# The Finance Bill 2009

## Volume II: Evidence

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**Written Evidence**



The Report of the Committee is published in Volume I, HL Paper No 113-I
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# Minutes of Evidence

## TAKEN BEFORE THE ECONOMIC AFFAIRS COMMITTEE

## ON WEDNESDAY 13 MAY 2009

| | | |
|---|---|---|
| Present | Barnett, L | Powell of Bayswater, L |
| | Best, L | Sheppard of Didgemere, L |
| | Blackwell, L | Wakeham, L |
| | MacGregor of Pulham Market, L | Vallance of Tummel, L (Chairman) |
| | Paul, L | |

**Memorandum by the ICAEW Tax Faculty**

Introduction

1. We welcome the opportunity to submit evidence in response to the invitation published on http://www.parliament.uk/parliamentary_committees/lfinbill.cfm

2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Appendix 1. Our 10 Tenets for a Better Tax System which we use as a benchmark are summarised in Appendix 2.

Foreign Profits: Clauses 34–37 and Associated Schedules

3. We welcome the broad thrust of these provisions in the Finance Bill, but remain concerned about the overall balance of the Foreign Company profit proposals and their impact on the UK's tax competitiveness. Headquartering a multi-national business in the UK, or inward investment into the UK, is likely to be less attractive in the future on account of these changes.

*Clause 34 and Schedule 14, Corporation tax treatment of company distributions received*

4. We welcome this clause and Schedule under which all distributions (both UK and foreign) will be exempt provided they fall within one of the five specified exemptions. We note that the related issue of the taxation of foreign branches has not yet been addressed. We note and welcome that these provisions will apply to dividends paid by overseas subsidiaries on or after 1 July 2009 while the introduction of the worldwide debt cap will be delayed until accounting periods beginning on or after 1 January 2010. This will allow time for further time for consultation on the worldwide debt cap provisions.

*Clause 35 and Schedule 15, Tax treatment of financing costs and income*

5. We remain 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.

6. The world wide debt cap attempts to restrict the quantum of the interest deduction against UK profits to an amount which is reasonable in the context of the worldwide activities of the particular group. In broad terms the amount of that UK deduction is limited by reference to the consolidated gross (external) finance expense of the particular group.

7. We believe 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.

8. We 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.

9. The revisions to the December 2008 proposals, announced on 7 April 2009, will remove many of the practical difficulties that would have been posed by the original proposals, but the rules remain complex and it is anticipated that a significant proportion of companies, including nearly all entirely UK based and UK

headquartered groups, will still fall within the worldwide debt cap rules. This will add considerably to the UK tax compliance burden.

10. We note that HMRC has assessed the administrative burden of these rules at £8.7 million per annum which we consider is likely to prove extremely conservative.

*Clause 36 and Schedule 16, Controlled foreign companies*

11. We believe that as part of the wider review of the existing controlled foreign companies (CFC) legislation there is merit in considering, as an alternative, a tightening up of the existing anti-avoidance legislation which has as its aim to prevent artificial diversion of profits from the UK.

12. We welcome the decision to retain the exemption for local holding companies which was to have been removed under the 9 December 2008 proposals.

*Clause 37 and Schedule 17, International movement of capital*

13. We welcome the abolition of the existing Treasury consents and their replacement by new reporting requirements. We welcome the extension of the time period during which companies have to comply with the new reporting requirements from 14 days of the end of the quarter in which the transaction took place, as proposed in the 9 December 2009 draft legislation, to the Finance Bill proposal of within six months of the transaction.

14. Further consideration needs to be given to these rules, in particular the debt-cap rules, so as to ensure that the identified concerns are addressed in ways that minimise UK compliance burdens and which do not harm the UK's competitiveness.

### Real Estate Investment Trusts (REITS): Clause 65 and Schedule 34

15. We contributed to the extensive consultation that took place before the introduction of the REIT regime. We note that the regime is only just over two years old and, in spite of extensive prior consultation, the scheme continues to be amended. This is probably more a reflection on the difficulty in establishing a new taxation regime for property investment companies and ensuring that it caters properly for many different sets of fact circumstances rather than the fact that the original legislation was defective.

16. Whilst we appreciate that It takes time to fine-tune a new taxation regime, we hope that following these latest changes the REIT regime will now enjoy a stable framework which will provide an opportunity to analyse the success of the REIT regime.

17. REITs were only introduced with effect from 1 January 2007 and our experience of the effectiveness of the regime in practice is limited. We understand informally that about 16 existing property investment companies converted to REITs and that one or two new REITs have been established since then.

18. The above numbers suggest that the demand for REITs is quite low but as referred to above 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.

### Pensions: Clause 71 and Schedule 35

19. It was announced in the Budget that from April 2011 tax relief on pension contributions will be restricted for those earning over £150,000. In addition, whilst existing pension arrangement are not affected, an anti-forestalling measure was announced aimed at limiting tax relief for those with earnings of £150,000 seeking to make additional pension contributions in the period from 22 April 2009 until April 2011. Schedule 35 enacts the anti-forestalling provision.

20. We have a number of major concerns with these proposals, as follows:

- the proposed measures taken as a whole are likely to damage the pension industry and discourage saving for retirement using a pension; and
- the anti-forestalling provisions discriminate against the self employed and those made redundant who might top up their pension as part of any terminations arrangements.

*Damage to the pension industry*

21. The proposed restriction on tax relief breaches the fundamental principle which underlines 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.

22. The proposals will discourage long-term saving using pensions and are likely to damage confidence in the UK pensions industry. Many will consider that, given the relative inflexibility of pension savings (particularly extracting money on retirement), the return on net investment will be too low to make contributions worthwhile and will therefore stop saving for retirement using pensions. In addition, at the margins around £150,000, taxpayers may opt to reduce income by reducing hours etc rather than fall within the new regime.

23. 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. Set out in Appendix 1 are some comments made by the then Financial Secretary to the Treasury during the passage of the FA 2004 which confirm these principles.

*Anti-forestalling provisions*

24. The provisions effectively bring forward the restriction on tax relief by up to two years and as drafted discriminate against, for example the self employed. The provisions are also likely to apply in cases of redundancy, when taxpayers may receive termination payments which significantly increase current year income and often pay larger than usual contributions to improve their pension provision. In addition, it would appear that the provisions for 2009/10 and 2010/11 are more penal than the proposals for 2011 onwards, although in the absence of any detail for 2011 and beyond we cannot be certain on this point. For example, there are no tapering provisions prior to 2011 which give the 'cliff edge' effect mentioned below.

25. As currently drafted the provisions are likely to affect far more taxpayers than those at which we are told they are targeted and the provisions can result in marginal rates of tax far in excess of 100%. For example, we have calculated that a difference in income of just 1p between two individuals who otherwise have identical levels of income and pension contributions results in one paying £6,000 more tax than the other, a marginal rate of 600,000%. We therefore challenge the premise that the anti-forestalling rules will not increase tax take.

26. 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. As noted above, complex legislation leads to significant extra costs for HMRC.

27. The provisions apply to prevent higher rate tax relief for most pension contributions on or after 22 April 2009 other than where contributions "are paid quarterly or more frequently". We are unclear about the rationale for ongoing regular contributions being limited to quarterly or more frequently and consider that this is far too restrictive. In particular it discriminates against the self-employed. Pension contributions paid by self-employed individuals are often one-off or annual contributions made once the likely level of profits for the tax year is known. As currently drafted, many self-employed who make regular annual or six-monthly contributions face the possible immediate loss of higher rate relief. We note that in his Ministerial Statement on 22 April 2009 the Financial Secretary to the Treasury stated:

> 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 the objectives above.

28. The inclusion of pension contributions made by employers in taxable income (as defined for this purpose) is likely to result in the new provisions affecting those with incomes considerably below the £150,000 threshold being quoted. This is likely to result in compliance issues particularly for those taxpayers who do not believe that they will be affected by these changes. HMRC will need to undertake an extensive publicity campaign so that taxpayers understand the changes.

29. In the same way as mentioned above in connection with personal allowance withdrawal, dealing with the changes through PAYE and net pay arrangements is likely to be very cumbersome and difficult, resulting in extra costs for HMRC, employers and taxpayers and adding to the administration burden for employers and pension schemes.

### ICAEW recommendation

30. Individuals who make regular annual contributions should be able to benefit from higher rate relief until the proposed changes in 2011. We therefore suggest that the proposed rules should be amended to cater for regular annual contributions. This could be done a number of ways. One approach would be to have a further

test calculated by reference to average contributions made in, say, the highest two tax years out of 2006/07, 2007/08 and 2008/09—perhaps indexed up by reference to the changes in the annual personal allowance.

*11 May 2009*

## APPENDIX 1

CLAUSE 71 AND SCHEDULE 35

*Comments by the Financial Secretary during the passage of the FA 2004*

The FA 2004 provisions, which came into effect in 2006, were the result of considerable consultation and when the changes were being debated in the Public Bill Committee the then Financial Secretary to the Treasury noted that:

> "We are sweeping away the existing rules and regulations and replacing them with a single regime for all tax-privileged pension saving. That represents a hugely positive step for those saving or looking to save towards their retirement.
>
> Simplification will introduce greater individual choice and flexibility. For the first time, everyone will have the same opportunity to make tax-relieved pension savings over a lifetime. Our proposals will create a transparent, consistent and flexible system that is readily understood. That will make it easier for people to concentrate on things that matter, such as when and how much to save for their retirement, rather than on trying to understand anomalies between the different tax regimes.
>
> Simplification will reduce the administrative burdens and regulatory cost for pension schemes, their members, operators and sponsors, and will create opportunities for people to save more towards a pension and a retirement lump sum. The new rules will allow everyone to pay what they can afford when they can afford it.
>
> The pension simplification provisions represent the outcome of two formal consultations and extensive informal consultation. At every stage, we have had regard to the views of those who will be affected, whether individuals, employers or pension providers.
>
> The new regime will consist of two key controls: a lifetime allowance and an annual allowance for the amount of tax-relieved savings that can be made. It is important to recognise that the allowances will not prevent people from saving more in registered schemes if they wish to. The lifetime allowance will initially be set at £1.5 million and will rise to £1.8 million by 2010. The annual allowance will initially be set at £215,000 and will increase to £255,000 by 2010. *Those allowances represent very generous levels of tax-relieved savings. They are far in excess of what 99% 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.* [our emphasis]"

These new (2006) provisions introduced both an annual allowance and a lifetime allowance so that that the tax relief obtained is restricted in a clear and transparent manner. Those taxpayers who took on board the message that the annual allowance was generous enough that they could make top up payments in later years should have time to re-arrange there affairs before the changes come in.

## APPENDIX 2

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 130,000 members. 3,000 new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 10,000 members of the ICAEW who pay an additional subscription.

4. To find our more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

## APPENDIX 3

The Tax Faculty's 10 Tenets for a Better Tax System

The tax system should be:

1. *Statutory*: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. *Certain*: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. *Simple*: the tax rules should aim to be simple, understandable and clear in their objectives.

4. *Easy to collect and to calculate*: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. *Properly targeted*: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. *Constant*: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. *Subject to proper consultation*: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. *Regularly reviewed*: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. *Fair and reasonable*: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. *Competitive*: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99; see http://www.icaew.co.uk/index.cfm?route = 128518.

## Examination of Witnesses

Witnesses: Mr Frank Haskew, Head of Tax Faculty, ICAEW and Mr Peter Cussons, International Corporate Tax Partner, Head of PricewaterhouseCoopers LLP's EU Direct Tax Group, examined.

**Q1** ***Chairman:*** This afternoon's hearing is the first in the Committee's inquiry into selected aspects of the Finance Bill 2009 and the topics chosen this year are foreign profits, Real Estate Investment Trusts—REITs—and pensions. In the case of pensions I should emphasise that the sub-committee, bearing in mind its recess, will look at the process leading to the restriction on relief for pensions and the anti-forestalling provisions in the Finance Bill in the light of experience of the new pensions regime since its introduction in 2006. We will not consider the principle of restriction of relief or the level at which the restriction is to be introduced. Before I start I should refer to my declaration of interests in the register. Welcome back, witnesses, and thank you for making time to be here again this year; and thank you to for your written evidence. I do not need to tell you that if you could speak reasonably slowly and clearly for the benefit of both the stenographer and the Members it would be useful; and if when you first speak you could introduce yourselves, especially for the benefit of the web broadcast that would be useful. Do you want to make any introductory remarks or shall we go straight into questions?

*Mr Haskew:* Straight into questions.

**Q2** ***Chairman:*** Let me start and let me start with foreign profits and ask you what is your opinion of the way the current round of discussion on foreign profits has been handled? Why was there such an adverse reaction to parts of the original package, particularly those on the Controlled Foreign Companies, the CFCs?

*Mr Cussons:* If I might take that question, please? I am Peter Cussons, a partner with PricewaterhouseCoopers LLP, but I also Chair the Institute's Large Business and International Tax

Committee. 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, but with the caveat that I will come back to on CFCs, which I think is the second part of your question. I would, however, like to put on record that I personally think the process really kicked off about a year earlier, in April 2006, because there was a business group and a representative body group who were consulted over that summer. One of my points would be that I think it is very welcome that we have got where we are with the dividend exemption—I am sure we will come on to the debt cap. I think it is unfortunate, however, that it has taken in my book nigh on three years to get to this place because obviously business follows this sort of discussion very, very keenly and if you were thinking of repatriating a foreign dividend or changing the finance structure you would probably keep waiting for the next shoe to drop and three years is a long time in business, as I think it is in politics. On the second part of the question, the CFC part of the package has been largely split off and is to come over the next two years, which obviously will straddle the General Election and a possible change of government, and the reasons for that I think are implicit in the question. When the discussion document came out in June 2007 if I may—and if Philip Gillett, the ex Tax Director of ICI would indulge me for a moment—go back to the famous unbundling of the can of Glidden's paint. Some of you around the table may remember that ICI took over a US firm very long ago. ICI have the Dulux brand; the US target firm had a brand called Glidden's. ICI, as I understand it—and I say this from public knowledge—did not invest in the Glidden's brand, they did not contribute to any of the patents, so nothing to do with Glidden's was anything to do with ICI; but the changes to the UK CFC regime as put out in the June 2007 document would potentially have required ICI to unbundle each $5 sale price of Glidden's can of paint and say, "50 cents of that is to do with intellectual property; that must be attributed back upstairs to the UK", without any factual test as to whether there really was any nexus between the US IP and ICI plc. So understandably, I think, business reacted very strongly to the proposals. But credit to the Treasury and Revenue because fairly shortly thereafter—I forget the exact timeline, but within six months or so—the Treasury said, "We will look at it again," and that is why it has gone back to the drawing board.

**Q3** ***Lord Blackwell:*** At the start of the inquiry could I also draw attention to my interests set out in the register and in particular note that of the companies of which I am a director one is a REIT, one is a major pensions provider and I think several have foreign profits. I am interested in the questions on competitiveness and the package on competitiveness. Firstly, looking specifically at the foreign profit provisions, how you see the impact of that on competitiveness; and perhaps you could in particular enlarge on the impact on headquarters and inward investment, about which you have expressed concerns. Then perhaps you could also address more widely the provisions of the Finance Bill on competitiveness, and in particular clause 92 and the impact of that on the duties of senior accounting officers.

*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 1st July, are extremely welcome. However, the debt cap provisions in Schedule 15 are already 32 pages long. When my colleague counted the definitions they contained upwards of 120 new definitions. There is the necessary promise of further government amendments; there will also be a number of sets of regulations under the Schedule. 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, where there is a gateway test in paragraph 3, which is intended to take most groups out, but as it is currently defined our view as the ICAEW, and certainly as PricewaterhouseCoopers, is that it probably will not actually screen out as many people as had been hoped. It is a balance sheet test as to whether the aggregate UK group net debt is no more than 75% of the aggregate worldwide group net debt, but the definitions are not as you perhaps might expect them to be. The concern I think of the Institute is that one understands that if a country introduces a dividend exemption the particular country may wish to protect itself further against abuse of that exemption—drawing down more debt and putting equity down into very low tax subsidiaries where the dividend is then exempt—but this is going to create an enormous compliance burden. If I may just conclude my comments on this question, my own firm hosted a seminar this morning at which I spoke. We had 107 clients and we got them to vote on the package and I am afraid that about 64% or thereabouts of them said that they thought the package would make the UK less internationally competitive and only about one-third—36%—said that they thought it would make it more, and I think that is solely attributable to the complexity of the debt cap.

*Mr Haskew:* Frank Haskew, Head of the ICAEW Tax Faculty. Just picking up on the final point about the wider aspects of this, 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 the general emerging view is both in terms of the foreign profits and the VAT places of supply of services apply, and with 11,000 pages of primary tax legislation with the best will in the world it is almost impossible for any one single person to be able to take responsibility for everything that is going on in potentially worldwide groups. So I think there is a question mark slowly arising as to just how uncompetitive are provisions like clause 92.

**Q4** ***Lord Blackwell:*** Is it practical to have tax legislation that you cannot ask somebody to take responsibility for? Does that not create a problem?
*Mr Haskew:* I think it is a problem. Peter raised it this morning, but would you want to sign your name to something—and this is all taxes as well, it is not just corporation tax, it could be excise duties, the VAT aspects? With the best will in the world some of these provisions are extremely complicated and problems will arise possibly in future years further down the line which could result in a potentially personal onerous liability. It is just not a route that we feel the UK should be doing down; it is not a route that is actually going to encourage people—it is going to put people off.

**Q5** ***Lord Powell of Bayswater:*** Chairman, can I also draw attention to my declaration of interests in the register. Continuing on down the road on exemption for foreign dividends where it is moving, in essence, towards a territorial system, you obviously think that the changes are desirable and your view is that they are sufficiently desirable to justify what is actually quite a major change and quite a costly change. Can you just articulate the reasons why you think that?
*Mr Cussons:* I will take that question, if I may? I think there is one very compelling reason why we have the Schedule in the Bill and that is European law and the tax case known as the Franked Investment Income Group Litigation Order, which more or less won at the ECJ in December 2006 and definitely one in front of Justice Lancelot Henderson in the High Court in November although the decision is under appeal. But as at the moment the Bill conforms UK law to the EC Treaty because before the Bill you have a UK to UK inter-corporate dividend exemption but foreign to UK's dividens are taxable with credit, so if you happen to have Ireland, say, or a country that taxes lower than in the UK subject to something called eligible unrelieved foreign tax, where you can mix and match double tax relief on other dividends the Irish dividend that is taxed at 12.5 downstairs in Ireland will attract another 15.5% upstairs in the UK. So my first point is I think from a European law perspective certainly—we do not have the final FIIGLO judgment—my own personal view is that the High Court judgment will be upheld—I think that this is something we will ultimately find we have to do. If that is the case then the question becomes: are we doing it in the most internationally competitive way possible? You might then take issue with that because the structure of Schedule 14 is that it starts with the introduction of charge on all dividends; then it offers five alternative exemptions which might overlap—you might find that you are in more than one of them, but probably not all of them—and those are then backed with seven anti-avoidance conditions, three of which tie in with three of the five exemptions and four of which float somewhere up in the stratosphere above all the exemptions. So it is not simple but I think it is a pretty decent bit of drafting and I think it is the right policy; so I personally do not have much problem with Schedule 14.

**Q6** ***Lord Powell of Bayswater:*** Even though it is obviously very complex.
*Mr Cussons:* Even though it is obviously very complicated. We could have the debate which was had with the Treasury and latterly with the Revenue, why did you not just introduce an exemption with anti-avoidance rather than the charge with the exemptions with anti-avoidance. It may be that there are some foreign tax reasons why we have done it this way. The Japanese, for example, I think might find it helpful that there is a charge on the statute book before an exemption because the Japanese CFC regime, if a Japanese group was trying to use the UK as a holding company location, if we just have a blanket exemption everything in the UK holding company would be attributed upstairs to Tokyo, so this may give us perhaps something more than a fig leaf to hide behind in front of the Japanese and say, "Your CFC does not apply to a UK sub-holding company."

**Q7** ***Lord Powell of Bayswater:*** Is the exemption regime now more common than the credit regime?
*Mr Cussons:* Very much so; the last bastion of the credit system is the United States who are paddling their own canoe, as you observe in your questions later on. Ireland is not quite still there on the credit system, but if you cross the Channel I think practically the whole of the rest of the European Union is on exemption now.

**Q8** ***Lord Powell of Bayswater:*** So we are joining the rest of the world and anyway we would have to do it because of EU legislation.
*Mr Cussons:* That would be my personal view, yes.

**Q9** ***Lord Sheppard of Didgemere:*** Can I refer to my interests as set out in the register of interests and I have nothing to add to those. My questions are about interest restriction. On the debt cap rules, to which you refer, these are to prevent a disproportionate amount of the interest paid being claimed against UK profits. You are concerned, according to our notes, that this will add considerable complexity to the UK tax system and affect its competitiveness. How serious do you consider this is? One specific point: is Schedule 15 as complex as it looks?

*Mr Cussons:* Answering that last question first, yes, I think is the answer because it is 32 pages and 60 or 70 paragraphs and I think it is pretty complex. You asked how serious we thought it was. We do think that it is serious because the gateway test, the balance sheet test, testing UK net debt, group net debt against worldwide net debt—is the UK net debt no more than 75% of the worldwide net debt—is supposed to screen a lot of people out. If you look at the detail of the test it does not actually help the simpler situation. If you imagine a completely domestic group, a plc that borrows £100 million and lends it at the same rate of interest to its trading subsidiary—I can do if you wish, but I will not take you through the detail in the schedule—our evaluation is that that simple situation, which does not involve debt dumping—it is an entirely domestic group, it does not involve an upstream loan by a foreign subsidiary, it has no foreign subsidiaries—that group will fail the gateway test as it is currently designed. That is highly unfortunate, to put it at its lowest because it will mean that unless a group is very, very small—because there are some *de minimis* limits—entirely domestic groups, 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 by companies headquartered here—other groups then have to go through the detail of the schedule. I am not suggesting that they come out with a disallowance in the main body of the schedule—they do not. We go back to a previous Committee colleague's question on clause 92—is it Schedule 46. If I was a finance director I would insist on this calculation being done either by my team or by a firm such as mine every year because otherwise how could I sign my certificate? So you are going to have medium and large businesses all dragged through the bulk of the schedule for small revenue gain. I think Jonathan Leigh-Pemberton of the Revenue, who was at our seminar this morning, was saying that the current estimates are a net tax giveaway on the whole package of 150 million in this financial year and 350 next. So the figures against the larger backdrop are not that large, but an awful lot of complexity. We did favour—and I think we fed this into the debate, and the government have their own agenda—tightening up of thin capitalisation provisions to police alleged excessive debt dumping by inbounds and possibly looking at something the Americans did many years ago—Internal Revenue Code, Section 956 I think it is. So for a long time—at least as long as I have been in tax, which is about 30 years—if you had an upstream foreign loan to a US parent company that would be treated as if it was a dividend. So if those are your two policy targets, target them narrowly and not have some enormous net that then take people out at the back, if you like.

**Q10** ***Lord MacGregor of Pulham Market:*** I too wish to declare the interests as in the register, although I think in this case they are fairly remote. Back to the CFC Rules: was it right to introduce a package in this Bill which excluded substantively revised CFC Rules? Are there continuing discussions on the substantive changes to the CFC Rules? Are these likely bear fruit and introduce sufficient protection for UK tax revenues and what do you see as the likely outcome? And do you think that your desired alternative outcome of tightening up the existing rules is likely?

*Mr Cussons:* I think you asked firstly was it right to introduce a package which excluded substantively revised CFC Rules. Given what I said earlier in relation to businesses' difficulty, particularly with regards to the tax treatment of intellectual property in the June 2007 discussion document, it was right to make these modest changes—abolition of acceptable distribution policy dividends from 1 July, abolition of superior and international but happily retention of local holding company exemptions; so I think that was absolutely right. Indeed, discussions led by the Treasury have just started up again in March/April with Finance Bill 2011 as the target for draft law. Are they likely to bear fruit and introduce sufficient protection for UK tax revenue? I think the answer to that question depends crucially on what the government sees the future UK corporate tax system as doing. Are we going to move away from the current more or less global approach, such as the Americans have and, if you will forgive me, but I think it is a good illustration, move more towards Hong Kong as a classic example of the territorial system? Again, if you will indulge me, our clients this morning—107 of them—told us—and I think the figures were again roughly the same, some figure in the 63%—would favour moving towards a territorial system even though—and this may sound a bit anomalous—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. It is all resting on the negotiations and behind that what is the policy framework of the future; what is going to be the ambit of the UK corporate taxation. Our own comment: if all we were doing was carrying on with the *status quo* then I think it would be possible to make the current UK CFC system EC Treaty compliant—and there are issues with the Cadbury case, and the Vodaphone case was in the Court of Appeal last week, which is based on Cadbury, so I think it is possible to make the current system compliant with EU law and adequate protection if we carried on with our current system; but I think it is too early days really to judge where that is going.

**Q11** ***Lord Wakeham:*** I join my colleagues in declaring my interests on the register and adding to the fact that one of our witnesses, MacFarlane's, I am a client of theirs. I do not know if that is an interest to declare or not, but I think I had better. On the changes to the regime concerning international movements of capital will the new reporting requirements provide sufficient protection to the UK Exchequer? Has the threshold for £100 million for a transaction to be reportable been pitched about right?

*Mr Cussons:* I believe that the new reporting requirements will provide adequate protection to the Exchequer. They largely replicate the remaining elements of Treasury consent that I think were enacted, if I recall, in the Finance Act 1951 when we were rearming and they still cover the same sort of transactions. The process has been de-criminalised, although I understand there never was a criminal prosecution, but I think that is extremely welcome; and it is no longer a permission to do the transaction. The general consents are not being replicated—there are some excluded transactions—but I would have thought it would give the Revenue the same sorts of information flows that they have had previously, that hopefully has been more or less adequate over the last 58 years. £100 million: I would have thought that is probably about the right order—I think it is transactions or events of strictly greater than £100 million; maybe it might have been pitched slightly lower or even slightly higher but I think it is probably a reasonable number.

**Q12** ***Lord Best:*** Turning to the changes that have been announced recently in the US by President Obama, these appear to be moving in a different direction. How do you see the US proposals? Do they suggest that the territorial approach of exempting foreign profits might not be the best? Do they suggest that the UK proposals are being too beneficial to business to the detriment of the UK Exchequer?

*Mr Cussons:* From what I have read about the Obama proposals and there has been a little bit more detail, even this week—they are moving more towards a global current taxation system, so I think there is a strand in the Obama package that is understandably saying that you cannot have current expense upstairs in the US in relation to foreign income that you have not repatriated and you have no present intention of doing. I do 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 a siege economy—it is six times the size of the UK economy and they can bring the portcullis down. I do not think that we have that luxury because we are a much more international and smaller economy. I think therefore 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; so I do not think that the Obama proposals are something that we should emulate.

**Q13** ***Lord Barnett:*** I have no personal interest to declare in foreign profits, I am sorry to say! It would be fair to say that mostly the word "welcome" appears more than concerned in your submission, but you say you welcome the broad thrust of the provisions but remain concerned about the overall balance of the proposals. Can you quantity that?

*Mr Cussons:* I think the reference to balance is to the debt cap on the downside of the scales in comparison with the dividend exemption and the repeal of Treasury consent on the upside, CFC I would say at this juncture being broadly neutral. Could I quantify that? Not in terms of percentages and inversions, if you see what I mean, or inbounds not coming here, but I can do no better than the PricewaterhouseCoopers' client base, if you will forgive me returning to that, and if 107 people who probably would represent something like 80 or so groups because several people tend to come from one group, if they think—assuming they are reasonably well informed, and they were asked to vote at the end rather than at the start of the seminar so one would hope that they are reasonably well informed—there is a worry that they see the debt cap, even if it is not going to cause them an interest disallowance, they see that as very burdensome annually; so the relief of not having to do double tax relief calculations, which is quite an onerous business—sometimes you had to get accounts going back 30 years of a foreign subsidiary if you were paying up all the reserves to work out the average double tax relief rate—is obviously very welcome but I do worry seriously about the debt cap schedule; it is very long, very complex, not many people will get out through the gateway test and very large compliance burdens are a disincentive for people to remain headquartered here or to come here if they were looking at a country which does not have a regime like this.

**Q14** ***Lord Wakeham:*** Let us assume for a moment that the government has heard what you have said and wonders whether they have it quite right, they do

not suddenly change and completely change their course, so what could be done at this stage to improve the situation?
*Mr Cussons:* The debt cap goes on the statute book and perhaps what could then be done is that an administration who wished to review what is on the statute book would look and say can we police the dividend exemption, which we accept we have to do for European law reasons, in a different way, then I would have thought that discussions could open up again on using the thin capitalisation regime that we have had for—Trevor will remember better than me—20 or 30 years in some shape or form, and looking at this issue if upstream loans from low tax subsidiaries are still an issue can we look at what the Americans have done, not the Obama proposals but that particularly targeted upstream loan provision. That is what I would recommend.

**Q15** ***Lord Barnett:*** Pensions. I have a past interest to declare in the sense that I took advantage of the system that was then in place, and I am happy that it is not on the levels of similar pensions that one hears about these days. You are concerned about the simplicity of the proposals. I cannot think why; I would have thought the more complex the better fees you could get! Could I ask you whether you believe there should be any cap at all?
*Mr Haskew:* If I could come in on this one, Lord Barnett? I presume there that you are talking about the £150,000 in the anti-forestalling rules and the proposal from 2011 to restrict higher rate relief, rather than the overall limit on pensions—the annual limit? If we are talking here about the new £150,000 limit I think our view is that obviously tax policy is ultimately a question for the government of the day to decide, but in looking particularly at pensions there are quite a number of factors that you need to take into account; and looking at pensions it is certainly a long term commitment that people make and the comment has been made that pensions are effectively deferred earnings. There has been a fundamental acceptance of the principle of taxation of pensions since time immemorial really that you get full tax relief on contributions made in but then you get a full charge of tax when the pension eventually comes out. So if it comes out at a time when you are a 40 or 50% taxpayer then you get taxed at 40 to 50%. So that has been the established position on pensions for a long time. We had a considerable consultation period where the existing schemes were reviewed back in the early part of the century. That then resulted in the FA 2004 pension provisions where the government acknowledged at the time that the potential limits, the limits that were being placed were very generous but they thought that was a reasonable level; and indeed they were set to encourage people to top up the contributions and to make generous provision for their retirement. So the whole system and scheme was set up on that basis. We would have to say on the Powers Review that there was a once in a lifetime opportunity to have a set of powers that would see us through for a generation. I think pensions is very much the same thinking. So looking at that we had a new FA 2004 with a regime coming in in 2006 and I think it would not be unreasonable, and certainly the expectation was, that we had a regime then that was set which would see us through for a very long time. So three years in to have some fairly fundamental changes—and with the best will in the world I think there is a view that it could be seen as the thin end of the wedge—that, I think, is where our concern lies.

**Q16** ***Chairman:*** Would it have been possible for the Treasury and HMRC to have consulted on the anti-forestalling provisions before Budget day? And did the information available immediately afterwards cover everything you needed to know and, if not, what additional information did you need and how unsatisfactory was it that it was not available at the time? And is it available now?
*Mr Haskew:* I will have to unbundle that, I think. The first question is could we have had consultation on the anti-forestalling provisions? That is actually quite a difficult question to answer because in the normal run of things one of the areas where you would not normally expect to have consultation beforehand is what one can loosely call anti-avoidance rules or taking action to prevent avoidance. 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 there should have been consultation on the proposal with a view to it coming in at some future date and that there should not have been anti-forestalling rules of this nature introduced at this time. So I think our view would be that if you have anti-forestalling rules it is not unreasonable not to consult on them but this does not really fit that category and there should have been consultation on the principles. Going back to the other parts of your question, HMRC produced a lot of information on Budget day, both for employers and employees, for instance, so that there was quite a lot of information produced. I think it would be fair to say that as accountants we were scratching our heads slightly to understand how this special charge was actually going to work. In fact it is relatively simple but when you look at the stage calculations in the Finance Bill it is not immediately apparent how it is working. So I think our view is that HMRC actually did quite a lot of work beforehand—there clearly was quite a lot of work going on behind the scenes on this. HMRC certainly produced a lot of

information which is very helpful, but the fact is that it is a very complicated provision and it has taken people time to actually get to grips with it.

**Q17** ***Lord Blackwell:*** Could I ask you about the concerns you have about the transitional arrangements in Schedule 35? Firstly, do you think that these are more penal in those transitional years than subsequently and, if so, why? Secondly, in terms of dealing with the particular issues of people who make irregular contributions, the self-employed, etcetera, you make some recommendations around those. Do you think that those would deal with the issues? What if the government adopted the proposals of the Chartered Institute in Scotland of a five-year base measure?
*Mr Haskew:* The first thing we need to make clear is that the provisions within the Bill for Schedule 35 are actually only the anti-forestalling rules and again that probably was not picked up on to begin with. But the actual rules we are going to get from 2011 we do not have at the moment, so presumably we are going to get a new set of rules that will apply in two years' time. So we do not know what those rules are going to say but we do know, according to the Budget note, that there was going to be some tapering off of higher rate tax relief between income of £150,000 and £180,000. That is not in the special charge that we have under the anti-forestalling rules, so under the anti-forestalling rules if you hit the £150,000 then any pension contribution effectively which is not regular, which is more than £20,000 will suffer a 20% tax charge. We have done some calculations on this but you only need 1p of income to effectively get within the charge. So you could have a position, say, of somebody who makes a pension contribution of £50,000 and they have 1p of income which takes them up to £150,000 of income. They will then have a special charge on the £30,000 excess over 20,000; 30,000 at 20% is £6,000 so 1p of extra income, which threw them up to the £150,000 could mean that they face a tax bill of £6,000. So to that extent we feel that the anti-forestalling problem is potentially more penal than whatever rules might be introduced in 2011. As I say, we do not actually have the rules for 2011. Going back to the other part of your question, obviously there was no warning of this, there was no consultation so we were faced with these provisions and the rules have a let-out for quarterly or more regular contributions. But of course most self-employed people tend to pay annual contributions once they have established the profits of their business. So they would be outside of the let-out. So our view is that those people who make regular annual contributions should be entitled to get within that provision; in other words the rules need to be made more flexible to account for them and we suggested possibly looking back at an average of maybe the last two or three years at what contributions did they make and they would still be allowed to effectively make annual contributions to that same amount. We saw the ICAS representation on this but we are not actually attracted to it because it talks about doing that over five years and that would take you back to the pre-A Day rules where of course you were limited by your age—17.5% for over 35 years up to 40% for over 50, I think it was. So the chances were that you would have a different pension profile in those early years. So really we feel that it should be based on post-A Day contributions.

**Q18** ***Lord Blackwell:*** You draw attention to the problem of people who are made redundant and might want to use some of that money to top up their pension, is there a way of solving the problem of those people being caught in these rules?
*Mr Haskew:* I think we need to have some further discussions on those points. I can see the problem here that once you start straying into including annual contributions then effectively almost everybody is going to be in the let-out so there will be no point in having the anti-forestalling rule. We need to have discussions with HMRC and Treasury to actually see how people like that can be accommodated within the new rules because I am not actually sure that there is an immediately obvious test for those people.

**Q19** ***Lord Powell of Bayswater:*** Continuing down this road you have obviously taken the view that this is a very complex way of dealing with what is essentially a transitional problem lasting just a couple of years and, from what I hear, that seems to be the understatement of the year. But would not your suggestions add even further complexity?
*Mr Haskew:* There is always a need in tax to balance complexity with, for want of a better word, fairness and legitimate expectation.

**Q20** ***Lord Powell of Bayswater:*** Even if fairness requires further complexity.
*Mr Haskew:* Yes. So I think this is a case because it is a fundamental policy change where there is a need to address the fairness issue and if that leads to more complexity our view is that that is the price we have to pay. We would really prefer not to have had the schedule in the Bill at all but to have had discussions on the fundamental policy of this and to have had a future date when the measures comes in so that it would be simpler to the extent that we would not have had any transitional problems.

**Q21** ***Lord Powell of Bayswater:*** You talk about the administrative difficulties in your paper. Just expand a little on what those are and the need for publicity.

Also on this point about other matters which are not properly covered, for instance un-funded pension.
*Mr Haskew:* We are still looking at un-funded pensions but we can come back to you on that.

**Q22** ***Lord Powell of Bayswater:*** Can you give us a note perhaps?
*Mr Haskew:* Yes. In terms of the publicity we were trying to point out, the £150,000 cap includes items like employers' contributions to pensions, and so an employee may only, for instance, get £100,000, but his employer might be making £50,000 pension contributions. So that person may not actually realise that they are within the new rules. What we are saying there is that a lot of people underneath this who might think they are out of it and who actually could be in it and that there is a need therefore to publicise exactly how the rules work for most people.

**Q23** ***Lord Powell of Bayswater:*** You need some flashing lights.
*Mr Haskew:* Yes, a double amber, whatever. Also, a lot of this is going to be picked up after the tax year under the self-assessment tax return and that is bound to result in more complexity for a number of taxpayers.

**Q24** ***Lord Sheppard of Didgemere:*** Would there have been alternative means of achieving the overall objective of limiting the cost of relieving pension contributions to higher earners, at least in the transitional period? Would these have been preferable and, if so, why? In particular, would it have been sufficient to restrict the annual and/or lifetime limit? Are there particular technical issues with the government's longer term proposals which need to be thought about now?
*Mr Haskew:* I think it would be fair to say that this is why there is a need for further consultation on this because a lot of these issues are still coming to the fore. We have been, for want of a better word, batting around some possible ideas but I think it would be fair to say that we have not come to any settled view on this. 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.

**Q25** ***Lord MacGregor of Pulham Market:*** Can I ask a wind-up question on pensions? You referred at the beginning to the thin end of the wedge and quite a number of critics so far have drawn attention to what was said when the 2004 opportunities were brought in; that this was a long term regime, that it was going to be fairer and it would allow everyone to see what they can afford and it would make it easier for contributors and so on and so forth—a lot of things. I think a lot of people felt that this was a scheme subject to changes in the limits; it was a scheme that the structure was in place. Mr Cussons referred earlier to the seminars you have already had with clients. If you have any view on this one do you have any sense of whether one of the actions which will be that this is just yet another blow to defined benefits schemes because the rules keep changing and it is very difficult to carry on with all the other problems of defined benefit schemes if this is happening too.
*Mr Haskew:* It will damage confidence in the pensions industry; I think there is absolutely no doubt that it will do so, given the reasons that you have just said, that these are long term provisions where you need absolute stability and certainty in the regime and also as we know often if you change one thing the problems do not arise until some years down the line. For instance, in 1997 when we saw the withdrawal of tax credits on pension funds, which was one of the first actions of the new government, that was on the basis that we had booming stock markets; but ten years on effectively those changes and those withdrawals came home to roost. 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.
***Chairman:*** Thank you very much indeed; that is a good point to draw this session to a close. Thank you for spending time with us this afternoon. We found your answers to our questions very helpful.

## Memorandum by the Law Society of England and Wales

FOREIGN PROFITS

*Clause 34 and Schedule 14: Corporation Tax Treatment of Company Distributions*

Schedule 14 to the Bill introduces a new Part 9A into the Corporation Tax Act 2009. The new Part 9A governs the tax treatment of dividends and other distributions received by companies which are subject to UK corporation tax. Part 9A applies both to dividends and distributions received from UK resident companies and dividends and distributions received from companies which are not resident in the UK.

Under existing legislation, dividends received by a UK resident company from another UK resident company are exempt from corporation tax.

Dividends received by a UK resident company from a company resident outside the UK are taxable. However, the recipient company is entitled to credit against the UK corporation tax on the dividend for any tax withheld from the dividend and, in cases where the recipient company holds directly or indirectly 10 per cent of the voting power in the paying company, tax paid by the paying company on the profits out of which the dividend is paid. The credit regime is reasonably generous, but it is complex and imposes a significant compliance burden on UK-based companies. For this reason, there have been calls for some time from UK-based companies for a move to a system under which dividends from non-UK resident companies are generally exempt from UK tax.

The existing system has also been the subject of challenge before the European Court of Justice on the grounds that it breaches non-discrimination and freedom of movement of capital principles in the EU Treaty. It is clear from the decisions of the Court that UK law will have to change in order to prevent further challenges. A system under which dividends may benefit from exemption irrespective of whether or not the paying company is UK resident is one means of addressing this issue.

The intention is that, under Part 9A, most dividends and distributions will be exempt from UK corporation tax irrespective of whether they are received from another UK resident company or from a company which is resident outside the UK.

In principle, we welcome this change.

- It should address the EU Treaty issues.
- By adopting an exemption system (as opposed to a credit system) for both UK and foreign dividends, in principle, at least, the system should be simpler and compliance costs could be reduced.
- The adoption of an exemption system will bring the UK into line with many competitor holding company jurisdictions (such as the Netherlands and Luxembourg).

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.

- As a starting point, the default position in the Schedule is to treat all dividends as taxable (see new section 930A(1) Corporation Tax Act 2009). A taxpayer must then show that a dividend falls within one of the exempt classes in order to claim the exemption. A dividend may then fall out of the exemption (and become taxable) if one of the anti-avoidance rules applies. This is a trap for the unwary.

  In our view, the Schedule could be rewritten so that the default position is that dividends are exempt unless one of the anti-avoidance provisions applies.

- The Schedule changes the law so that certain distributions made by UK companies, which are currently exempt in the hands of a UK corporation taxpayer, will become taxable. This is a result of the exclusion of "distributions of a capital nature" from the Schedule (see new section 930A(2)). As a consequence, many distributions will have to be tested against some relatively unclear case law principles to determine whether or not they are of a capital nature and some transactions which, in the past, were clearly regarded as exempt distributions as between UK companies will no longer be so regarded. This change will introduce an element of uncertainty to the tax treatment of some relatively common transactions.
- In the draft of the legislation which was published on 9 December 2008, small companies could not benefit from the exemption in respect of dividends, which they received from non-UK resident companies in which they had a stake of 10% or more. (Such dividends remained taxable with a credit for foreign tax). The restriction of the exemption in this way was clearly contrary to EU law.

Schedule 14 now allows small companies to benefit from the exemption regime for all dividends irrespective of the size of the stake which they hold in the paying company. However, it does so by creating a separate regime for small companies, which in some respects is narrower than the exemption available to large and medium-sized companies (in that it can only apply to dividends paid by a company which is a resident of a qualifying territory), but in other respects is wider than the main exemption (in that the dividend does not have to fall within any of the exempt classes).

The creation of a separate regime simply adds to the complexity of the regime, creates boundary issues and adds to compliance costs. In our view, there should be a single regime for all companies and the small companies exemption may be a better model.

— 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.

*Clause 35 and Schedule 15: Tax Treatment of Financing Costs and Income*

Schedule 15 contains provisions relating to the tax treatment of financing costs and income referred to as "the worldwide debt cap", which are being introduced as part of the changes relating to the taxation of foreign profits of UK resident companies.

The worldwide debt cap was originally included in the package of measures to reform the taxation of foreign profits as a revenue-raising element to counter-balance the loss of tax, which the Treasury and HMRC perceived would arise from the introduction of an exemption from tax for foreign dividends (and which is now contained in Schedule 14 of the Bill). In the course of the consultation process, the Treasury and HMRC have moved away from the need for the package to be demonstrably revenue-neutral, although they have at all times remained clear that the measures should be regarded as a package.

The worldwide debt cap will restrict the relief given to UK companies which are members of multi-national groups in relation to their interest and finance expense by reference to the external financing costs of the worldwide group. As the consultation process has proceeded, more and more anomalous effects of the debt cap have been revealed. The Treasury and HMRC have brought forward many changes to the original draft of the legislation in an attempt to address some of these concerns. However, they have not been prepared to revisit the underlying principle of the legislation. In our view, many of these anomalies are inevitable consequences of the underlying principle and, as a result, these changes can never do more than paper over the cracks in the basic policy.

We believe that the policy underlying the worldwide debt cap is fundamentally flawed and that the Schedule should be omitted from the Bill. If some form of revenue-raising measure is required to counter-balance the introduction of the exemption for foreign dividends, revised provisions should be brought forward.

Our reasons are as follows.

The underlying principle of the worldwide debt cap is to restrict financing costs of UK companies within a worldwide group by reference to the external financing costs of the worldwide group. At a superficial level, this does not appear to be an unreasonable principle, but it does not withstand closer scrutiny.

As an initial point, 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—in the transfer pricing legislation and its extension to counter-act the thin capitalization of UK companies. Those rules are based on the internationally agreed arm's length standard, which forms the basis of the vast majority of the UK's double tax treaties. 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.

In our earlier submission as part of the consultation process, we made all of the above points and also pointed out that the debt cap would incentivize certain types of taxpayer behaviour, which we would not have thought were intended to be encouraged. In particular, the debt cap will:

— encourage UK groups to incur more debt;

— encourage multi-national groups to move assets out of the UK;

— discourage inward investment into the UK; and

— provide a competitive advantage to over-leveraged groups to make acquisitions in the UK as compared with cash-rich groups.

As we mentioned above, various changes have been made to the draft provisions following the consultation period and incorporated in the Bill. None of those changes addresses these points.

Furthermore, the new rules will significantly increase the compliance burden for corporate groups doing business in the UK.

— Groups will have to monitor and track finance costs in group companies in order to determine whether or not the debt cap is likely to apply.

— Groups will have to allocate disallowed costs and excluded income amongst UK group members in a manner which does not fall within the normal tax return process.

— The Government has in the past correctly identified the UK's relatively liberal regime governing relief for interest on a major competitive advantage: The advent of the worldwide debt cap will in our view actively damage this advantage.

In our view, Schedule 15 should be omitted from the Bill.

— If it is necessary in order to balance the package to include a revenue-raising measure which operates by restricting relief for interest costs in some way, there are examples of such measures in the tax codes of other jurisdictions, which—although they have their own disadvantages—would not have the fundamental weaknesses of the current approach.

— If the new rules are intended to counteract specific abuses of the existing system such as debt dumping or the use of upstream loans, they would be more appropriately addressed by targeted anti-avoidance rules.

— If the new rules are intended to counteract specific abuses of the existing system such as debt dumping or to use of upstream loans, they would be more appropriately addressed by targeted anti-avoidance rules.

## Real Estate Investment Trusts (REITs)

*Introduction*

The REIT legislation came into force on 1 January 2007. Since then, the rules broadly appear to have worked as intended and to have been applied appropriately by HMRC.

Since the initial wave of conversion of existing property investment groups into REITs when the legislation came into force, there have been relatively few new REITs launched. While this is no doubt in large measure due to the economic environment over the last two years, it may also be a reflection of the high costs of forming new REITs. Not only is there an entry charge of 2% of the market value of real estate held when a company becomes a REIT, but the company will also have had to incur 4% stamp duty land tax when it purchases property to form part of its portfolio. This means that the tax costs of establishing a new REIT can absorb a significant part of the investors' initial investment. It might be appropriate to consider relieving measures to encourage the formation of new REITs.

When the initial legislation was introduced in 2007, expectations were high that HM Government would then look to amend the REIT legislation to facilitate residential REITs, which has long been a stated aim of the legislation, but to date there have been no residential REITs and no steps taken to recognise their business model within the REIT rules.

*Clause 65 and Schedule 34*

Paragraph 2 and 7 of Schedule 34 adjust the conditions that must be fulfilled before a group can become a REIT. They are aimed at ensuring that pub groups with tied premises can satisfy the conditions and that groups whose main business is not property investment cannot restructure themselves in an artificial way to allow themselves to become REITs. We agree with the policy behind both these provisions. We have briefly reviewed the secondary legislation designed to implement these provisions. We have some concern that as currently drafted it may not fully achieve its aim. In particular, it may not counter artificial restructuring which takes place before a group becomes a REIT.

Paragraph 3 of Schedule 34 allows REITs to issue convertible preference shares. This is a welcome expansion of the options available to REITs when they wish to raise additional capital.

The other provisions of schedule 34 are for the most part minor clarifications of the legislation and we have no particular comment on them.

*Provisions not in Finance Bill*

The dramatic decline in the value of commercial property over the last two years has posed particular issues for REITs, particularly when combined with tenant defaults over the last few months. REITs have found that they need to raise extra capital in order to avoid breaching banking covenants. While allowing REITs to issue convertible preference shares is welcome, additional measures could have been considered to allow REITs to conserve cash or raise additional capital. These include:

1. REITs are obliged to pay out by way of dividend 90% of the profits of their property investment business within 12 months of the end of the accounting periods in which the profits arise. In order to enable them to retain cash for longer to give them additional time to raise fresh capital, the 12 month period could have been extended, perhaps on a temporary basis.
2. Similarly, REITs could have been given the option to satisfy this 90% dividend requirement through the issue of shares in lieu of dividends (as REITs in the US have been allowed to do since earlier this year). 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.
3. REITs incur an additional tax charge if their profits are less than 1.25 times their financing costs. This ratio was set at a time when the economy was booming and can now be breached as a result of adverse economic circumstances (rents falling as tenants go into administration and interest increasing as banks demand more interest in agreeing loan covenant breach relaxations). Relief could be given against this tax charge where the ratio is breached as a result of matters outside the REIT's control, perhaps on a temporary basis.
4. In order to raise additional equity capital, REITs may wish to bring in a cornerstone investor or investors to acquire a significant part of the new capital being raised. Two facets of the REIT legislation can impede this. Firstly, a tax charge is imposed on corporate investors who receive more than 10% of a REIT's dividends. Secondly, a REIT must not be a close company—broadly, a company under the control of 5 or fewer investors. It would be appropriate to consider whether these restrictions can be relaxed.

PENSIONS

*Clause 71 and Schedule 35*

Members of the Law Society Tax Law Committee do not regularly comment on or consider the tax provisions relating to pensions. However, the Committee wishes to make the following comments on the anti-forestalling provisions contained in the Finance Bill in relation to pensions:

1. The current framework for pensions and pension contributions was established in 2004 and came into effect in April 2006. Under that framework a member of a registered pension scheme is entitled to relief for contributions paid by him into the scheme provided certain conditions are satisfied. In broad terms the conditions represent a fairly complex set of checks and balances. For example, the individual concerned has to satisfy certain tests relating to whether he is resident in the UK. Each year such an individual will receive tax relief on his pension contributions of up to 100% of his earnings subject to an "annual allowance" above which tax will be charged (the annual allowance for the year 2006/7 was £215, 000, rising to £255,000 in 2010). There is also a lifetime allowance against which the total value of benefits in a pension fund will be tested. The value of any savings above the lifetime allowance is subject to a tax charge. The lifetime allowance for the year 2006/7 was £1.5 million and will rise each year until it reaches £1.8 million in 2010. Generally tax relief is given by deduction of tax at source currently at the rate of 20% on contributions to pension schemes. Relief from higher rate tax has to be claimed through the return. The current framework was implemented after considerable discussion between the pensions industry and the government.
2. A pension is generally thought to be a form of deferred income. So that an individual who has the benefit of the pension defers part of his entitlement to income until he has retired. The mechanism for this is that the relevant part of his income ceases to be taxable in his hands, is diverted to the pension fund which is allowed to roll up the amounts of the diverted income and any receipts in respect of them tax free and subsequently the individual receives the income on retirement. The relief for the contribution was under the rules introduced in 2006 at the highest marginal rate of the individual concerned and the pension was subsequently taxed in the hands of the individual at the rate applying to the individual at the time of receipt. The various limits described above were conferred in exchange for this ability to defer.

3. The Government in the Budget on 22 April 2009 announced its intention to limit pension contributions for high-income individuals to relief at basic rate from 6 April 2011. Relief will be "tapered away" for those whose income exceeds £150,000 relief will be restricted and for those earning over £180,000 relief will be worth 20%, the same as for a basic rate taxpayer. The Government also announced its intention to introduce anti-forestalling rules to prevent individuals taking advantage of the delay between the announcement of the alteration to the rules for pension contributions and the date of their implementation. Accordingly Schedule 35 of the Finance Bill introduces anti-forestalling rules to apply from 22 April 2009 until 5 April 2011. The rules operate by imposing a charge, the "special annual allowance charge" ("SAAC"), on an individual where the" total adjusted pension input amount" (the "TAPIA", or pension contributions of the individual for the relevant period) for that individual exceeds the "special annual allowance" of £20,000. If an individual has "protected pension input amounts" (see below) then both the TAPIA and the special annual allowance are reduced. The effect is that the TAPIA is reduced by the greater of (in broad terms) the protected, that is regular, pension input amounts and the SAA. The excess is then charged to tax at 20%. It is not quite clear what will happen to the rate of 20% through the SAAC when the proposed additional 50% income tax rate is introduced from 2010. The form which the new provisions takes follows that of the existing provisions, so that relief is generally given for pension contributions, but if the limits are exceeded a tax charge arises, clawing back the excess relief. It would appear that a pension contribution made in 2010 will obtain relief from tax at the new 50% rate, but if the anti-forestalling rules apply any contribution in excess of the limit will be subject to the SAAC, which would presumably be increased to 30% to ensure that relief is only available at basic rate.

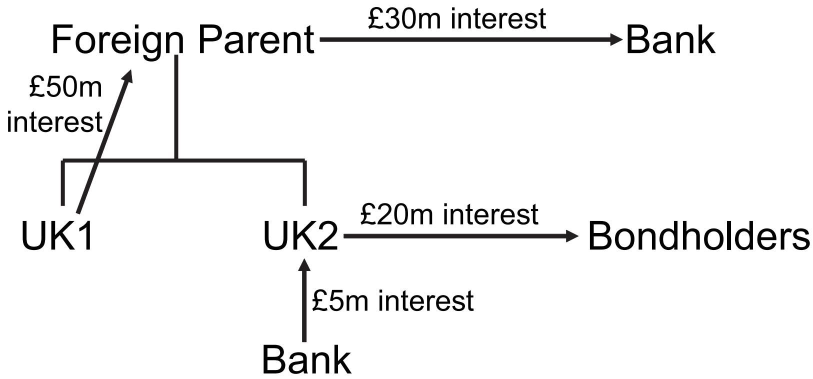
4. Both the TAPIA and the special annual allowance are reduced by "protected pension input amounts", which are, in broad terms, regular pension savings. These are defined throughout schedule 35, in relation to the type of Scheme concerned as amounts made on a quarterly or more frequent basis in pursuant of an agreement made before noon on 22 April 2009. This caters largely for the majority of employees who are likely to have arrangements under which either they or their employers contribute on a regular basis to their pension schemes. The rules, however, prejudice the self-employed. The self employed are likely to work out their profits on an annual basis on the basis of the accounts drawn up after the year-end for the enterprise concerned (whether solicitors, architects, accountants, other professionals, or other businesses). It is only at the year-end that the profits of the business for the relevant period will be capable of being determined and only at this point that the individuals involved in the business will become aware of the true amount of their earnings. Generally they will have been drawing amounts from the business during the year on the basis of a budget which is often quite prudent. For many individuals who are self-employed the excess of the earnings determined by the accounts over the amounts drawn during the year, less deductions for tax provisions, expenses, reserves, capital and so on, represents an amount of cash that can be taken out of the business and used to fund pension contributions. Generally, because of accounting arrangements of this type, the self-employed will make reasonably regular but annual contributions to pension schemes. While contributions on a quarterly or more regular basis may be made these are likely to be far smaller than the contributions made on an annual basis. Therefore the anti-forestalling rules are likely to prejudice the self employed. It is considered that a more reasonable basis would be to average contributions over a 3 year period and treat contributions below this limit as protected pension inputs for the purposes of the legislation.

5. For the rules to apply to a person he has to have income (determined broadly by adding back pension contributions to his total income for tax purposes) of £150,000. In determining whether an individual exceeds the income limit the current year and each of the previous two tax years are considered using the same calculation. If the maximum of £150,000 is exceeded in any of the three years the individual is treated as a "high-income individual" and the rules apply to him. It is considered that this is anomalous at a time of economic crisis when salaries and earnings are falling. An individual may have moved from a high earning job to a job with earnings at a much lower level—for example from a job where he is earning £200,000 plus to a job where he is earning £50,000. He will find his pension contributions restricted in the new employment if he did not make regular contributions as defined for the purposes of the legislation. It is considered that only the earnings for the tax year in which the payments are made ought to be considered for the purposes of the anti-forestalling rules rather than prior years.

*May 2009*

**Memorandum submitted by The Law Society of England & Wales during the Oral evidence session**

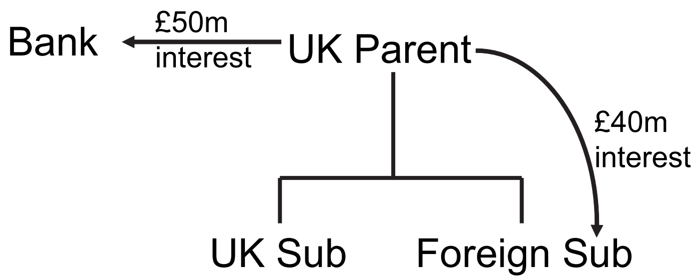
## Example 1 – Inbound Investment




Tested expense amount – £50m + £15m = £65m
Available amount – £20m + £30m = £50m
Disallowed amount – £15m
(Group can choose whether disallowance in UK1 or UK2)
Rules work as intended

Linklaters 0
A10296405

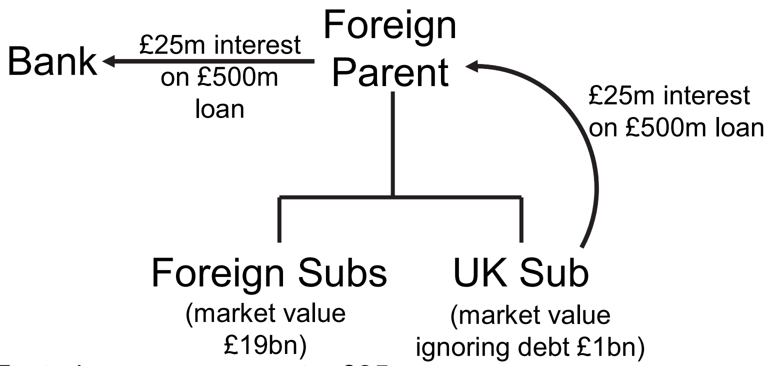
## Example 2 – Upstream Loan




Tested expense amount – £90m
Available amount – £50m
Disallowed amount – £40m paid by UK Parent
Rules work as intended

Linklaters 1
A10296405

## Example 3 – Debt Dumping
## Debt Cap does not limit deduction

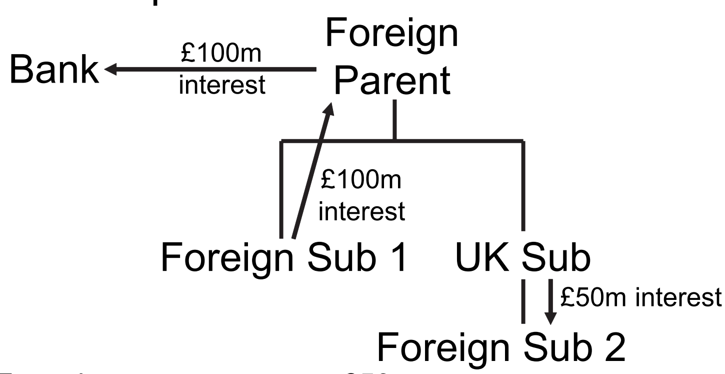



Tested expense amount – £25m
Available amount – £25m
No restriction even though all group debt has been on lent to UK Sub (comprising only 5% of market value (excluding intra group debt) of group activities)

Linklaters

2
A10296405

## Example 4 – Upstream Loan
## Debt Cap does not limit deduction




Tested expense amount – £50m
Available amount – £100m
No restriction even though Foreign Sub 2 has made an upstream loan that has effect of reducing UK Sub's taxable profit

Linklaters

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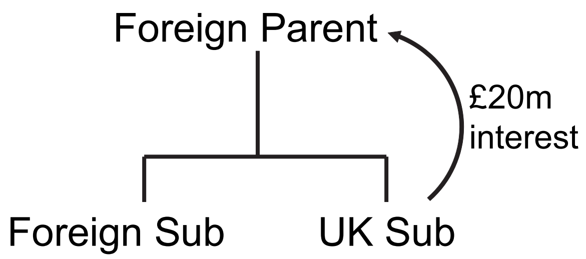
A10296405

## Example 5 – Equity Financed Foreign Parent

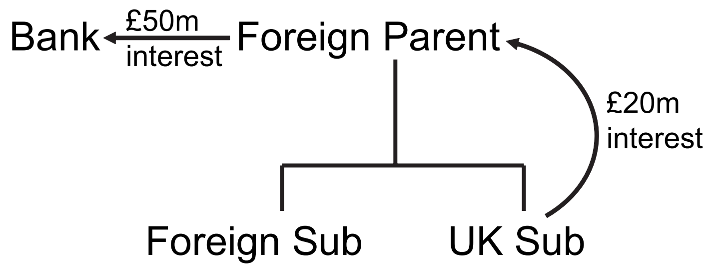



Tested expense amount – £20m
Available amount – Nil
Disallowed amount – £20m paid by UK Sub

Linklaters

4
A10296405

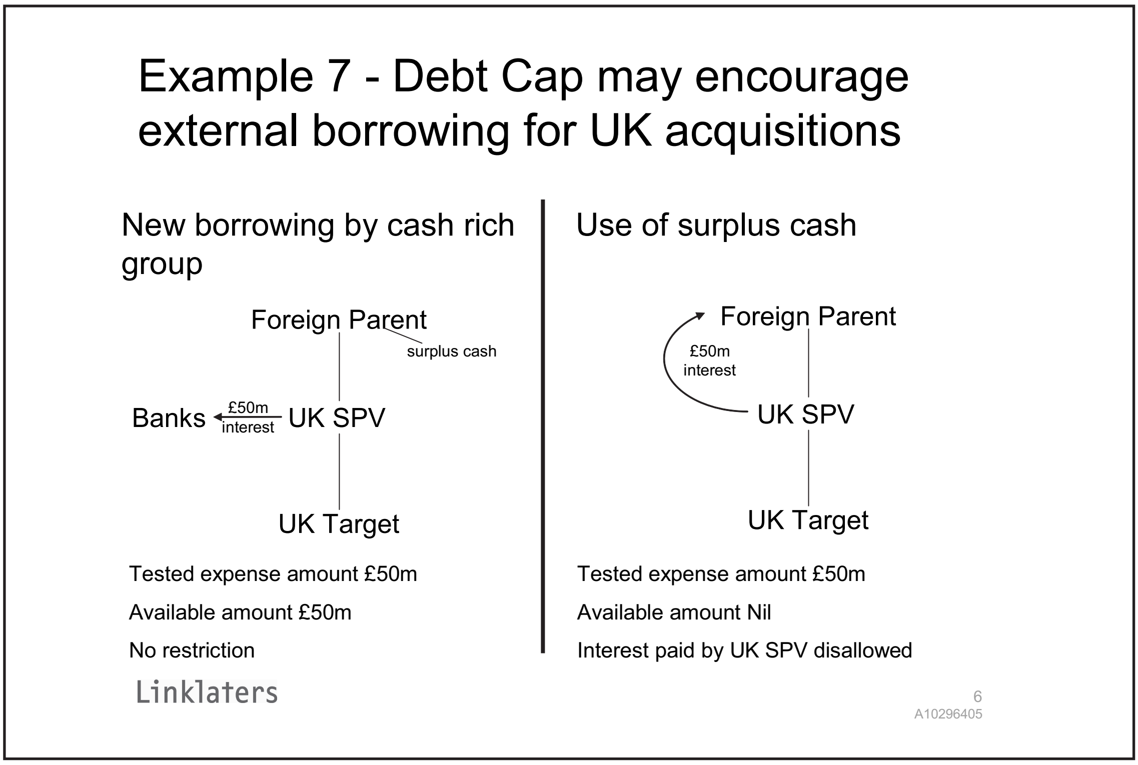
## Example 6 – Debt Financed Foreign Parent




UK Sub's assets, liabilities and activities identical to Example 5
Tested expense amount – £20m
Available amount – £50m
Disallowed amount – Nil
→ The method of financing Foreign Parent can make a major difference to otherwise identical UK subgroups

Linklaters

5
A10296405




**Memorandum by the Law Society of Scotland**

The Law Society of Scotland welcomes the opportunity to give evidence to the House of Lords Finance Bill Sub-Committee.

FOREIGN PROFITS: CLAUSES 34–37 AND ASSOCIATED SCHEDULES

The Society welcomes the introduction of an exemption for foreign dividends received by UK companies but has some concerns about the complexity of the provisions introducing this change.

In particular, the Society believes it is unfortunate that the legislation assumes that foreign dividends are taxable unless they are 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.

The extension of the exemption to small companies is welcome, but the Society questions whether it is necessary to have a separate and different regime for small companies and is concerned that this will introduce unnecessary complexity.

The Society also has concerns about the changes to the treatment of UK distributions received by UK companies which mean that distributions of a capital nature will no longer be exempt. It will be difficult for taxpayers to ascertain which distributions fall into that category.

The decision to delay the introduction of the world wide debt cap rules until 2010 is welcomed, but the Society is concerned that yet again the Finance Bill has not caught up with the ongoing consultation on a highly technical area.

In relation to the world wide debt cap, the Society is extremely alarmed by the huge complexity of this body of legislation and believes that these proposals are fundamentally flawed. It seems very clear that HMRC are listening carefully to the concerns of companies and their advisers, however even with the various changes that have been included in the Finance Bill and the government amendments which have been referred to in the letter from the Financial Secretary, it is hard to see how the new provisions will be workable in practice. They will present a massive compliance burden to multinational groups coupled with considerable uncertainty. Coupled with the proposed increases in personal taxation these changes may well mean that the UK is perceived as less competitive in tax terms.

### Real Estate Investment Trusts (REITS): Clause 65 and Schedule 34

The Society believes that the REIT regime has operated successfully, but that REITs are now facing a number of pressures as a result of the current economic situation which need to be addressed sooner rather than later.

The Society also recommends that consideration should be given to extending the REIT regime to include unquoted companies.

The Society welcomes the changes to Real Estate Investment Trusts which are proposed in the Finance Bill 2009 but regrets that a number of changes which have been requested by a range of different bodies, and which could have been extremely helpful in the current economic climate have not been introduced.

These include the requirement for REITs to distribute 90% of their income from property. This rule is extremely inflexible and current market conditions are making it difficult for REITs to comply with the requirement, with a consequent risk of loss of tax advantaged status.

It would have been possible to introduce either a relaxation of the 90% requirement or an extension to the time period in which the distributions required to be made. Alternatively REITs could have been permitted to meet the distribution requirement by way of a scrip dividend.

REITs also face difficulties at the present time because of the requirement for profits to be at least 1.25 times financing costs. The current economic situation means that planned income streams may not materialise, and that banks may increase interest charges, thereby causing REITs to breach this requirement due to circumstances beyond their control. Again it would have been possible to introduce relieving measures, perhaps on a temporary basis, to address these issues.

### Pensions: Clause 71 and Schedule 35

The Committee is concerned that the anti-forestalling provisions, as proposed, do not take account of the pension contribution patterns of a very significant number of self employed tax payers.

It is our members' experience that the great majority of such tax payers do not make contributions by monthly or quarterly payments into their pension schemes, but instead make single annual lump sum payments, normally towards the end of the tax year, when they have been best able to assess the likely profitability of their businesses, and therefore the level of contributions which can be made.

Such tax payers would be significantly prejudiced and discriminated against by the anti-forestalling provisions, and in particular by the definition of "regular ongoing pension savings", as proposed.

In order to avoid this, the Society would suggest that this definition is extended so that "regularity" is measured by reference to the total value of pension contributions made by the relevant tax payer in the preceding period, which may be one year, or perhaps an average of the last three years.

If the proposals are not amended, the effect will be to bring forward the effective limit to pension contributions from 2010/11 to 2009/10 for a significant proportion of self employed tax payers.

The Society also believes that it is unfortunate that these changes to the tax regime for pension contributions have been introduced so soon after the major pensions reforms of 2006.

*11 May 2009*

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## Examination of Witnesses

Witnesses: Mr Richard Stratton, Chair of the Committee, LSEW, Mr Ashley Greenbank, Partner, Macfarlanes, Mr Mike Hardwick, Partner, Linklaters, Ms Isobel d'Inverno, Convenor of the Tax Law Committee of the LSS, and Mr Bill Pagan, Convenor of the Private Client Tax Sub-Committee of the LSS, gave evidence.

**Q26** ***Chairman:*** Welcome back to the Finance Bill Sub-Committee and thank you for making time again this year to spend a little while with us today. Thank you for your written evidence. Do you want to make any introductory remarks or shall we go straight into questions?
*Mr Stratton:* I think straight to the questions, thank you.

**Q27** ***Chairman:*** What is your opinion of the way that the current round of discussion on foreign profits has been held? Perhaps you could expand a little on why there was such an adverse reaction to parts of the original package, particularly those on the controlled foreign companies, the CFCs.
*Mr Greenbank:* Ashley Greenbank, Macfarlanes. Overall, we found the process a little unsatisfactory. It broke into two parts. There was the discussion document issued in June 2007 and that included the original controlled company regime, essentially the

price for a dividend exemption. 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. The problem was that we would turn up and be told where the process had got to at the time and we ended up commenting on an update which was given to us in the meeting, instead of having a development of ideas with us putting forward our comments and having a response to them. The process then changed in the autumn of 2008 really when the policy seems to have been reformulated. That was the point at which the debt cap became essentially the price for the dividend exemption and the extension of the CFC regime to UK companies was dropped. 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 not been prepared to take comments on 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, we had the framework of the dividend exemption and the debt cap but there were lots of pieces of it missing. We would turn up for consultations where the subject really was to design the bits that were not there at the time, so there has never been any real in depth consultation on the drafting itself. That is how I feel it has been unsatisfactory.

**Q28** ***Chairman:*** Is that a general view?
*Mr Stratton:* Yes, I would agree with that.

**Q29** ***Chairman:*** Can you come back to the second half of my question which is to expand a little bit on the adverse reaction to the original proposals?
*Mr Greenbank:* Yes. The original proposals, which were to extend the CFC regime to UK companies as a means of addressing the challenges to the CFC regime under EU law, did not meet with a lot of approval. There was a widespread belief that the cost of those proposals to UK companies would far outweigh the benefits of the dividend exemption. There was a huge compliance burden associated with it because it meant applying the CFC regime to all companies in the worldwide group. The combination of the two meant the business decision was that that should not go forward.

**Q30** ***Lord Barnett:*** You seem to be in favour of the change in principle on foreign dividends and the exemption, but it is moving towards a territorial system. You talked about the complexity but almost any scheme you recommend as an alternative is likely to be complex. Would you care to highlight the significant changes you might like to see? I noted what you said about the consultation with the Treasury and HMRC, that you were unhappy about the in depth consultation. I take it you put the main points you want to see changed. Presumably they were rejected by the Treasury and HMRC without any in depth consultation. Why do you think the consultation was not satisfactory and why did they reject your suggestions?
*Mr Greenbank:* I will make an exception to start with. Parts of the legislation on which we were commenting have only just appeared in the Bill. The provisions for example in relation to small companies have only just appeared in the Bill so, yes, we have made comments on that in the submission that we have made to you which the Revenue will not have seen. The bulk of the comments we made were comments that we have made throughout the process. We have not had any formal response from the Revenue or the Treasury at all so implicitly we assume they have been rejected. If we go to how we would restructure the proposal, yes, we are in favour of the proposal in principle for the reasons that we gave in our submission. If we were to restructure it, I think we would start by saying that this is meant to be an exemption so you ought to start off with the basic default position that dividends are exempt, unlike the current default position which is that all dividends are taxable. From there, we would have exceptions for specific anti-avoidance provisions. Looking at the schedule as it is drafted at the present time, the model we would adopt is probably the model that is adopted for small companies. All dividends are exempt provided that they are paid from a qualifying territory, subject to specific anti-avoidance rules. We would abandon the exempt classes which are currently set out in the legislation. That is how we would restructure it.

**Q31** ***Lord Barnett:*** You referred a couple of times to small companies. How many small companies would be involved in this area of foreign dividends and foreign profits?
*Mr Greenbank:* I think the answer to that is probably relatively few, but in the previous draft of this legislation the small companies were excluded in so far as they received dividends from companies in which they had a 10% or more stake. That was so obviously contrary to EU case law principles. Many people made that observation. A change has been made in that respect, which is why the simpler regime has been included for small companies in the Finance

Bill. We welcome the change to include small companies but I do not think we really understand why you would necessarily create two regimes which creates inevitably boundary and compliance issues.
*Ms d'Inverno:* Isobel d'Inverno, Law Society of Scotland. This applies to UK dividends as well. It is a change to the whole system because of the EU issues. It is these kinds of complexities across the board which make it quite problematic. As has been mentioned, a lot of this legislation has not seen the light of day yet. Some of it has not even been drafted yet in some areas. It is really quite difficult to have an in depth consultation on things which have yet to be produced. Obviously in relation to the worldwide debt cap we will go into that in more detail.

**Q32** ***Lord Best:*** On the debt cap rules, the aim is to prevent a disproportionate amount of interest paid being claimed against UK profits but the societies consider this policy is fundamentally flawed, that schedule 15 will not do and indeed that schedule 15 should be omitted from the Bill. What are the real underlying reasons for your strong views on this? Have you put these to the Treasury and HMRC? I think you have put them to the Treasury. Why have they rejected your views? Do you feel there is a lot of other support for them from other quarters?
*Mr Greenbank:* We have brought along some examples of how the debt caps work which we can come to. We can talk you through why in principle we think it is fundamentally flawed. That is my phrase so I suppose I had better own up to it. It sounds quite a reasonable principle but because the debt cap is a worldwide cap it means that UK companies are being taxed by reference to transactions which are undertaken elsewhere within the worldwide group. The effect is the companies are not taxed on the transactions that they themselves undertake. You can end up quite easily with two companies doing exactly the same things, making exactly the same profits, being taxed in wholly different ways. We think that is fundamentally wrong. The tax system should not end up with that result. The debt cap conflicts with other taxing provisions. We already have a set of rules which seek to work out whether or not there is excess debt in a UK company. The transfer pricing rules were extended to include thin capitalisation in 1998 and those rules operate by reference to the internationally agreed arms' length standard. Of course companies have been agreeing with HMRC what the correct level of debt and interest expense for their group is and have often entered into very complicated agreements with the Revenue to agree what level of expense in the UK is appropriate. Now we are introducing another set of provisions which do not operate by reference to the purpose for which you have incurred the borrowing. They are just another set of rules which try to work out in another way what an excess amount of debt is. Inevitably the two will conflict, so there will be times when the company has agreed with HMRC what the level of appropriate expense in the UK is but, because of the operation of the debt cap, that agreed level of expense gets disallowed because of the way the debt cap works. Back to my first point: that may well happen because of something that has happened far away from the UK. Mike has brought along a few examples which we might take you through.
*Mr Hardwick:* Mike Hardwick, Linklaters. In the interests of speed I will not deal with the first two examples which are simply designed to illustrate how the debt cap works and are not contentious. They are examples where the debt cap does what it is supposed to do. My third example is designed to illustrate the limit of the debt cap as a vehicle for making sure that groups do not put too much of their debt into the UK. What I have is a foreign parent whose UK operations amount to about 5% of the value of the group. The whole of the group's borrowings have been put into the UK so that one would imagine that that is a case where there is a disproportionate amount of debt in the UK, but the debt cap does not impose any limitation because the amounts you test (the net UK tax deductions) are identical to the external interest. There is no restriction there even though it does appear to be a case of debt dumping. I draw from that that the debt cap is likely to 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. Example four is designed to deal with what I understand to be the other target of the debt cap legislation, upstream loans, where the UK company has borrowed from a non-UK subsidiary and the interest on that loan has been used to reduce UK tax. Here I have an upstream loan from the foreign sub on which £50 million of interest is being paid, but the debt cap will not bite simply because there are unconnected borrowings outside the UK. Again, I draw from that that, while the debt cap will be effective in some cases to limit interest on upstream loans, it will not always be effective. Examples five and six go together. What they are designed to show is that identical UK operations can be affected very differently depending upon what has happened outside the UK. In my example five, I have a foreign group which is entirely funded by equity, with the consequence that interest paid by the UK sub is disallowed. Example six on the other hand has an identical UK subsidiary. The only difference in the facts is that this time the foreign parent happens to have bank borrowings and, because of the interest paid on those bank borrowings, there is no disallowance of interest. 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.
*Ms d'Inverno:* I think these examples show just how complicated it is. That is one of our main concerns. It is hardly going to encourage multinational companies to headquarter themselves in the UK if this is the kind of detail that has to be gone into. It makes it impossible to plan with any certainty at all about how things are going to work out.
*Mr Hardwick:* Example seven is drawing on the same principle of examples five and six. 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.

**Q33** ***Lord Best:*** What about the point that you have already put these very strong arguments to the Treasury and HMRC? One wonders why they appear to have taken no notice of your representations. What kind of reaction do they seem to be making?
*Mr Stratton:* Richard Stratton, from the Law Society. We have put not these exact slides but an earlier set of slides which were very similar 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.

**Q34** ***Lord Wakeham:*** Neither of you have commented on either the CFC rules or the Treasury consents in the written submissions. I just wondered whether there was anything you wanted to add that might be helpful to us.
*Mr Greenbank:* We did not comment on the CFC rules. Some of the changes which are in the Bill are inevitable consequences of the introduction of the dividend exemption. We have little comment on them. You might question whether or not the changes made to the local holding company regime and exemptions from the CFC rules there are over the top, but at the end of the day we thought to ourselves these are a transitional regime while the Revenue works out its answer to the EU challenges to the CFC rules, which we would expect not to be in place for another two years. The more important question we suspect is not really one for the Finance Bill but how the Treasury and the Revenue are going to respond to those cases, because our bigger concern is that the existing rules, including the sticking plaster legislation that was put in place after the *Cadbury Schweppes* decision, remain contrary to EU law. What we have at the moment is an unenforceable set of CFC rules in relation to EU subsidiaries of EU companies. At the end of the day, the Revenue and the Treasury need to come forward with a set of proposals which will meet that point and decide whether or not they can really put in place any workable CFC regime, other than in completely sham transactions, that applies to the EU companies and then decide whether or not, having made that decision, they can extend the CFC regime which excludes EU companies to major treaty partners.

**Q35** ***Lord Sheppard of Didgemere:*** How do you assess the overall position in competitiveness for UK business from the introduction of these measures? Is it going to cause some real harm?
*Mr Hardwick:* You have to look separately at a number of different constituencies. Firstly, UK based multinationals. Here, I think the overall effect is positive subject to one point which I will come onto. The dividend changes will obviously be beneficial to them because it will be much easier for them to repatriate their profits from their foreign subsidiaries. The abolition of the Treasury consent rules will also make life easier. They will be able to do transactions without needing advance consent from the Treasury. On the other hand, there is the debt cap. For a UK based multinational, the debt cap may mean a bit of extra compliance but in most cases is unlikely to mean much extra tax. The one reservation for the UK based multinationals comes back to the final form of the controlled foreign companies legislation. The uncertainty about where that legislation is going to end up is currently damaging. UK based multinationals are concerned it may go too far. It may have the effect of countering foreign tax planning as well as UK tax planning. Looking at inbound investors, the position is a bit less favourable. For inbound investors, they do not benefit from the dividend changes or the Treasury consent changes unless they are proposing to use the UK as a jurisdiction for intermediate holding companies. On the other hand, they do need to worry about the worldwide debt cap and that may in some circumstances impose limits on their interest deductions. It will certainly impose some monitoring. Therefore, looking at the position of the inbound multinationals, the position is negative particularly when taken with other changes elsewhere in the Bill. I am thinking here possibly of the accounting officer changes. Lastly, for the wholly domestic groups, the changes are mildly negative. They do not benefit from the dividend changes because they do not have foreign subsidiaries. Indeed, the dividend changes require a bit more monitoring of dividends within the UK group. The debt cap increases their compliance costs but probably only marginally. It probably does not actually cost them much money. I think the main

gainers are the UK multinationals. For inbound investors and for wholly domestic groups I think it is negative. In response to the earlier question, I was going to say a few words on the Treasury consent rules, if I may. This is an aspect of the proposals which we welcome and indeed have been advocating for a number of years. We are pleased to see that it will no longer be necessary to obtain consent before doing transactions involving shares in foreign subsidiaries. We are pleased that the criminal sanction for breach has gone and we are pleased to see a £100 million limit, which should remove a lot of the smaller transactions from the ambit. The current Treasury consent rules have some general consents which let out transactions with third parties and straightforward loans and share subscriptions from the UK. The new reporting rules do not replicate those exclusions, although there is a power to make regulations to include further exclusions, and we hope that similar exclusions can be added. More generally, one could ask whether the reporting rule could be limited to transactions that might be expected to reduce UK tax or even whether you could rely on the existing tax avoidance scheme disclosure rules to extract the information that the Revenue wants. This is a change that we welcome.

**Q36** ***Chairman:*** Do you have any comments on the changes that have been announced recently in the US by President Obama which seem to be moving in just the opposite direction to the way we are moving? For example, they suggest that the territorial approach of exempting foreign profits might not be the best way of doing things. You do not have to answer this.
*Ms d'Inverno:* Can I return to the competitiveness question whilst others are thinking of the answer to that one? Our concern is that this whole 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. It is really not the best way to approach these kinds of issues. The consultation not having properly engaged with the major players has not been ideal.
*Mr Hardwick:* I have not looked at President Obama's proposals in detail but my understanding is that there are two main themes. Firstly, a limited change to the US residence rules, which I think it not really relevant in the UK context. The US regards companies as resident if they are incorporated in the US. If they are incorporated outside the US, however much they are managed in the US, they do not become US resident, unlike in the UK. There is a proposal to change that as I understand it, which seems fair enough but I do not think has any great implications for the UK. The other strand to the proposals I think is the anti-tax haven proposals, which are operating in a similar area to our controlled company rules but at a detailed level and in a rather different way because of the different US tax framework. I do not think they are fundamentally going in a different direction from us.
**Chairman:** If you have any further thoughts, just drop us a line. Perhaps we can move on to Real Estate Investment Trusts, REITs.

**Q37** ***Lord Powell of Bayswater:*** Overall, how far have REITs been successful in meeting their objectives? To the degree that they have not been successful, is it just due to the economic circumstances or do tax factors have any significant impact on that? Reading your evidence, I guess you would say that the tax costs of REITs are an unfair burden. A great deal of the initial investment, I think you say, goes into meeting the tax costs. What are the changes you would make if you were the Chancellor to make things a bit better for REITs and make them more successful?
*Mr Hardwick:* What has happened over the last two and a quarter years while we have had the REIT regime is that most of the large property investment groups have converted into REITs. My understanding is that that change has gone down well with their shareholders and has increased liquidity in their shares. To that extent the REIT regime has been successful. What we have not seen is many new REITs being launched. In particular, I do not think we have seen any residential REITs. In large measure, I think that is a function of the economic environment in which we have been operating for much of the period while we have had REITs. Tax may play some part because, as we said in our representations, there is quite a chunky initial tax charge when you establish a REIT. There is a 2% entry charge on the market value of the properties when you become a REIT, but you will also have to pay 4% stamp duty land tax to acquire the properties forming part of your portfolio. 6% of the initial investment is quite a big up front cost, at any rate when the property market is not booming. On the residential side, I think there are a number of other factors that have made things difficult, not really to do with the design of the regime. While you can buy commercial property in big lumps, it is much harder to do that with residential property. The costs—I do not mean particularly tax costs; I mean just legal costs, agents' costs—of assembling a sizeable residential portfolio are quite significant. Before the property market turned down, when residential

prices were high, the yields that you could earn were relatively low. That background made it quite difficult to establish new REITs. What would I do if I were Chancellor? I suppose one could ask whether the rate of SDLT could be reduced for the formation of new REITs or whether the entry charge could be waived where it is an entirely new fund being launched. On the residential side, I think there are a couple of other points. My understanding of the residential model for funds is it involves selling bits of the portfolio much more frequently in order to increase the quality of the portfolio. There is a concern that if you buy and sell frequently you may be trading in the underlying properties and may not qualify for the REIT tax exemptions. Exemption of the profits you make where you turn over the portfolio would be helpful. The other thing that may be helpful on the residential side is some reduction of the 90% distribution requirement. The 90% distribution requirement would bear more heavily on a residential REIT than it would on a commercial REIT. Commercial REITs can claim capital allowances for the fixtures in the building which will have the effect of reducing the dividends they have to pay to satisfy the 90% requirement. That is not true of the residential REIT.
*Mr Pagan:* Bill Pagan. I chair the private client tax committee of the Royal Society of Scotland. My committee comes at this from a slightly different angle from the point of view of those who would have liked to have invested. I think there is disappointment out there among the private investors who felt when REITs were first announced that this was going to be a wonderful opportunity. I suspect they are all rather relieved now because, had everything gone rather easier, they might have filled their boots with new REITs earlier on, which would not have been a very good idea. There was I think a perception among most private investors that the way it all worked was fine for the companies that wanted to restructure themselves and therefore the private investor had to think about restructuring his portfolio in order to take in a different type of company that he would not otherwise have had. I think generally there is disappointment that they have not one way or the other worked out, originally because of the time it took to get the new ones going and then, secondly, because of the market.

**Q38** ***Lord Powell of Bayswater:*** Are you saying the economic environment is probably 70% of the problem and the tax aspect is about 30%?
*Mr Hardwick:* Yes.
*Ms d'Inverno:* 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.

**Q39** ***Lord Powell of Bayswater:*** These points have all been put to HMRC and the Treasury?
*Mr Stratton:* They have been discussed in consultation. In fairness to the Treasury on REITs, they had to start somewhere and the quoted model was the easiest place to start. In relation to an unquoted REIT, there is in place now legislation for Property Authorised Investment Funds, PAIFs, which are the unit trust equivalent of the REIT. The benefit is they are not listed so you will not get the discount to the list price that you have with a REIT. The disadvantage is that they are open ended, so an investor can come along and ask for his money back, which is inconvenient if you run a shopping centre at the time. There is a plus and a minus there, but the government is making initiatives in this area and constantly trying to look at what products might be available. Generally, there are positive things to say despite the market.

**Q40** ***Lord Blackwell:*** A lot of the impetus for REITs came from the successful experience in the US and developments there. I just wondered whether there was anything structural in the way that REITs have been introduced or operated in the States that led to that better performance over and above the simple difference in market timing.
*Mr Hardwick:* I think there was but it is worth remembering that even in the States it took some time for REITs to take off. As I understand it, they were introduced in the US in 1963 but it was only really in the 1980s that they expanded beyond a relatively small number of REITs. My understanding of what caused this expansion is that it was the introduction of what is known as the up-REIT structure, which is essentially a structure that gives tax relief for people disposing of properties to REITs. That made it much more attractive for people to establish new REITs. I think maybe similar reliefs have been tried in France to stimulate the regime.

**Q41** ***Chairman:*** Can you tell us whether solicitors have found any particular difficulties with the current provisions?
*Mr Hardwick:* The current provisions are inevitably fairly complicated. I think there are two main sources of the complexity. Firstly, they were drafted with single company REITs in mind but actually all the

REITs out there are complex groups of companies. What you have to apply is deeming rules that are grafted on to the single company rules and that produces some uncertainty. The other thing that has caused uncertainty is that a REIT group is notionally divided into its exempt property rental business and its remaining business. That division runs across its legal structure and requires you to do a certain amount of rethinking of the way you normally think when you approach corporate groups. 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. One area that potentially can cause some difficulty, particularly if we get an increase in the number of mergers and acquisitions involving REITs, is the degree of discretion that the rules allow to the Revenue, where breach has occurred or where a REIT leaves the regime within ten years. That discretion can act as a drag on mergers and acquisitions because solicitors need to be able to advise a client what is actually going to happen, how the Revenue is going to react, and it is very difficult to do that without discussing it in advance with the Revenue.

**Q42** ***Lord Barnett:*** Mr Pagan told us there is disappointment amongst private investors. Could I try to get it in some kind of perspective? How many companies are we talking about here and how many more could there be if it was a better arrangement?

*Mr Pagan:* I do not think I am competent to answer that question. My experience has come from the individual and family investors who have been looking to broaden their portfolios and from working with investment managers who would like to have been able to offer collective interest in property. It is a question really which is only answerable by saying what should be your asset allocation within a particular portfolio. Some charities have gone very heavily into property, for example. I know of some which are approaching 50%, which may cause some embarrassment. The average family, I would have suggested now, would probably be very wary of even going to ten. The market downturn has made quite an impact on what originally was hoped. Logically, there should be demand now. I really could not put a statistical answer to you. I am sorry.

**Q43** ***Lord Best:*** This is about the impact on the REITs changes to pubs. Do you really think it likely that pub groups are going to take advantage of these changes and enter into the REIT regime?

*Mr Hardwick:* There has certainly been press comment that a number of pub groups are looking at it and I think it possible that groups that own tenanted pubs may well try to restructure into the regime.

***Chairman:*** I think that brings this current session to a close. Thank you very much for spending some time with us this afternoon and thank you for your answers to our questions which have been very helpful.

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## Supplementary memorandum by the Law Society of England & Wales

### Introduction

There was not sufficient time at the sitting of the committee on Wednesday 13 May 2009 for the LSEW to deliver evidence in relation to the taxation of pensions. We have set out written evidence in relation to the questions which were being considered by the committee below.

10. *How well did the new rules for the taxation of pensions work in the three years from A day? Did they provide all the features which were intended—simplicity, certainty, flexibility, consistency, choice with reduced costs—and could they be readily understood?*

In general we believe that the provisions for the taxation of pensions have delivered many of the features described in the question. It should be said that the taxation provisions relating to pensions in Finance Act 2004 are long and detailed, and there have been various "glitches" in the operation of the provisions which have inevitably come to light since 2006. The provisions have not been in place long and represent a very significant set of changes to the pension system so it is inevitable that teething problems of this type would occur. However, these issues are being ironed out. Leaving these issues aside we believe it is the case that the pension system brought in on A day, in terms of the broad framework, is simple and relatively straightforward to understand—the concepts of the annual allowance, the lifetime allowance, and the lump sum are all transparent features. One of the great advantages of the system introduced since A day was its flexibility. Because of the annual allowance it was possible for those contributing to a pension to contribute greater amounts in years when they have available funds and lesser amounts in years when they do not or when other priorities intervene, without prejudicing their overall ability to build up an adequate pension over the course of a working life.

11. *Might it have been possible for the Treasury/HMRC to have consulted on the anti-forestalling provisions before Budget day?*

We do not believe that this would have been possible. The proposed tax charge represents a very significant alteration to the framework of the tax provisions that was implemented in 2006. Any consultation would have inevitably resulted in the type of forestalling that the Government are seeking to avoid through Schedule 35 of the Finance Bill.

12. *LSEW makes clear recommendations to remove from the anti-forestalling provisions what you see as a prejudice against the self employed and those whose incomes have fallen. Would you care to expand on what you say? How far do you see your recommendations as meeting your concerns in these areas?*

There are two areas where we believe that the new rules go too far. The first is the definition of "high-income individual". This is an individual whose income exceeds £150,000. However if the limit is not exceeded in the current tax year, each of the two previous tax years are examined. If the limit is exceeded in either of those two previous years the individual concerned falls to be treated as a high-income individual with the result that he is then caught by the anti-forestalling provisions regardless of the actual level of his remuneration in the year in which he contributes to the scheme. We believe that at a time of the economic crisis, when salaries are falling and where many individuals who were "high-income individuals" take posts with lower salaries, to restrict pension contributions in these circumstances by reference to prior years' earnings is not justified. There are two reasons for this. The first is that this is not in accordance with the current system where, subject to the overall lifetime allowance, it is only the earnings in the year and the annual allowance for that year that are considered. The second is that if an individual has a salary of £149,000 he can obtain relief at his marginal rate for his entire earnings. The disparity when comparing this position with someone who had earnings in excess of £150,000 but whose earnings then fall is marked. We would also point out that although the anti-forestalling rules are, in the press releases, expressed to be in force for two years, Schedule 35 itself is not limited. It comes into effect on 22 April 2009 and continues unless and until a new regime replaces it.

The self-employed pay tax by reference to the accounts period of their business or profession which ends during the current tax year (known as the "current year basis"). A self-employed individual working on his own or in partnership will only be able to ascertain his taxable profit for a tax year following the preparation and auditing of his accounts. These accounts will reveal the profits for the year, the tax liability, and may also reveal other matters, such as the necessity to make provisions or reserves against future liabilities. At the same time the self-employed individual will need to assess the cash position of his business. As the committee will be aware, taxation is levied on an accounts basis. The self-employed professional is obliged to bring in at the end of the year the value of his "work in progress" that is matters for clients which are not yet completed. He is obliged to bring in such unfinished tasks at an estimate of their realiseable value. At a year end levels of work in progress and debtors (that is in respect of amounts owed by clients who have been billed but not yet paid) can represent a considerable proportion of turnover. These amounts are normally turned into cash over the months after the year end as clients pay bills and matters which are ongoing are completed. This cash is then used, at least in part, to fund the tax bills of the firm. It is the surplus leftover which the self-employed will very often use to fund pension contributions. It is only once the liabilities have been established that the free cash available for pension contributions and other matters can be considered. Generally in a professional partnership, and probably in many other business entities, the proprietor will, during the year, tend to take relatively low drawings or payments out of the business in order that sufficient cash is available following the year end to discharge liabilities as described above. The likely effect of this is that for most self-employed persons, (and whether or not regular contributions to pension schemes are also made), the significant contribution for such an individual is likely to be through lump sum annual payments. The pre-April 2009 system was advantageous; it was flexible enough to allow irregular lump sum contributions. If contributions could not be made, for whatever reason, there would be the opportunity to make these up in later years. The anti-forestalling rules particularly prejudice the self-employed as a result of the characteristics of their businesses; these characteristics mean that the self-employed are highly likely to make annual contributions. However, under the anti-forestalling rules an annual contribution cannot be treated as a regular payment and will therefore be caught in its entirely by the anti-forestalling rules. We would see our recommendations as going some way towards meeting our concerns in these areas.

We would note also that the adverse effect of the anti-forestalling rules is exacerbated in a recession. If an accounting period ends before an economic crisis (as was the case in 2008) a relatively high value might be placed on work in progress reflecting its anticipated recoverability. As the economic crisis bites clients will cease paying bills and cease to instruct professionals. There is less cash in the business. Under the pre-April 2009 system any shortfall in contributions could be made up just as effectively in later years—this is no longer the case.

*Are there any other significant problems with Schedule 35 or matters which are not properly covered?*

The difficulty with Schedule 35 is that the Government are seeking to introduce provisions which apply to both defined benefit ("DB") schemes and to defined contribution ("DC") schemes. An example of a defined benefit scheme is an occupational scheme where, for example, on retirement at a particular age an individual will be entitled to, say, a pension of one-sixtieth (or some other fraction) for each year of pensionable service of final pay, which may be index linked (with or without at cap, if at all), and his widow may be entitled to a pension of half of this (for example). There may be other benefits attached to the pension. The mechanism for valuing the increase in contribution made to a DB scheme as currently set out in the Finance Act 2004 involves taking the accrued pension under the scheme at the start of the tax year and multiplying that amount by 10. This is then compared with the amount of the accrued pension at the end of the tax year, again multiplied by 10. The difference between these amounts is the deemed contribution to the scheme. This type of a calculation for a DB scheme is unsophisticated in the extreme. It takes no account of the age of the individual concerned. For example to provide an increase in the accrued pension benefit (payable at age 65) of a 30 year old costs markedly less that providing the same benefit for a 55 year old. The current legislation does not deal with these valuation issues.

On the other hand a DC scheme measures whether or not the annual allowance is breached by reference to the amounts actually contributed to the scheme, a far simpler assessment. It is therefore 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 (eg 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.

*Is this not a very complex piece of legislation to address a transitional issue which will apply for only two years?*

The legislation is complex, but this reflects the different types of pension schemes. As we hope we have made clear from the above evidence we believe that the regime which the Government are proposing to introduce in 2011 will prove far more complicated than the current rules in Schedule 35 as the new legislation will require the accurate valuation of pension scheme contributions. If this is not the case it will not be possible to work out what those contributions are in order to work out whether they exceed the annual allowance or the protected pension inputs.

13. *Would there have been alternative means of achieving the overall objective of limiting the cost of relieving pension contributions to high earners? Would these have been preferable? If so, why?*

If it is desired to limit the cost of relieving pension contributions to high earners, there still has to be ascertained the value of any contribution made by those high earners and there has to be fairness between contributions made to different types of schemes. This, in our view, inevitably leads to considerable complexity. It is notable that although the 2006 regime is complex the issue of valuing DB accruals has only been addressed with a rather unsophisticated formula. We do not therefore believe that there is a preferable alternative.

*In particular, would it have been sufficient to restrict the annual and/or the lifetime limit?*

The lifetime limit appears high (between £1.5 million and £1.8 million). Many self-employed or employees will be unable to build a pension fund of this amount. However it has to be recognised that with falling annuity and interest rates capital sums of this size do not produce very large pensions especially for DC scheme members who retire early. 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.

*Are there particular technical issues with the Government's longer term proposals which need to be thought about now?*

As mentioned above we consider that the technical issues 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 unfairnesses between different constituencies of taxpayers.

*May 2009*

## APPENDIX 1

Law Society of England and Wales

*President Obama's International Tax Proposals*

We were invited last Wednesday to submit to the Finance Bill Sub Committee of the House of Lords Select Committee on Economic Affairs any comments which we had on President Obama's International Tax Proposals. We set out below some brief thoughts on the proposals.

1. *Contrast with Direction of Reform in the UK*

The US, like the UK, has traditionally taken the approach of taxing its resident taxpayers on foreign income but allowing them to credit any foreign tax on the income against their domestic tax liabilities. The UK is now considering moving to a territoriality system under which foreign income, at least insofar as it derives from shares, would not be taxed.

President Obama's tax proposals reinforce the current US tax system of taxing foreign income with credit for foreign tax. There is no move towards a territoriality system.

We do not believe that the line of reform taken by the US represents an appropriate model for the UK. The US is a much larger economy. The UK is in a very different competitive position and competes directly with other European countries for international investment and as a base for international operations. The UK therefore needs an attractive tax regime for multinational investors.

Moreover, the direction of reform in the UK is to a large extent dictated by EU law issues. These require the UK to treat dividends from UK subsidiaries and from EEA subsidiaries in the same way. If the UK wished to continue to tax with credit for foreign tax dividends from EEA subsidiaries, it would have to apply the same system to UK subsidiaries. This would involve very significant additional compliance costs for business and would be deeply unpopular. EU law is also a major influence on the form of the controlled foreign companies legislation and the worldwide debt cap. The USA is not subject to similar constraints.

We note that even in the US there has been press comment that President Obama's tax proposals will disadvantage US companies and may lead to some emigrating from the US or being taken over by foreign companies.

2. *Expenses Relating to Foreign Activities*

Under President Obama's proposals, US tax deductions for expenses associated with foreign activities would be deferred until the earnings from those activities are subject to US tax. For example, a US parent would be prohibited from taking any deductions for interest expense associated with investments in a foreign subsidiary until it repatriated the profits of that subsidiary.

In concept, this has some similarities to one of the proposals which we put forward to the Treasury as an alternative to the Worldwide Debt Cap. We, too, considered that there was logic in seeking to match expenditure with the income which it generated. We considered that if dividends from UK and foreign subsidiaries were to be exempt from tax, there would be logic in preventing UK companies from deducting interest on loans financing the acquisition of shares in subsidiaries. Neither expenses relating to foreign subsidiaries nor the income from the foreign subsidiaries would be deductible or taxable. We understand that this proposal was not adopted because it was thought to raise too much tax and to be unlikely to command widespread support among business. It would not, on its own, have led to a balanced package. It would, however, be possible to devise a balanced package either by combining the proposal with a cut in corporation tax rates or by disallowing only part of the interest expense.

3. *Tax Residence Rules*

The UK regards a company as resident for tax purposes in the UK if it is either incorporated in the UK or centrally managed and controlled in the UK. Traditionally, the US has only regarded a company as a resident in the US if it is incorporated in the US. A legislative proposal was made in Congress earlier this year ("Stop Tax Haven Abuse Act"), under which certain companies incorporated outside the US that were managed and controlled in the US would be treated as resident for tax purposes in the US for US federal income tax purposes. While such a change would bring the US rules closer to the UK rules, it was not repeated in President Obama's proposals.

## APPENDIX 2

LINKLATERS

MEMORANDUM 5 May 2009

*President's International Tax Proposals*

On Monday, 4 May 2009, the Obama administration released a series of proposals (the "Proposals") aimed at reforming the US tax treatment of multinationals and cross border transactions. These proposals will be debated and likely modified in the US Congress before their possible enactment. In keeping with the President's general approach to tax legislation (stimulus now, reform later), the proposals are not intended to be effective until 2011.

The principal elements of the Proposals are described below. The Proposals have been released only in the form of a high-level summary, and no legislative text is yet available. Consequently, the description here may not precisely track the actual terms of the Proposals.

1. *Foreign Tax Credit Reform*

The Proposals include two major changes to the foreign tax credit rules, requiring credits to be determined based on an overall blended foreign tax rate, and allowing the credit only to the person that recognizes the income under US tax principles.

1.1 *Blended foreign tax rate*

By determining the foreign tax credit based on the amount of total foreign tax actually paid by the taxpayer on foreign earnings (including earnings through foreign entities), the credit will be allowed only at the overall effective rate of foreign tax borne by those earnings. This will restrict the ability of taxpayers under current law to maximize foreign tax credits by repatriating pools of highly-taxed earnings first.

1.2 *Tying the credit to the income*

Under current law, the person that is legally subject to the foreign tax is entitled to claim a credit for that tax, even if the income that is subject to the tax is earned by a different person for US tax purposes. For example, foreign tax on income earned through a "reverse hybrid" entity (which is transparent for foreign tax purposes but opaque for US tax purposes) is considered to be paid by the owners of the entity, even though for US tax purposes the income is earned by the entity itself.

The Proposals would allow the credit to be claimed only by the person that reports the income for US tax purposes. In the case of a reverse hybrid entity, this means that the owner would not be allowed a credit until the income is distributed to its owner, and even then only at a rate that reflects the owner's overall blended effective rate of foreign tax.

The Treasury Department had previously issued proposed regulations that, when finalized, would achieve a similar result. As a legislative proposal, however, it will be treated as a revenue raiser that can be used by Congress to fund other initiatives.

2. *Restrictions on "Check the Box" Regulations*

The Proposals revive a Clinton-era proposal to limit the use of "check-the-box" elections in connection with foreign tax planning by US multinationals. Prior to the adoption of the check-the-box rules, deductible payments by foreign subsidiaries in high-tax countries to affiliates in low-tax countries triggered "subpart F income" that was immediately taxable to the US parent under the US controlled foreign corporation rules. The check-the-box rules allowed these subsidiaries and their affiliates to be treated as branches of a single entity, causing payments between them to be disregarded for US tax purposes.

While the Proposals are clearly intended to stop this use of check-the-box elections, it is unclear whether they contemplate any broader restrictions on their use. Some press reports have characterized the proposed restrictions as a "repeal" of the check-the-box rules, but such a broad step does not appear necessary to accomplish the objectives of the Proposals.

3. *Expenses Relating to Foreign Activities*

Under the Proposals, US tax deductions for expenses associated with foreign activities would be deferred until the earnings from those activities are subject to US tax. For example, a US parent would be prohibited from taking any deductions for interest expense associated with investment in a foreign subsidiary until it repatriated the profits of that subsidiary.

Deductions for research and development expenses would not be subject to this deferral. In keeping with the preferred treatment of R&D, the Proposals would also make permanent the existing 20% tax credit (currently set to expire at the end of 2009) for increases in qualified R&D expenses.

4. *Stricter Reporting Requirements*

The Proposals contain a number of provisions relating to tax reporting and withholding. In particular, non-US financial institutions will be given stronger incentives to participate in the Qualified Intermediary ("QI") program. (A financial institution can be a QI if it signs an agreement to share information with the IRS about its US customers.)

— US financial institutions will be required to withhold 20-30% of all US payments to individuals that are made through non-US financial institutions that are not QIs. The withholding tax would be refundable only to investors who disclose their identities and establish their compliance with US tax laws.

— US investors who use financial institutions that are not QIs will be presumed to be obligated to disclose their ownership by filing a Foreign Bank and Financial Account Report.

— A financial institution may only be a QI if all commonly controlled financial institutions are also QIs.

— The statute of limitations for international tax enforcement would be extended from three years to six years.

5. *No Change to Residency Rules*

In legislation proposed earlier this year in Congress (the "Stop Tax Haven Abuse Act"), certain non-US corporations that are managed and controlled in the United States would be treated as domestic corporations for US federal income tax purposes. The Administration did not include such a rule in the Proposals.
We will be monitoring any proposed legislation in this area as it moves forward.

## MONDAY 18 MAY 2009

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| Present | Barnett, L | Powell of Bayswater, L |
| | Eatwell, L | Sheppard of Didgemere, L |
| | Griffiths of Fforestfach, L | Vallance of Tummel, L (Chairman) |
| | Macgregor of Pulham Market, L | Wakeham, L |

**Memorandum by Julian Heslop, Chief Financial Officer, GSK: on behalf of the 100 Group**

1. Introduction

The 100 Group represents the UK's largest groups of companies covering all major business sectors. The 100 Group welcomes the opportunity to give evidence to the House of Lords Economic Affairs Committee: Sub-Committee on the Finance Bill (FBSC) on aspects of the Finance Bill 2009.

The 100 Group has worked with HM Treasury and HMRC for a number of years. Our goal has been, and continues to be, ensuring that the UK tax system remains competitive and attractive to business by encompassing the principles of certainty, simplicity, predictability and equity for corporate taxpayers. It is our strong view that consultation prior to the implementation of significant changes to the UK tax system is essential if we are to achieve this goal.

In this written evidence, we have focused on the technical issues of tax administration, clarification and simplification rather than rates or incidence of tax relating to the areas being addressed by the Committee. The majority of our comments focus on the clauses in the Finance Bill on Foreign Profits (clauses 34–37 and schedules 14-17) and we have also made some remarks on pensions (clause 71 and schedule 35). We have not made comments on Real Estate Investment trusts as this area is not particularly relevant to most members of the 100 Group.

2. Taxation of Foreign Profits (Clause 34—37 and Schedules 14–17)

A significant proportion of companies, both those entirely UK-based and UK-headquartered, will be affected by the changes introduced in the Finance Bill. The Committee will be aware that these proposals have resulted from an extensive consultation between HMT and industry since the release in June 2007 of "The taxation of the foreign profits of companies: a discussion document". This included a package of proposals addressing participation dividends, controlled companies rules, interest and treasury consents.

We 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. These include the decision to defer and revisit the Controlled Companies proposals (which the 100 Group had significant concerns with), and the delay between the introduction of dividend exemption and the introduction of a debt cap.

Our view on the proposals in the Finance Bill can be summarised as follows:

— we fully support the introduction of a dividend exemption regime and the abolition of Treasury Consent as these will be beneficial to UK companies;

— 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;

— we would have preferred that the Controlled Foreign Companies changes introduced in the Bill would have been made as part of an agreed package of changes in the more comprehensive ongoing review of the CFC regime.

*Dividend Exemption*

The dividend "exemption" is intended to enable tax free repatriation of dividends from overseas operations. The proposed structure in the Bill means that all dividends will be taxable unless they fall into one or more of five different exemptions. Whilst we support the policy goal of the exemption, we do not believe that this approach offers the greatest simplicity or certainty to taxpayers and we would have preferred an outright exemption for all dividends, subject to carve-outs for specific circumstances. However, the proposal is a major positive step forward for the UK and improves UK global tax competitiveness.

There remain some areas of uncertainty, for example:

— where groups have split shareholdings in subsidiaries or joint ventures they may have to rely on different exemptions for the dividends received;

— dividends are exempt if they fall into one of the five exemptions and are not "distributions of a capital nature". There is currently no definition of what is covered by this term.

These issues could respectively be addressed by introducing:

— a concept of ultimate shareholder or parent company control that includes direct and indirect shareholdings. This would potentially reduce the compliance burden and increase certainty;

— a definition of "distributions of a capital nature", which would increase certainty for taxpayers.

We would also ask HMRC to publish its guidance on the legislation as soon as possible so that taxpayers will be given greater certainty.

*Debt Cap*

The debt cap regulations seek to limit the amount of interest relief that companies can claim in the UK. As announced by HMT following publication of the Finance Bill, HMRC will be publishing further points of detail before the introduction of the regime so a further period of consultation will be possible. It would have been preferable to have this prior to the publication of the Finance Bill.

The debt cap rules apply to large businesses (other than financial services). While simplified since their original form, they remain complex. Notwithstanding the "gateway" test (designed to exclude those companies with limited internal debt compared to overall external group debt), 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.

*Repeal of Treasury Consent*

The requirement of the Treasury Consents (to seek prior approval for certain classes of transactions or face the risk of criminal sanction) dates from the time of exchange controls. The repeal of these regulations is long overdue and is therefore well received by business. Further simplification could be possible if the reporting requirements' regulations enabled HMRC to adopt simplified arrangements for transactions of a recurring nature.

*Changes to the CFC regime*

With the planned reform of the CFC regime the changes included in the 2009 Finance Bill may operate for only a short time. There is still work to do on the CFC regime and its interaction with EU law. Therefore, the next most important step in respect of CFCs will be continuing the dialogue with HMT and HMRC to ensure that the new regime moves to a territorial basis and that the UK remains a competitive business location.

3. Pensions (Clause 71 and Schedule 35)

The changes announced in the 2009 Budget and included in the Finance Bill apply from April 2011 and operate to both limit tax relief available to individuals on pension savings and tax employees in respect of employer pension contributions for higher earners. Although the new regime comes into effect in 2011, the anti-forestalling provisions (transitional arrangements) now apply.

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. We are concerned that it will have a negative impact on the competitiveness of the UK.

*14 May 2009*

## Memorandum by the CBI

### 1. Introduction

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

1.2 The CBI welcomes the opportunity to give evidence to the House of Lords on aspects of the Finance Bill 2009.

### 2. Documents

Annexed to this paper are:

(a) CBI's March 2009 response to HMT/HMRC's Consultation Document and Draft legislation on the Taxation of the Foreign Profits of Companies of December 2008.[1]

(b) Letter of 24 November 2008 from the Financial Secretary to the Treasury to Richard Lambert.[2]

(c) Open letter of 30 April 2009 from the Financial Secretary to the Treasury.[3]

(d) CBI Tax Task Force Report *UK Business Tax: a Compelling Case for Change* September 2008.[4]

### 3. Written Notes ahead of Oral Evidence

We have been asked to focus our attention on three main topics in the Finance Bill:

- Foreign Profits;
- Pensions; and
- Real Estate Investment Trusts (REITs).

### 4. Foreign Profits

*Finance Bill Provisions—Background*

4.1 The Finance Bill gives legislative effect to the CBI's proposal to the Government that a Foreign Dividend Exemption should be introduced into the UK rules for taxing Foreign Profits in the 2009 Finance Bill.

4.2 We warmly welcome the Government's acceptance of our proposal and its early action to make the requisite changes in the law.

4.3 Our basic position on Foreign Profits tax reform was set out in detail in our response to the Government's consultations. That Ministers were minded to take action in this area was heralded in the PBR and the letter of 24 November 2008 from the Financial Secretary to the Treasury to Richard Lambert.

4.4 Not only had the CBI pressed for this action in the course of normal government/business consultations but we had given prominence to it in dialogue relating to the Business/Government Forum on Tax and Globalisation, the proceedings of which can be found at: http://www.hm-treasury.gov.uk/tax_governmenttaxforum_index.htm

4.5 The genesis of our case was the need to improve the UK's international tax competitiveness and this need was recognised in the Financial Secretary's letter.

*Lack of legislative preparedness*

4.6 Despite the Government's welcome moves to address problems emerging from the very helpful and positively conducted consultation on Foreign Profits reform, many of the points we made in our response remain, in essence, valid today. Whereas action on Dividend Exemption is broadly satisfactory the position on the other major aspect of Foreign Profits reform, introduction of a new Worldwide Debt Cap, is not.

4.7 The problems with the Debt Cap are set out at some length in Annex A. Although the Government has responded to many of the problems identified, the basic, unsatisfactory, position of trying to do too much in too short a time remains. It is not right that legislation of this complexity and importance should be laid before Parliament in an incomplete state.

[1] Not printed here.
[2] Not printed here.
[3] Not printed here.
[4] Not printed here.

4.8 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.

4.9 Unfortunately events have proved our concerns to be well founded.

4.10 Indeed, welcome though the Dividend Exemption is, there are still uncertainties about the meaning of the legislation providing it. For example, it is not clear how the dividend exemption applies to joint ventures where the 40% shareholding test does not apply. The only exemptions which seem to be available are the one for "ordinary shares" and the one relying on the purpose test. Joint venture partners will often make normal commercial arrangements for unwinding their joint venture and these may cause shares to fall outside the definition of "ordinary shares". Experience with purpose tests in other contexts, such as the CFC regime, has demonstrated that great uncertainty can arise and in ordinary commercial transactions these tests are often the cause of considerable cost and delay.

4.11 The exemption should be extended in a clear and unrestricted manner to holdings in joint ventures.

4.12 Such uncertainties could, and in our view would, have been resolved had official resources not been stretched too far in trying to include the Debt Cap in this Bill.

4.13 As to the Debt Cap itself, the lack of legislative preparedness has been officially acknowledged by the Financial Secretary in his open letter of 30 April 2009 where he says that the Government plans further discussion before final legislation is published and is introduced to Parliament by way of amendment when the Finance Bill reaches Committee.

4.14 The Bill has now reached the floor of the House of Commons but has not yet moved to Standing Committee where the relevant provisions will be debated.

4.15 The Financial Secretary's letter also indicates that other details, set out in the Appendix to the letter, are not yet reflected in the Bill because of time constraints and that further amendments to accommodate these will be made as the Bill progresses which, of course, could be after the Committee Stage debate.

*Legislation—not just official guidance*

4.16 It is clearly preferable to business that problems it has identified be picked up before the Bill becomes law rather than left legislatively unaddressed and subject only to HMRC guidance.

4.17 There are two fundamental issues which apply to this Bill and all Finance Bills.

4.18 First, it is sub-optimal to lay before Parliament part only of a package of reform proposals with no guarantee that at the time of debate of the published part of the proposals the other part will be available. Without all the relevant legislative text the total package cannot be assessed in the round.

4.19 Second, without the total package being on the table it is not clear to those outside government whether all their concerns will actually be covered at all, whether Government amendments are laid at Committee or Report Stage. Uncertainty of legislative meaning and scope is, of itself, detrimental to international competitiveness. The longer the uncertainty continues the worse the impact.

4.20 It is of particular note that concerns of a very similar nature were raised in relation to the Finance Bill 2008's introduction of new rules on Residence and Domicile. The private sector was united in the view that the Government was trying to do too much in too short a time to the detriment of the Parliamentary process and UK competitiveness.

4.21 This year the consultation process on Foreign Profits has been much improved compared with the situation on Residence & Domicile in 2008 or, indeed, Clause 92 of the current Finance Bill on the new duties of senior accounting officers of large companies which has been introduced without any prior consultation at all. Nonetheless it would be better for perceptions of the UK tax regime, both within the UK and to potential foreign investors, if solutions to problems were identified and agreed before introducing legislation into Parliament.

4.22 It is particularly the case with fundamental changes in the law that new rules should be set out as fully and clearly as possible in legislation rather than being left to clarification by non-legislative official guidance. The case for explaining the Government's detailed reasoning to Parliament is all the greater where, as in the case of the Debt Cap, there is no immediately apparent policy principle necessitating a link between Dividend Exemption and a Debt Cap despite the official joining of the two in a so-called package.

*Ongoing Uncertainty*

4.23 CBI Members who are still taking advice and trying to understand the full implications of the Foreign Profits provisions, have expressed concern about their ability to pay dividends when the new Dividend Exemption regime becomes operative because of uncertainties about the meaning and scope of the legislation and what approach HMRC will take to its application. Such companies say they will want to test their position through clearances with HMRC. Again more time and resource spent on this topic should, by now, have resolved many such uncertainties and reduced the need for clearances and the concomitant need for dedicated resources within HMRC and businesses. It is not clear, for example, whether questions such as the interpretation of what constitutes a scheme and a main purpose will, in HMRC's view, need to be determined at policy level rather than being left to local resolution at Customer Relationship Manager level.

*HMRC Guidance—preferable to publish as and when issues are covered*

4.24 At present HMRC guidance is still awaited. Such guidance should be made available as it is determined within HMRC, preferably before the relevant provisions are debated in Parliament, even if this means publishing it as and when particular parts are ready rather than waiting for the whole package of guidance to be completed.

*CBI's General Position on Competitiveness and Tax Reform*

4.25 The CBI's Tax Task Force Report reiterates the CBI's longstanding argument for improved consultation in tax matters as one of its key recommendations for enhancing the international tax competitiveness of the UK. 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 with the risk that further corrective measures may be needed in a subsequent Finance Bill if the original legislative material proves inadequate.

*Debt Cap—Complexity and remaining problems*

4.26 As regards the Debt Cap in particular, impressions based on the legislation so far published is that it is extremely complex, is likely to create traps for the unwary, will increase regulatory costs in the taking of professional advice, system changes and day to day implementation around the globe and runs counter to the Chancellor of the Exchequer's 2007 PBR statement that " . . . making Britain one of the best places in the world to do business, also demands a modern tax regime based on three clear principles: that our system is competitive, it's simple and fair . . ."

4.27 The call for simplicity was echoed in the Minutes of the 16th February 2009 meeting of the Business/Government Forum on Tax and Globalisation at Item 2: ". . . so that the final rules are easy to implement and easy to understand . . .".

4.28 The Bill is not yet clear about even basic questions such as whether the new Gateway test designed to avoid having to become involved in the complexities of the main legislation is itself compulsory. In other words can a taxpayer which believes it would fail the Gateway test simply opt to go direct to the main legislative tests or does it have to go through two hoops? Must it first demonstrate that it actually fails the Gateway test before being able to move on to the second hoop, the main test? To reduce compliance costs here, the Gateway test should be made optional.

4.29 That it has proved difficult to produce legislative provisions on the Debt Cap to lay before Parliament is of no surprise to business. That such provisions are so complex and are not yet fully formulated is also of no surprise.

*Impact Assessments*

4.30 A further process difficulty is posed by the Impact Assessment. It is difficult to see how the costs to business can be accurately assessed when the totality of the provisions is not yet available and firms are not yet in a position to determine precisely what all the changes mean for them.

*International Movement of Capital—New Reporting Requirements*

4.31 The CBI welcomes the abolition of Section 765 ICTA and ending of the criminal liability it contained. Abolition has been a CBI policy proposal for very many years.

4.32 It is, however, regrettable that in deciding not on simple abolition but in replacement of Section 765 with new reporting requirements, the Government has not formulated the new rules in such a way as to exclude all the situations which over the years had become the subject of Treasury General Consents, to eliminate unnecessary compliance costs.

*Modifications to Controlled Foreign Companies Rules*

4.33 The Government has decided to incorporate a number of new restrictions or narrowing of existing CFC reliefs in the Bill. As there is currently in progress a separate, parallel, review on the need for any CFC regime at all, these changes may prove disproportionately costly, in that change itself creates costs, if they prove to have a very short shelf-life.

*Enhancement of UK Tax Competitiveness*

4.34 Does the Bill improve UK competitiveness?

— Foreign Dividends Exemption—Yes.

— Debt Cap—No.

— New Reporting Requirements—Could be better.

— CFC changes—No (subject to the outcome of the separate consultation process).

*Further Dialogue*

4.35 We believe that building on the constructive approach of government and business to the consultative process preceding the Bill, 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. This could make a positive contribution to enhancement of competitiveness.

4.36 The CBI stands ready to participate as soon as the Government initiates that dialogue.

5. Pensions

*Extension of personal tax to employer pension contributions and reform of higher rate tax relief*

5.1 The Budget introduced two major changes to the tax relief on pensions saving received by payers of the new higher rate of income tax (50%). The first of these—introduced in the budget speech—was the gradual tapering of tax relief received from 50% to 20% over the first £30,000 of income above the 50% threshold. The second change—which raises significantly more in revenue terms—was to make employer contributions taxable as income for this group. In making these changes, the government went against the judgement of the Pensions Commission, which highlighted the practical difficulties of this change in any system with a substantial element of defined benefit in it. The Finance Bill contains the first elements of the new system, namely the anti-forestalling powers in force from the date of the Budget until 2011.

*The CBI does not support the taxation of employer contributions as income*

5.2 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 saving for high earners through the A-day reforms of 2006, which introduced a lifetime savings cap for all pension scheme savers.

5.3 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, like the one set out below, suggest the net effect will be to disincentivise pension saving completely.

> A member of a typical 1/60th 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, ie 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%.

5.4 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.

5.5 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.

*The proposed anti-forestalling powers unfairly punish SME executives and partners in limited liability partnerships*

5.6 The pre-2011 anti-forestalling measures, anticipated in the Bill, are aimed at avoiding individuals ramping up contributions to pensions before the new restrictions on higher-income tax relief are introduced. The Bill contains a wide range of new and extended powers for the Treasury to implement this system. CBI members would like more detail on these powers from the Government, and a complete rethink on what constitutes the normal course of pension contributions.

5.7 The provisions in the Bill will be used to introduce a special annual allowance for pensions to apply to those individuals with incomes of £150,000 or over, in fiscal year 2009–10 or either of the two previous years. The provision will state that any qualified individual will only receive full tax relief to the higher of their existing regular pension contribution or £20,000 benchmark. Any contributions above that £20,000 benchmark, up to the standard annual allowance limit, will be subject to a special tax charge, reducing the effective rate of tax relief to 20%.

5.8 As the criteria currently stand in the Bill, "protected pension input amounts"—those arrangements put in place before 22 April 2009 that will not be tested against the special annual allowance—are defined as normal, regular, ongoing contributions or benefit accruals. CBI members are concerned that Treasury thinking is already that "regular" will be defined as contributions arrangements made on a quarterly basis or more frequently. This fails to acknowledge that many senior business people pay into their pensions annually, especially where pension contributions are drawn from bonuses or dividend payments—partners in LLPs, Chief Executives of SMEs and entrepreneurs are key examples where annual payments are common place.

5.9 Moreover, the exclusion of annual payments from "protected pension input amounts" means that individuals that had previously made special contributions of up to £30,000 towards their pension from their severance payment would no longer be exempted from taxation as previously under section 148 of the ICTA 1988.

5.10 CBI Members, therefore, strongly recommend that the anti-forestalling measures are reviewed so to allow for the protected pension input amount to be an average of those paid in the two previous years. This would also compensate for commonplace corporate revenue fluctuations.

5.11 CBI Members would also like to encourage the government to speed up the information sharing and consultation processes in relation to the new restrictions on higher-income tax relief. At a time of high economic instability, and only three years after A-day, these restrictions are unwelcome and present UK businesses with an unnecessary degree of regulatory instability. While the Treasury made a good start at involving stakeholders immediately after the budget, progress has been slow since then.

6. Real Estate Investment Trusts (REITs)

6.1 The CBI does not wish to give evidence on the Finance Bill provisions on REITs, but urges the Committee to listen to the issues and concerns raised by the property sector.

*May 2009*

## Memorandum by the Institute of Directors

Introduction

This evidence has been prepared in response to a request from the House of Lords Sub-Committee on the Finance Bill 2009. It starts with some general remarks on the Bill and on tax policy, then covers topics on which the Sub-Committee has said it wishes to concentrate.

General Comments

1. Policy-making would be improved by a clear plan for the direction of development of the tax system, stretching several years into the future and underpinned by some fairly specific guiding principles. One

essential component of such a plan is a numerical target for the ratio of tax to GDP, not just a general commitment to be competitive. That ratio sets the context for tax policy-making, for example by determining the extent to which winners must be balanced by losers. Governments tend to make policy with a view to the short term, and only talk in very general terms about long-term objectives. Parliaments may only last for five years at most, but long-term plans, the implementation of which would be conditional on election results, could still be made and published. Not only would publication commit a given government to stick to a course. It would also give confidence to investors that the UK would be a good place to invest, not just for a year or two but for the longer term.

2. The Government has indicated on several occasions that it would like to bring simplicity to the tax system. While there are some welcome simplifying measures in this Finance Bill, it does not overall increase simplicity. There are measures, such as those on pensions, that are carefully crafted to meet very precise policy objectives, when similar outcomes could have been achieved in ways that would have been much more straightforward. Another example of readiness to accept complexity is given by the decision to phase in the increases in individual savings account (ISA) allowances for the over-50s before other people. This measure will be introduced by regulations, but we encourage the Committee to challenge the Government on its general willingness to make things complicated for the sake of small differences in the effects of policies.

3. This failure to simplify overall is not just a problem for taxpayers and their advisers. It is also an increasing problem for HMRC, which is shedding staff in the interests of efficiency. And in some fields of policy-making, HMRC is heavily dependent on a small number of highly talented people. There is a significant risk that as that expertise is lost through retirement or for other reasons, the maintenance of a complex tax system will no longer be practical.

4. 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 lettings rules are to be abolished from 2010-11 onwards. This change will affect a number of taxes and will create complex interactions, particularly with capital gains tax reliefs. It should have been given a proper announcement in its own right and been subject to advance public consultation on the principle.

## Foreign Profits—General

5. The process of consultation and legislation to change the ways in which the UK taxes profits made abroad has now been in progress since 2007. This year's legislation represent the first fruits of the process, and there will be more consultation and legislation on the controlled foreign companies regime.

6. We are very pleased to note that serious concerns about the initial proposals were recognised, and that significantly different proposals were then brought forward. There has also been extensive consultation on draft legislation. 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. If something had happened at the end of 2007 or early in 2008, there would have been more time for consultation on the debt cap. But overall, we can congratulate the Treasury and HMRC on the consultation process.

## Foreign Profits—the Dividend Exemption

7. We warmly welcome the dividend exemption, and particularly the extension to smaller companies that had not been previously announced.

8. The drafting is however convoluted, starting with a tax charge and then granting exemption if a number of tests are satisfied. We believe that the convoluted drafting reflects a need to ensure that the legislation cannot be challenged under European law.

9. If the ownership structure simply involves ordinary share capital, there should be no difficulty, but many ownership structures are more complicated than that, so there will be a compliance burden. We do appreciate the need to exclude structures that would effectively park guaranteed income streams in offshore vehicles, in ways that would leave the ownership of the income stream in the hands of the company that had moved it offshore while submerging it in something larger so as to defeat the controlled foreign companies legislation. But there are also ownership structures that are convoluted for good reasons, for example to ensure the proper allocation of risks and rewards from a joint venture.

10. There will also be difficulty in passing the tests in relation to subsidiaries in some countries, where outsiders are not permitted to own the ordinary shares in a subsidiary and other instruments have to be used. We urge the Government to keep the provisions under review, and to amend them next year if difficulties come to light.

11. We had throughout called for an extension of the exemption to non-portfolio (10% or more) holdings by smaller companies. The Government was concerned about the use of companies in personal tax planning. We are 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.

### Foreign Profits—the Debt Cap

12. Schedule 15 is 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. 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.

13. Some tax revenue will be protected, but not much. On the other hand, the UK's competitiveness will be damaged, 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.

14. Given that borrowing at arm's length is restricted at the moment by market conditions, the transfer pricing rule denying deductions when borrowing could not have been made at arm's length should offer protection in the immediate future. We therefore call upon the Government to postpone introduction of the debt cap rules until 1 August 2010. That would give time for a re-think, in particular improvement of the gateways, and for adjustments to be made in the Finance Bill 2010.

15. Having said that, we would like to record 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, 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.

### Foreign Profits—Controlled Foreign Companies

16. The bulk of the necessary work on the controlled foreign companies regime will be for legislation in future years, probably in Finance Bill 2011. This year's legislation makes adjustments so that the regime continues to work in the light of the introduction of the exemption for foreign dividends.

17. The acceptable distribution policy exemption clearly needs to be abolished as the dividend exemption comes into force.

18. The modification of the exempt activities exemption is less straightforward. Superior and non-local holding companies will no longer qualify. In general, the two-year transitional period should give groups time to re-arrange their structures. But we understand that this will sometimes be problematic, when non-local holding companies are used for commercial reasons. For example, some groups use companies in Singapore that hold subsidiaries in other countries in the region, and it may not be practical to eliminate such Singapore companies.

### Foreign Profits—Treasury Consents

19. We warmly welcome the change from Treasury consents to post-transaction reporting.

### Pensions

20. Schedule 35 introduces a transitional regime, that will run until April 2011. The Government's intention is to replace it with a permanent regime that has not yet been designed. Indeed the difficulty of designing it has been acknowledged in paragraphs 5.93 and 5.94 of *Budget 2009: Building Britain's Future*. The difficulties with the transitional regime have been well-discussed in the press. They include the difficulty of making the regime work with defined benefit schemes, where it is not clear how much of each employer's contribution should be attributed to each employee, and the fact that many self-employed people do not make regular contributions quarterly or more often, but wait until they know what profits they have earned and then make annual contributions. We share the concerns of the House of Commons Treasury Select Committee about this measure (*Budget 2009*, HC 438-1, pages 43–45).

21. 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.

22. We note the extensive regulation-making power that is given by paragraph 18 of the Schedule. We are not normally big fans of generous regulation-making powers, but on this occasion the power could be useful. We hope that the Government will use this power to introduce a simpler regime. Such a change does however need to be announced promptly, so as to give certainty and allow taxpayers to act appropriately for the current tax year.

*12 May 2009*

## Memorandum by the British Bankers' Association

### Introduction

1. The BBA is the leading association for the UK banking and financial services sector, speaking for 223 banking members from 60 countries on the full range of UK or international banking issues and engaging with 37 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts.

2. The matter of HM Revenue & Customs' (HMRC) powers, a further significant issue for the banking industry (and others) and not specifically listed as one of the topics of the Sub Committee's inquiry but which falls within the Sub-Committee's remit of tax administrative matters, has additionally been flagged at the end of this submission.

### Foreign Profits

3. 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 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.

### Dividend Exemption

4. The BBA welcomes the confirmation, that the exemption for foreign dividends received by companies will be introduced with effect from 1 July 2009. This matches the "participation exemptions" which are now in place in the majority of European countries, and is therefore important for international competitiveness.

5. There is a 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. We believe that subsidiaries and branches should be on an equal footing. Although our preference would have been for a level playing field to have been effective from day 1 of the new regime, we now consider that, at a minimum, 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. We believe that failure to give, at the least, a firm commitment to treat branches on a similar basis to subsidiaries would send a negative signal to foreign-owned banks, which could adversely affect future decisions about the UK components of their overall corporate structure, and lead to sub optimal consequences.

### Replacement of the Treasury Consent Rules

6. The BBA welcomes the changes made in respect of the Treasury Consent rules but considers that the previous General Consents need to be reintroduced in to the new regime in order to minimise unnecessary reporting.

### Changes to the CFC Rules

7. The Finance Bill has introduced a temporary "fix" to the CFC rules in the form of withdrawal of the holding company exemption and repeal of the Acceptable Distribution Policy.

8. The BBA looks forward to actively engaging with HM Treasury on the full review of the CFC rules. We are hopeful that the Government will continue to seek to restrict the application of these rules to artificial arrangements rather than to genuine commercial operations.

### Unallowable Purpose Rules

9. The BBA welcomes the decision not to proceed with these rules in the current Finance Bill.

### Worldwide Debt Cap

10. There has been considerable discussion between HMRC, HM Treasury and the financial services industry since the publication of the Pre-Budget Report on the subject of the worldwide debt cap. In recent discussions, prior to the issuance of proposed legislation, there was a focus firstly on the possibility of an exclusion from the debt cap rules for financial services companies and secondly on the possibility of introducing a gateway test (available to all groups, including those conducting financial services) which would allow groups to avoid application of the detailed debt cap rules.

11. We have yet to see the final detail of the financial services exclusion—qualifying activities, the threshold etc. The Financial Secretary to the Treasury's letter on 30 April 2009 said "we plan further discussions before final legislation is published". Whilst we of course welcome the continuing dialogue with HMRC and HM Treasury in respect of such measures, we regard it as unhelpful that the government is determined to include this significant aspect of the reform in the Finance Act when its thinking on certain key elements was so undeveloped that draft legislation was not available in time for the laying of the Finance Bill. We consider it to be essential that some form of financial services exclusion is developed, coupled with an administrable gateway test, in order to avoid creating a significant additional compliance burden for a large number of BBA members.

12. In respect of the financial services exclusion, it is difficult in the absence of draft legislation for us to provide detailed comment. However, we have the following general comments to make on a financial services exclusion (to be developed) and the gateway test as contained in draft legislation:

- A financial services exclusion should exclude business where debt forms an intrinsic part of the way in which that business is conducted. Provided that the income generated from qualifying activities (including lending, insurance, and dealings in securities) represents substantially all of a group's consolidated income for an accounting period, none of the relevant group companies in that group should be subject to the debt cap for an equivalent accounting period. The BBA agrees with this in principle but considers that further detailed discussions around qualifying activities are needed.
- In respect of the gateway test as contained in the draft legislation, the BBA considers that it must be finalized and implemented as an easy to apply shortcut to avoid unnecessarily falling into the detailed debt cap provisions and as a result incur the associated compliance burden.

13. It is helpful that the introduction of the debt cap rules is to be delayed until 1 January 2010, at the earliest. The delay will enable groups to assess the impact of the rules and ensure that they are able to comply with them.

### HMRC Powers

*Personal Tax Accountability of Senior Accounting Officers of Large Companies*

14. 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.

15. The introduction of a personal tax liability for the senior accounting officers of large companies appears to impose a significant new compliance burden on businesses. HMRC does not view these measures as imposing any significant additional burden on companies where 'adequate accounting systems' are already in place. However, we would expect the reality (in line with the US Sarbanes Oxley experience) to be that considerable additional work will need to be undertaken in relation to documentation of processes, assessment and benchmarking of risks and the adequacy of controls and the implementation of remediation plans as well as potential changes to the set up of accounting systems including general ledger code set up. This effect will be particularly marked if the obligations fail to acknowledge the commercial need to apply both judgement and materiality in assessing and calculating tax liabilities.

16. We note incidentally that the additional burden would fall more heavily on the banking industry than elsewhere because of the role it plays in collecting certain taxes for the government (eg income tax on deposit interest, stamp duty reserve tax on UK share purchases, etc).

17. Such additional burdens on business are not justified by potential revenue gains to the Exchequer: we are highly sceptical of the claims made in the RIA for incremental tax revenues. Imposing additional administrative burdens for dubious benefit is even more inappropriate in the present difficult economic climate, and for the banking sector in particular, where other Government measures are already creating upheaval, such as with the VAT package (a brief description of the problems created by the VAT package is

appended for information and by way of explanation), staggered ISA subscription limit changes and the forthcoming European Savings Tax Directive changes.

18. The BBA considers it extraordinary that HM Government should impose a personal tax liability on the senior accounting officer of large corporates given the complexity and ceaseless churn of the tax regime. We believe that the costs for industry may considerably exceed the stated Exchequer yield from these measures. We wonder if this is proportionate given the array of other arrangements in place to ensure good tax compliance, such as HMRC's Large Business Service.

19. The BBA considers that this measure as currently drafted should be withdrawn for a full consultation to ensure that if any measure is subsequently introduced it is both workable and proportionate.

*HMRC to name and shame tax evaders*

20. 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.

21. Clause 93(2) defines, *inter alia*, a "relevant tax penalty" as including a penalty under paragraph 1 of Schedule 27 FA 2007 in respect of a deliberate inaccuracy. In turn this says; A penalty is payable by a person (P) where . . . Conditions 1 and 2 are satisfied. Condition 1 is that the document contains an inaccuracy which amounts to, or leads to:

(a) an understatement of a liability to tax,

(b) a false or inflated statement of a loss, or

(c) a false or inflated claim to repayment of tax.

Condition 2 is that the inaccuracy was careless (within the meaning of paragraph 3) or deliberate on P's part Para 3—For the purposes of a penalty under paragraph 1, inaccuracy in a document given by P to HMRC is:

(a) "careless" if the inaccuracy is due to failure by P to take reasonable care,

(b) "deliberate but not concealed" if the inaccuracy is deliberate on P's part but P does not make arrangements to conceal it, and

(c) "deliberate and concealed" if the inaccuracy is deliberate on P's part and P makes arrangements to conceal it (for example, by submitting false evidence in support of an inaccurate figure).

This appears to mean that "deliberate", as it includes both (b) and (c), could include a case where a taxpayer took a considered view on the deductibility of an item eg as qualifying plant and machinery and simply claimed it—this would be "deliberate". In a large company such an item giving rise to (cumulative) tax of over £25k could be quite common and not material enough to consider disclosing separately but could subsequently be successfully challenged by HMRC. This doesn't seem really to be a "deliberate tax defaulter" and certainly some way short of evasion—the criterion should be a penalty falling under (c) alone ie deliberate and concealed.

*Code of Practice*

22. The banking industry is of vital importance to the UK economy. Uncertainty regarding the tax environment in which banks must operate is unwelcome and therefore we look forward to the opportunity to consult on the detail of the draft Code of Practice on Taxation for the Banking Sector.

*May 2009*

## APPENDIX

### The VAT Package

The "VAT Package" was steam-rolled into European law last year introducing some unpopular measures in the UK, many of which were considered unnecessary and burdensome.

The measures are effective at various dates up to 1 January 2013 with the earliest being 1 January 2010. Many traders throughout Europe, including in the UK, have let it be known that this gives insufficient time for computer programmes to be written to deal with the changes and therefore they will be unable to meet the 1 January 2010 deadline.

Many Member States have only recently announced the changes—the Irish issued their first consultation document at the beginning of April 2009. The Finance Bill 2009 is the UK's only opportunity to transpose the Directive into UK legislation.

The implementation of the VAT package in the UK will be difficult. One of the difficulties is that there are many examples where the VAT treatment of supplies is not harmonised throughout the EU (a prime example is the VAT treatment of charges for global custody services—Member States are divided equally between those that consider the supply to be exempt and those that consider it to be taxable). This lack of harmonisation makes accurate completion of the statements (known as ESL's—European Sales Lists) problematic.

ESLs are not something that have previously been of any great concern to most of the BBA's members, as they had only related to dispatches of goods and not services. The introduction of a requirement for ESL's to include services (with a lead time of less than seven months to effect wholesale changes to pan-European accounting systems) will be challenging for our membership.

Despite the best efforts of HMRC to work through the issues presented by the VAT Package, it appears that there is simply insufficient time to resolve all of the outstanding issues in a timescale sufficient to ensure that systems will be up to scratch in the immediate term.

**Examination of Witnesses**

Witnesses: Mr Richard Baron, Head of Taxation, Institute of Directors, Mr Mervyn Woods, Head of CBI Taxation Policy Group, Mr Neil Carberry, Head of Employment and Pensions Group, CBI, Ms Angela Knight, CBE, Chief Executive, BBA, and Mr Julian Heslop, GlaxoSmithKline, on behalf of the 100 Group, gave evidence.

**Q44** ***Chairman:*** Good afternoon. This afternoon's hearing is the second in the Committee's inquiry into selected aspects of the Finance Bill 2009. Some Members declared their relevant interests at the last meeting. Welcome to our witnesses this afternoon. Thank you for coming along to the Committee and spending some time with us and thank you too for your written submissions. Would you like to make any introductory remarks or shall we go straight into questions?
*Mr Baron:* Questions, please.

**Q45** ***Chairman:*** Both the CBI and the 100 Group seem very positive about the consultation process conducted here by HMRC. Do the BBA and IOD agree? Is that a common feeling?
*Mr Baron:* Richard Baron, Institute of Directors. I would certainly be positive about the consultation around foreign profits. The only quibble we had was the ten month gap from September 2007 through to July 2008, waiting for the second stage to happen. Apart from that, we had a very good consultation. As you will have seen from our written evidence, we do have some concerns about the lack of consultation in other areas. Would you like me to say anything about that now?

**Q46** ***Chairman:*** You said in your written response that you saw a rather capricious approach to consultation in some areas. If you would like to expand on that, it would be helpful.
*Mr Baron:* If you look at a couple of the provisions in this year's Finance Bill, clause 92 is the one on senior accounting officers and clause 93 is the naming and shaming of serious tax defaulters. Those are both measures on which we cannot see why there was not advance consultation on the principle. It is quite clear that the government's aims with those measures are noble. We have no sympathy with serious tax defaulters and groups should have decent tax accounting systems in place, but there are serious questions about the way in which they have done it and whether they have achieved those aims in the most effective way. Another measure in this year's Finance Bill is the restriction of tax relief on pension contributions, where there would have been very great difficulty in having advance consultation because everybody would have shovelled huge amounts of money into their pension schemes while they were in the last chance saloon. We feel that the problem was that they had policy objectives but the cost of achieving those policy objectives exactly has been something that looks very complicated. If they had said, "These are our objectives but we are happy to achieve our objectives to within 5%, 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. Perhaps in the discussion as the Finance Bill goes through we will see an opportunity to get there.

**Q47** ***Chairman:*** Stepping back to the general point, are you happy as the BBA with the consultation process?
*Ms Knight:* Yes. We thought it went quite well. 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.

**Q48** ***Chairman:*** Why do you think there was such an adverse reaction to parts of the initial package, particularly on controlled foreign companies?

*Mr Heslop:* Julian Heslop, CFO, GlaxoSmithKline and chair of the 100 Group Tax Committee. For the 100 Group, it simply took intellectual property income earned anywhere in the world and brought 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. That is why we welcome that extensive consultation period and in particular the deferral of the controlled companies proposals.

**Q49** ***Lord Macgregor of Pulham Market:*** The written evidence that we have been getting makes it clear that the effect of this package on competitiveness is a combination of pluses and minuses. I would be interested in how you assess the overall effect. We are talking particularly about foreign profits and whether the effect is different for different groups. On competitiveness, leaving aside pensions, are there any other aspects of the Finance Bill that you think affect competitiveness?
*Mr Woods:* Mervyn Woods, CBI. 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. I do not know if your Lordships have been following the debates in another place but on the clauses that Mr Baron referred to there has been a certain amount of rewriting of the government's position on the hoof, which may be all right in the sense that those who are familiar with the UK practice and procedure will be familiar with it, but if you are thinking about people who live and work abroad, who take advice based on what they see in the press, the fact that the government here is 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. The ramifications of the lack of prior consultation are not just that people do not know what is going on when stuff comes to the House, which they ought to in the first place, but also the impact on would-be investors, which is very important.
*Mr Baron:* I would endorse that. I would also be concerned about some other elements in the Finance Bill package. The foreign profits package has been a pretty good deal in the end. That is subject to where we end up on controlled foreign companies. The government is absolutely right to take more time over that with a view to legislating possibly in 2010 or more likely in 2011, because it is important to get that right. There are other elements like the 50% 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 can say to people that the UK is able to become a high tax country again and might in a few years' time, which makes them think, "Do I want to move my business to the UK? Do I want some of my highly paid employees in the UK?" If a group decides they will not do that, there are knock-on effects. It is not just that business that we are losing; it is also the business of all the ancillary services. For example, a group with its head office in New York is going to use New York lawyers and accountants, not London lawyers. If you can say that London is a good place to be, 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.
*Ms Knight:* There are some positives and negatives. For us, it is not going to be possible to come to conclusions until we see the final legislation, on how the worldwide cap operates and impacts financial services companies and how the financial services exemption will work. 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.
*Mr Heslop:* In terms of the foreign profits, the 100 Group welcomes the overall package. It helps UK competitiveness. I do not think the senior accounting officer certification eliminates that. I think it is not helpful, introduced without consultation, with no materiality clause and will lead to significant administrative burden. The way modern companies work is that behind that certification will be quite a cumbersome process to satisfy the audit committee, the auditors and for that matter to have the evidence behind that, but I do not think it will lead to any improvement in terms of tax reporting. I think it is 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.

**Q50** ***Lord Powell of Bayswater:*** Coming specifically to foreign dividends, you are obviously all pretty happy with that moving towards a territorial system. One or two of you in your written evidence detect some omissions. I think the CBI mentions joint ventures as not being properly dealt with and the BBA is worried about foreign branches being left out. Are there any other major areas of concern on this specific aspect?
*Mr Woods:* Angela has referred to one glaring omission and that is that we have long been promised an exemption for the financial services sector. We still do not have that and that is very important, bearing in mind the position of London in this area. It goes even further than what you might think of as the normal, ordinary financial services because there are groups for whom the provision of finance of one form another is part of their general business, not as banks or insurers but as general providers of HP, etc. They are also affected by these things. One of the unfortunate things about the consultative process is that the government has been warned right from the outset that, in attempting to deal with the debt cap in this Bill as opposed to deferring it for 12 months, they would give themselves an impossible burden. Evidence suggests that we were right to warn them of that and they would have done better to say, "We will take this away and think about it for longer so that, when we do bring it to the House, we can bring it in a complete form."
*Ms Knight:* 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—and certainly how the financial services exemption works is an example of something that can be adverse or beneficial, depending how it is drawn and it is certainly going to be complicated—this does seem extraordinarily late.

**Q51** ***Chairman:*** If you feel like sending us any written evidence on that, feel free to do so.
*Ms Knight:* I will do so with pleasure.

**Q52** ***Lord Powell of Bayswater:*** I know Lord Sheppard is pawing the ground to talk about the debt cap but do you think the joint ventures point and the foreign branches point can be dealt with in committee in the other place or will be?
*Ms Knight:* I would hope so. The issue about this is that some banks for example are organised with subsidiaries; others are organised with branches. The legislation addresses the position of subsidiaries, but not branches. We would hope this gets resolved pretty quickly, otherwise obviously there are advantages for constructing a banking operation in one way rather than the other solely for this reason. At the very least, this lack or equivalency would be against the principles for example of the EU, where the whole branching, passporting arrangements are an embodiment of the single market. As to whether it can be done quickly, I suspect the answer is that there may well be some delay, but as long as it is addressed so that there is not an obvious disadvantage in having branches we would be content.

**Q53** ***Lord Sheppard of Didgemere:*** Specifically on the interest restriction part of the Bill, you have each expressed in your papers concerns at what it will do to adding to the complexity of the UK tax system and the competitiveness resulting to British industry. How serious do you think those points are? Obviously they are serious; otherwise you would not have made them, but do you think it will add quite a bit to the complexity and seriousness of our position in the world?
*Mr Woods:* Anything that creates a new burden of red tape is something that we would not welcome. We have long said that it is time for the UK tax system to be simplified. What we have with the debt cap is movement in the opposite direction. Not only is it movement in the opposite direction but the rules in the relevant schedule are complex, detailed and will require quite a lot of examination by in-house tax directors or external, professional advisers, which will, of course, add to costs. They depend on fact circumstances not only in the UK but abroad, all around the world. The impact of what groups do, how they finance themselves, what transactions they conduct, has an impact on the outcome of the tests in the UK schedule. In the light of the Financial Secretary's letter of November 2008 which I think we put in our evidence, where the government committed itself to moving towards a territorial system, one might ask how far it is compatible with the thinking that lies behind the territorial system to say, "Ah, but UK tax results will depend on what you do elsewhere that has absolutely nothing to do with the UK whatsoever." Is that a territorial system? It does not exactly fit, to my mind at least.
*Mr Baron:* In terms of complexity, it is worth thinking about the particular types of group which will have a legitimate complaint against the impact of the debt cap. A group that is organised and managed centrally as one business, borrows £10 million externally and then engineers £20 million of internal loans hardly has grounds for complaint. We think the main issue is going to be with a group that is not run as one business. It may be a diverse group in which different bits organise themselves, where

there is not necessarily a central strategy which dictates that, no, subsidiary A will not lend that amount to subsidiary B because of the effect on the overall position and where you could very easily, quite accidentally, get greater debt being lent into the UK than there is worldwide. 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 its 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. This has an impact on the ways in which groups are run, which I think means that the debt cap is going to have its most serious effect on the people who have the most legitimate concerns about it.
***Lord Wakeham:*** You are not the first witnesses to have told us about the difficulties of the debt cap but I do not have a clear view as to what you think the alternative ought to be.

**Q54** ***Lord Eatwell:*** You presumably believe it would be unreasonable to let interest restrictions go to any level whatsoever, so what would you do?
*Mr Baron:* You could have a clause that said the debt cap will kick in where debt has been engineered deliberately for the purposes of gaining a tax advantage. I know it is vague but we have for a number of years had the unallowable purpose provision in legislation which says you cannot get a deduction for interest where it has been clocked up for unallowable purposes, which includes gaining a tax advantage. How useful is this debt cap going to be? How much tax revenue is it going to protect? A major concern is upstream loans from a foreign subsidiary into the UK. Now, with the dividend exemption, you are going to be able to dividend the cash up from foreign subsidiaries without clocking up an extra tax liability, we reckon quite a few of these upstream loans are going to be cleared off anyway.
*Mr Heslop:* If you wanted an alternative, if you look at the US, I think it is two to one so operating profit has to be at least twice interest. You could use a variant on that if you wanted to come up with a test that was less complicated. Our overall view on the debt cap is that we will live with it. Does it add complexity? Yes, it does. Is it going to change the world? Probably not but the more complicated tax legislation is the harder it is for an inbound investor. We have all been there, where you make the decision, shall I go, and the more you have to look at five or six different advisers who all give you complicated advice and the ultimate conclusion is it depends I think the more you are likely to be hesitant, but there are alternatives.

**Q55** ***Lord Eatwell:*** Would you support an interest restriction rather than a debt restriction?
*Mr Heslop:* We would be happy with no changes to the debt cap restrictions at all. Given that the debt cap has come, the debt cap the government is proposing to introduce is liveable with in the context of the other legislative changes, provided some of the technical points my colleagues have raised are sorted.
*Ms Knight:* Our issue is that we can live with the worldwide debt cap as long as there is a proper exclusion for financial services because debt is what financial services are so often about. As things stand at the moment we do not have the details of that exclusion. The knowledge that we have on the financial services exclusion so far is that, as long as the income generated from qualifying activities forms substantially all of the consolidated income of the group, the exclusion applies. When one looks at the list of qualifying activities, there is a whole range of activities that financial services undertake which do not count as qualifying. The next test is the gateway test and again we seek to have at least some simple way of applying this. When one considers the size of the financial services industry in the UK, what will stand or fall as far as this worldwide debt cap proposition is concerned is whether we have a simple, easy to apply financial services exemption or not and whether the gateway test, if you do not fall within the financial services exclusion, operates simply or not. If neither is going to give sensible, operational ways in which financial services companies can assess their position, we could have something which is hugely complicated, that is going to be very complex and expensive and a compliance cost that is also going to be high. We think that could bring significant detriment. We do not know yet about the details. They have only just arrived and the first meeting with HMRC is tomorrow, commensurate with the start of the Finance Bill.
*Mr Heslop:* The key is those people that the government does not intend to catch if it can build in a simple exclusion. For those companies that are never going to reach this measure, a very simple test would mean that they do not have to go through a lot of process.

**Q56** ***Lord Barnett:*** Was it right, do you believe, to introduce a package at all in this Bill which excluded substantively revised CFC rules?
*Mr Woods:* Certainly. At the early stages we suggested there was more than enough to occupy the government in preparing for this Bill. To have added

in the CFCs would have been absolutely impossible and it would have had a twofold negative effect. Not only would it have meant that the preparations for this Bill would have been even further behind than they are; it would also have meant that we would have undoubtedly come away with a half-baked reform of CFCs. The beauty of giving more time for revision and examination of the CFC position is that it enables the whole process to be more thorough and perhaps to go back to first principles as to what the UK thinks it should be taxing. I would refer your Lordship to the Financial Secretary's letter of November where he was talking about a territorial system and profits totally associated with the UK. Those things go together. That letter remains as yet not fully explained by the government to the private sector. There are key phrases in that letter which relate to the form of CFCs, which government ministers and officials have yet to explain to the private sector so that we can kick off with understanding of what is in the government's mind etc. Undoubtedly, however, the fact is that we belong to the EU and ECJ court cases have demonstrated the UK regime does not sit easily with the basic freedoms under EU treaties, which means that we have to do some very serious first base thinking.

**Q57** ***Lord Barnett:*** You have a simple answer. You are saying that the government should delete this from the Bill?

*Mr Woods:* No. The government was right to defer the big review of CFCs and not to try to do everything at once. The particular measures they have taken to fit in with the dividend exemption are described as necessary to fit in with that. Some people would argue why not take all of that out and deal with it all together, because if you introduce some modifications to CFCs this year how long are they going to last if the legislation, which hopefully will come forward at the end of the big consultation, arrives at a totally different position on CFCs so their shelf life may be as short as 12 months? Is it worth it?

**Q58** ***Lord Barnett:*** What specifically are you suggesting should be done on the Finance Bill now?

*Mr Woods:* With the Finance Bill as it stands, we have to try and make sure we have all the provisions sorted out so that everyone has a clear understanding before it is finally put to bed in the other place and the difficulties such as those that have been alluded to on the financial services side are eliminated from the debate. While we do not have the government's position on any particular measure that is still outstanding, no one can be sure that they are covered or uncovered for financial services exemption, the gateway test or whatever. The sooner we get all of the government's proposals on the table—we also want the guidance from HMRC as soon as possible and we would prefer that guidance to be made available as and when officials have considered particular circumstances rather than holding it all back and saying, at the date of Royal Assent, "Now the Bill has gone through, here is our guidance." We would rather see bits of guidance as we go along so that we can tackle them to end uncertainty as soon as possible. In no way would we suggest that the major review of CFCs should have been included in this Bill at all.

**Q59** ***Lord Eatwell:*** The Institute of Directors mentioned some issues with schedule 16 and it was not terribly clear what those issues were.

*Mr Baron:* This introduces a small number of CFC changes. There is the acceptable distribution exemptions which clearly has to go as soon as you have an exemption system. That is fine. We were a bit concerned about some of the modifications to the exempt activities test, the main concern being when you have a non-local holding company no longer qualifying. We have heard anecdotally that this may cause some problems in some parts of the world. One example is where you have a Singapore subsidiary which then holds your other businesses in the south east Asian region. We understand that there may some difficulties in rearranging to get round that with the changes being made in this Finance Bill. We do not know how serious these difficulties are but there may be an issue here so will the government please keep an eye on it and be prepared to modify the legislation next year if that proves necessary.

**Q60** ***Lord Eatwell:*** Ms Knight referred to the interest restriction and the fact that you felt it was biased against branches. The whole regulatory community is beginning to think that branches are a very bad thing indeed because of the problems created in the regulatory structure. Surely a bias against branches is not such a bad thing?

*Ms Knight:* I do not think you can necessarily come to that conclusion at this moment. There will undoubtedly be some significant review of branches and subsidiaries across the EU as a consequence of the financial problems, which is what I suspect you refer to. There are different views in different countries. There are also different views in the Commission compared with those of some governments and that debate goes at a slow pace.

It would be difficult to say that meanwhile the UK should put some tax differential in place. 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.

**Q61** ***Lord Wakeham:*** On the changes to the regime concerning international movements of capital, the CBI and the BBA think that there will be unnecessary reporting because the general consent of the existing regime are not reproduced here. The 100 Group think that the simplified arrangements could be adopted for transactions of a recurring nature. I wonder whether others would agree that it should be possible to simplify this measure further?
*Mr Baron:* As the one who did not raise this concern and who said that we warmly welcome the change, yes, there may be a bit more paperwork but on the other hand it is in principle a good change. The matter of simplifying reporting, for example when there are repeated transactions or transactions which would clearly have fallen within the general consents as they exist now, could be arranged just by agreement between Revenue officials and the groups concerned. That is the sort of thing that I think we can happily leave to be sorted out on the ground. Others may differ.
*Mr Woods:* Although I think that may well be how things turn out, we do not depart from our general principle that we would like to see the law laid down in legislation and not left to official guidance in particular cases. It is far better to know what the position is in law up front. As regards the introduction of reporting requirements to replace section 765, one cannot help feeling that parliamentary counsel or those who advised him or her could have approached this from a different angle by saying, "What is it we are trying to do here?" First off, we are getting rid of the criminal liability, so why not simply say criminal liability in section 765 will cease? What else are we trying to do? If we are going to preserve the gist of what happens under the existing regime, why rewrite it, because every time you rewrite legislation people have to approach it from the point of view: what do the words now mean that they did not mean before? Do they mean something different because they have been expressed in a different way or is it that the same thing has been rewritten by a different draftsman to mean exactly the same thing? That sort of uncertainty could be avoided by simply approaching the legislation and saying, "Get rid of the criminal liability. 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.

**Q62** ***Lord Wakeham:*** I wonder whether your colleagues think that is a sensible way forward?
*Ms Knight:* Yes. That is fine as far as we are concerned.

**Q63** ***Lord Griffiths of Fforestfach:*** President Obama has announced a major crackdown on the taxation of US companies in terms of foreign profits which goes against the way we have been going in this country. I wonder how you see the proposals, whether you think they will be implemented in the way that President Obama would like from what he has said and what will be the implication for us in the way we tax foreign profits of business?
*Mr Heslop:* Time will tell whether he gets it through Congress in the form he wants but let us assume he does. There is a huge difference between the United States and the UK regrettably. The UK has to compete with a number of other EU countries for business in the European Union market. The United States can simply make rules and regulations within its borders and not worry about those sorts of things. If you look at the EU context, what we want to do is ensure the UK is the chosen place for inward investment, that we build in this country strong industries and play a competitive game in Europe that means the UK prevails. I do not think the UK can take that same view, given sheer market sizes. The UK proposal to move to a territorial basis which is simple and does tax things that arise in the UK as a result of UK activity, and does not tax anything else, is definitely the way forward.
*Mr Woods:* President Obama has asked Mr Volcker to conduct a study group in the US on US taxation. I believe that is due to report in December this year. On inquiry of our US colleagues, their current view is that they are not sure 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 Volcker report. To borrow a phrase used elsewhere, it may be too early to say.

**Q64** ***Chairman:*** Could I come back to a question we wanted to ask on the debt cap? The implementation of the proposals that has been referred to is accounting period beginning on or after 1 January 2010 but I think you specifically at the IOD want to defer it further so that adjustments can be made. Why do you think it will not be possible to solve the problems in the context of this Bill?

*Mr Baron:* It may be, but given that work on this is still ongoing—for example there were some changes announced on 7 April and further changes announced in a ministerial letter published on 30 April—it is not clear that it will all get sorted. In the light of that, given that 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. The obvious question is: is it safe to defer implementation like that or will businesses drain away the entire UK corporation tax base in the interim, in the course of 2010? We think it probably is safe. We also have protection against this capitalisation that is now part of the transfer pricing rules, which say that you cannot get a deduction for the interest expense unless you could have borrowed that money on those terms at arm's length. At the moment, the market for borrowing money is not particularly generous. Quite a lot of things cannot be borrowed at arm's length at the moment that could have been easily borrowed at arm's length a couple of years ago. If that situation continues for the next 12 months or so, the government has that level of protection against excessive debt being put into the UK for that period, which we think would allow a deferral, which in turn would allow us the opportunity to stand back from this year's legislation and say, "Have we got this right?"

**Q65** ***Lord Sheppard of Didgemere:*** I wanted to ask whether it would have been possible for the Treasury to have consulted on the substantial changes before the announcements. In particular, looking at the impact, I was struck by a lot of the evidence we have received, especially from the CBI, about the damage that these proposals are doing to the future of the defined benefits schemes as a whole. I wonder if you could say something about that and in particular your reference to the fact that the government has gone against the judgment of the Pensions Commission in this regard. Is there any evidence that all the damage that you are talking about is coming through in practice already and is there a fear that taxing employer contributions could set a precedent which leads to further uncertainty for defined benefits schemes?

*Mr Carberry:* Neil Carberry, CBI. On consultation, such substantial changes could not be brought forward in line with the Cabinet Office guidance for a 12 week public consultation. What was surprising to us was the speed at which news flows on this topic developed in the weeks before the Budget without much in the way of a clear statement from government. 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. We mention in our evidence owner-operator businesses. Partners in limited liability partnerships who may have year ends shortly after the end of April, for whom these provisions are effectively here and now. Usually, they make their contributions annually. 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 scheme due to the 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 in light of these changes. We have to look at it as another issue which adds to the instability of providing pensions in the UK.

*Mr Heslop:* The taxation of employer contributions is a dangerous extension of the tax system. If you take the simple example of a large company with 300 or 400 employees earning above this level for whom you will have thousands of people working, if you think about inward investment or incremental investment, you are about to stick it into a location with some highly paid people with support staff and you come to the UK as against somewhere else in the world, these are decisions that are taken regularly. It is yet another factor to say that UK taxation of these individuals is relatively high. There will be other places where we could locate this facility or these people which I do not think is helpful to UK overall employment. Is it going to move people or businesses tomorrow? No. Is it going to have a creeping, detrimental impact? I think yes. If there is anything to change, it is this particular aspect of the legislation. The cliff edge way it works at 150,000, you could see individuals who for one reason or another will not know whether they are or are not caught. If they are caught and go over, there is this huge impact on them. If they fall just short there is not, but the fundamental worry that we have is taxation of employer contributions and the long term impact we think this will have on employment in the UK.

*Ms Knight:* The same issues have been raised with us and 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. Now it presents the problem that even though some of the issues may well be addressed it has left a view out there that the UK will change all aspects of taxation. That seems to be a recurring concern.

**Q66** ***Lord Powell of Bayswater:*** How well did the new rules for pensions work in the three years since A day? Did they achieve their objectives of flexibility, consistency and choice? Has it been a good system so far?
*Mr Baron:* Yes. That makes it all the more disappointing that the government, given that it had these objectives, did not choose to work within that framework, particularly when the obvious thing mooted by several people is to say, "We want to reduce the benefit being obtained from tax relief and pension contributions by high earners rather than having a cut off at £150,000 of income. Why not simply say that, instead of being allowed to pay up to £245,000 a year into your pension scheme, you can only pay £50,000 in but you still get tax relief at your top rate? " That would hit roughly the same people and it would be entirely within the framework of the system that was introduced three years ago.

**Q67** ***Lord Powell of Bayswater:*** Would you like to speculate on their motives for doing it the way they have?
*Mr Baron:* This is speculation but it was probably considered by the government to be very important to have a headline: if you earn under £150,000, you definitely do not need to worry about this at all. If you capped pension contributions at, say, £50,000 instead of £245,000, there would be a few people earning under 150 who might hit that cap and some people earning very high salaries who would still be benefiting from 40% tax relief on their pension contributions, so it would not achieve exactly the same objective. That is probably why the government did not go down that route. They must have considered that possibility. It would have got them pretty close to their policy objective. This is the sort of thing I was talking about at the beginning of this session. You need to be aware not only of what your policy objectives are but of the option of getting to within 5% of your policy objectives, not hitting them exactly, in exchange for bringing in something much simpler within an existing framework that we could all live with.
*Mr Heslop:* It might have been better to adjust the relief on contributions of employers and leave the employer contributions without any tax impact.
*Mr Carberry:* I would agree with that analysis. The move which raises two-thirds of the revenue from the changes announced in the Budget is taxation of employer contributions, which did not receive a lot of coverage in the speech or public discourse on the day of the Budget compared with the tax relief changes, which accounts for only a third of the revenue raised. From our members' point of view, there is a significant concern about long-term staff incentive programmes, things that will push people over the 150,000 in one year. If someone has a very volatile income, that will cause a much more negative effect than the 2006 regime which was designed to be effective for a lifetime, which ought to be a reasonable position to take on pensions which are of course a lifetime savings vehicle.

**Q68** ***Lord Sheppard of Didgemere:*** You mentioned that one objective would be continuing the annual allowance. The same sort of thing could have been done on the lifetime allowance, could it not?
*Mr Baron:* It could have been but of course you know—it is completely obvious to you—if you are in a defined contribution scheme, how much is being paid in this year. Even with cutting down the annual allowance, you would still have the problem of translating contributions into a defined benefits scheme, which is a somewhat arbitrary procedure.
*Mr Heslop:* If you adjusted the lifetime allowance—we already have one adjustment which is the cut off at 1.8 million—and if you had gone and done it again, 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. The arrangements introduced in 2006 worked very well. Companies lived with them well. Employees understand them reasonably well.

**Q69** ***Lord Powell of Bayswater:*** There is no really good reason to change them?
*Mr Heslop:* No.

**Q70** ***Lord Sheppard of Didgemere:*** Would there have been alternative means of achieving the overall objective of limiting the cost of relieving pension contributions to high earners? Would any of your suggestions have been preferable? If so, why?
*Mr Carberry:* Leaving aside the issue of what the total marginal tax rate should be on this group where we have very significant concerns, 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.
*Mr Heslop:* Or employee contributions with a tax rate favourable to relief for those.

**Q71** ***Chairman:*** How do you see defined benefit, including unfunded schemes, being covered?
*Mr Carberry:* I assume you mean the operation of the calculation. It is practically impossible to establish what an employer contribution is for an individual to a defined benefits scheme on an annual basis and therefore we would assume that it would operate in the same sort of way as the lifetime cap is currently operated for defined benefits schemes, which is that there is a formula which works out the difference between the benefit you would have received the previous year and the benefit you would have received this year and taxes you on the difference.

**Q72** ***Chairman:*** Is it possible to protect those who make irregular or annual contributions? How do we handle those?
*Mr Carberry:* We are talking about the owner operators of small businesses and partners in limited liability partnerships. I think the preference from our members very strongly is to look at an average over the previous two or three years as that would be a route which enables this group to make a decision about the position of their business and the availability of cash for them to put into the pension fund at that time. If you look at partners or owner operators of small businesses, they may go a year and not make a contribution at all because of the current situation. Also, many of these people only have defined contribution personal pension pots which have taken a hammering over the past year and it seems slightly obtuse to stop them making annual contributions to those pots at this time to make up the difference.

**Q73** ***Chairman:*** Can I take you back to the ministerial statement issued on Budget day by the Financial Secretary to the Treasury which said, "The government recognise that those will 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 the objectives of the measure." Have you put in views?
*Mr Carberry:* Yes. We have put in the view I have set out to you to the Treasury.

**Q74** ***Lord Barnett:*** Would I be wrong to assume that you are opposed to this legislation in the first place? I have previously declared an interest in that I have benefited in the past from the tax allowances for pension payments, not to the extent of some, but I should also declare an interest as a chairman of an SME company and a major investor in that company. I am not one who would benefit or disbenefit from this legislation at these levels. How do you define an SME? What size? How many such companies would be hit by this, in your view?
*Mr Carberry:* Most companies in the UK employ fewer than five people. From our perspective, there is a significant cohort of owner operators for whom any pension saving at all takes place in personal pensions. They would be significantly affected by this under the circumstances that they earn over 150,000 in any given one year. Also, we have the partnerships and anyone in a limited liability partnership, where annual contributions to pension funds are the norm because they are made on the basis of the performance of the partnership in the previous year.

**Q75** ***Lord Barnett:*** If it is one person or one company, that one company would find it significant. When you refer to "significant", how many SME companies from your members' perspective are likely to be affected here?
*Mr Carberry:* You will appreciate that it is only a few weeks since the Budget and we have not yet had the chance to do quantitative work but our members are very exercised by this issue.

**Q76** ***Lord Sheppard of Didgemere:*** You commented in your paper on the effect on the position of senior accounting officers and their responsibility. Do you want to comment on that?
*Ms Knight:* It was something that we put in our paper to yourselves because we see it as being of significant concern. One is reminded that obviously, when the Sarbanes Oxley legislation was passed, it was st as a high level requirement. But by the time individuals had worked out exactly what had to be done in order to meet that high level requirement, it was very expensive on companies. It was detrimental to business and manifestly over the top. We potentially have the same situation here in which, for the responsible officer—the Finance Directors—to be able to certify in the way implied and stated within the Bill would mean a very significant undertaking and therefore would require substantial over-excessive work underneath. Whilst one understands the basic principle, how one articulates that principle is going to be vital.
*Mr Heslop:* I would fully endorse that. If we have to live with this bureaucracy, at the very least I would add the words "in all material respects" to the section that talks about the objective and to the certification, which is consistent with most

accounting certifications. I would defer implementation from 1 July to 1 January and I would use the time to try and resolve some of the issues Angela has talked about.

**Q77** ***Lord Barnett:*** On this question of the cap, from your previous answers I am not at all clear whether you would be opposed to any size cap at any level, either annual or lifetime. Can you clarify that?

*Mr Carberry:* Returning to the pensions issue, the annual cap, of course, is in place. The lifetime cap is in place under the 2006 regime. From our perspective, it would have been preferable to bring forward any changes within the 2006 regime on those issues rather than, in a sense, throw out what was meant to be a stable regime three years ago in favour of a new regime now.

***Chairman:*** That brings this session to a close. Thank you very much again for spending some time with us and thank you for your very helpful answers to our questions.

## Supplementary memorandum by the British Bankers' Association

### Introduction

1. The British Bankers' Association ("BBA") is the leading association for the UK banking and financial services sector, speaking for 223 banking members from 60 countries on the full range of UK or international banking issues and engaging with 37 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts.

### Foreign Profits, Worldwide Debt Cap & the Financial Services Exclusion

2. A number of financial services trade association representatives, including the BBA, met with HM Revenue & Customs (HMRC) on Tuesday 19 May to discuss provisions for a financial services exclusion to the Worldwide Debt Cap.

3. HMRC were not in a position to share draft clauses at this meeting. We understand that this is in some part due to the backlog faced by the Office of the Parliamentary Counsel (OPC).

4. The discussions were helpful, although not conclusive. Further talks are scheduled to take place over the coming weeks.

5. The BBA is mindful that the HMRC team assigned to deal with this issue have been working extremely hard to resolve the outstanding issues. We urge HMRC and the OPC to now commit sufficient resources to ensure that all work can be completed to a satisfactory timescale.

*May 2009*

## Memorandum by the Chartered Institute of Taxation

### 1. Introduction

1.1 The Chartered Institute of Taxation (CIOT) is pleased to be able to submit comments to the House of Lords Finance Bill Sub-Committee (FBSC) in relation to the Finance Bill 2009. We note the three areas of focus for the sub-committee, on which we comment below.

1.2 On a general note, as we have consistently maintained, better law comes as a result of proper, full consultation, and this Budget/Finance Bill demonstrates that well. Areas such as foreign profits have benefited from detailed consultation. However, proposals such as the pension forestalling rules (commented on below), "naming and shaming" and the responsibilities of Senior Accounting officers were announced for the first time at Budget stage. As a result, consultation is to take place after the publication of the Finance Bill on these measures. This does not engender good relations, and reduces the chance of good, efficient law.

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

2. Foreign Profits: clauses 34–37 and associated schedules

2.1 The 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. HMRC are to be congratulated on listening to the concerns of advisers and business, and it is to be hoped that the constructive engagement will continue. All parties have put a huge amount of effort into the development of these new rules, which are very important to get right as they will become a key part of the UK's internationally competitive tax system.

2.2 We welcome the dividend exemption, but still have concerns over the worldwide debt cap. Many of the issues surfaced only when the original draft legislation was published last December. We are pleased that the timing recognises the need for some delay in the start date of the debt cap measures.

2.3 This delay should allow a better timescale to evolve the debt cap rules so that they do not discriminate against UK-based groups (as the original proposals did) and do not impost undue administrative burdens. It remains our view, however, 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 interest relief in certain situations including transfer pricing, anti-arbitrage provisions and Finance Act 1996 Schedule 9 paragraph 13.

2.4 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 ("excessive" debt in the UK group companies as compared to the worldwide group).

2.5 As explained in an open letter dated 30 April 2009 from The Financial Secretary to the Treasury (available on HMRC's website at http://www.hmrc.gov.uk/finance_bill2009/fb09.pdf), we do not yet have all the legislation relating to the worldwide debt cap rules. The Government intends to bring forward amendments in Public Bill Committee regarding the exclusion for financial services and the Targeted Anti-Avoidance Rule, in respect of which it has not yet concluded its thinking. 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.

2.6 With regard to the dividend exemption, there is one area where further clarity is required: it needs to be clearer that dividends from commercial joint venture companies are within the exemption. Whereas all dividends from controlled companies and portfolio investments are exempt, the position for joint ventures is less clear. They must satisfy either the "ordinary share test" or the "purpose" test. The ordinary share test may be difficult to pass in joint venture arrangements where the parties make arrangement for their investments to be unwound in due course, and experience with other 'purpose' tests has demonstrated that these can be very difficult to administer.

3. Real Estate Investment Trusts (REITS): clause 65 and Schedule 34

3.1 We understand that the FBSC will be looking not only at the clauses, but also at the experience of the legislation since its introduction in 2007 and how it compares with expectations then.

*The Finance Bill clauses*

3.2 The amendments introduced in clause 65 and Schedule 34 provide clarification on a number of technical points. We will comment on technical drafting issues in our Finance Bill representations.

3.3 However, we wish to highlight one point of concern in Schedule 34 paragraph 7. The Explanatory Notes to clause 65 and Schedule 34 indicate that the insertion of new section 136A into FA 2006 is to deal with companies restructuring with the aim of meeting REITs conditions to enter the regime. Neither the Explanatory Note nor the proposed amendment to the legislation makes clear whether the intention is to counter perceived avoidance. If this is the intention, it should be dealt with in a manner consistent with other anti-avoidance primary legislation, rather than through regulation.

3.4 This proposed power to make regulations is framed in terms of the Treasury considering it expedient in the public interest. It is unclear how a public interest provision will operate in these circumstances. It could be argued, for example, that greater investment in a more efficient property sector through the establishment of REITs is clearly in the public interest and, therefore, restructuring to achieve this end is similarly in the public interest.

*Experience of the legislation and how it compares with expectations*

3.5 The REITs legislation was introduced following extensive and welcome consultation. However, there remain significant areas of concern in terms of the continued development of the REITs regime, particularly for the residential sector. We focus below on two particular taxation aspects.

3.6 The entry charge for companies entering the regime is levied at 2% of gross property rental assets. This is in addition to Stamp Duty Land Tax (SDLT) payable at 4% when properties are acquired. The level at which the entry charge is set is intended to compensate for two elements: first, the enjoyment of future tax exemption on income profits and capital gains in respect of rental properties, and secondly, the benefit of eliminating historic latent capital gains on assets held by a company when it enters the REITs regime. The second element is not relevant for a newly formed REIT acquiring a new portfolio and, therefore, the rationale for the charge upon entry and at the current level is not met.

3.7 Another problem faced by existing groups contemplating moving properties into a REIT which could be spun off is the TCGA 1992 section 179 "degrouping" charge. This has undoubtedly deterred some property-rich groups (or sectors) from setting up REITs.

3.8 Since the introduction of the regime, a thematic concern has been the extent to which the regime encourages increased investment in the residential sector through the facilitation of residential REITS, or fails to do so. To the extent that residential REITs are likely to be formed via a new IPO rather than through conversion of existing residential property companies, the current level of entry charge is a barrier to entry for new residential REITs.

3.9 A further barrier to the assembly of a residential property portfolio, and thus the promotion of residential REITs, is the requirement in the SDLT 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 charged on the price of each property (at rates of 0%, 1%, 3% or 4%).

3.10 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.

4. Pensions: clause 71 and Schedule 35—special annual allowance charge, etc

4.1 The CIOT is very disappointed that major changes are now being proposed to the April 2006 "A-Day" pensions regime, which was settled after an enormous amount of consultation between Government, HMRC and the pensions industry.

4.2 The "A-Day" reforms were one of the subjects of the House of Lords Economic Affairs Committee's report on the Finance Bill 2004. The reforms were intended to provide certainty, and to bring simplification and increased flexibility. The Economic Affairs Committee's report included recommendations which sought to provide further certainty and to reduce compliance costs.

4.3 These new changes on top of the "simplified system" add both complexity and compliance cost, as well as reducing certainty and acting as a disincentive to save via pensions. (In terms of complexity, the anti-forestalling legislation runs—currently—to some 18 pages.) The tax effectiveness of saving in a registered pension scheme for many people is now undermined, and this will not only be to their detriment but will also take away significant business (and consequent investment) for the pensions industry as a whole.

*Restriction to 20% tax relief from April 2011*

4.4 We cannot make detailed comments on the post-April 2011 position, since the Chancellor announced only that tax relief would be restricted to basic rate tax for earners with income in excess of £180,000, and tapered relief between basic rate and higher rates for earners between £180,000 and £150,000. Detailed legislation is yet to appear.

4.5 One point we would make is that the provision means that a person with income of, say, £150,000 can make a contribution of £100,000 and gain 40% relief, but a person with an income of £200,000, making contributions of £20,000, gains only 20% relief, with the potential for his eventual pension being taxed at 40% (or even 50%).

4.6 Such a proposal will mean that many high earners will cease to make any pension provision. However, it is higher earners that potentially have the free cash to invest in pensions, and their contributions would naturally flow back into the economy through investment by the pension fund. They are also often people involved in the decisions over pension funds.

4.7 If there is a problem with the cost of tax relief, the simple solution surely is 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.

*Special annual allowance charge*

4.8 While noting the Government's apparent desire for a new cap on higher rate relief, we have particular concerns about the "anti-forestalling" provisions—which prevent large amounts of contributions in advance of 2011.

4.9 Until now, we have had a system where the maximum tax relief that anyone could receive was limited in absolute terms by the Lifetime Allowance, and the pace of tax relief was regulated by the Annual Allowance. (The A-Day transitional protection rules also made special provision for those who had been fortunate enough to have substantial pension savings before A-Day.)

4.10 Based on the Budget proposals, someone who is towards the end of his career, and has built up retirement savings of, say, 80% of the Lifetime Allowance, might not be troubled by the proposed reduction in tax relief. However, an individual high earner whose pension provision is currently at, say, 20% of the Lifetime Allowance will now see a massive reduction in the tax relief available.

*Definition of, and requirement for, Regular Contributions ("protected input amounts")*

4.11 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). Many self-employed individuals will make one-off contributions as their earnings allow.

4.12 Also, "regular" contributions to a number of different pension arrangements, done to spread the investment risk (eg one contribution per annum per scheme but six different schemes with a contribution effectively paid every two months) are no less regular than a bimonthly contribution to a single scheme.

4.13 This requirement also ignores the fact that many self-employed persons and senior employees or directors wait until their income and business cash requirements have been determined at the end of the year before making pension contributions. It affects those who receive a significant part of their earnings as bonus, rather than salary (eg salesmen), as they typically make small regular contributions plus a large annual top-up at the end of each year.

4.14 If these provisions are to be proceeded with, we would suggest that the "regular" contributions test be replaced by an 'historic' amounts test. This would allow for regular annual (or biannual) contributions and could be based on either the "average" or "highest" contribution for the last three or five years. Such a test should not result in an increase in contributions relative to those made in previous years, and so the change should be tax neutral.

*Defined benefit schemes—large v small*

4.15 Schemes with more than 50 members may enact changes to their benefits, and retain protected input status, but smaller schemes may not. This seems grossly unfair to individuals who happen to work in smaller organisations. While we can see a concern that a small number of individuals who control small companies might look to exploit a benefit increase option, the reality is that very many pension schemes for smaller organisations are already defined contribution. We believe that the removal of the 50-member qualification would not lead to many short term benefit changes to forestall the 2011 change.

*Defined benefit v defined contribution*

4.16 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 qualification) can make major changes to benefit accrual, whereas defined contribution arrangements are not able to make any increase in contributions (ie 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.

4.17 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.

*New joiners*

4.18 The HMRC guidance for individuals on the new anti-forestalling rules advises that benefits for new joiners to a defined benefit scheme or to an occupational money purchase scheme or group personal pension scheme will "normally" be treated as normal, ongoing, regular savings, as long as those benefits "are accruing on the same basis as others in the scheme".

4.19 This, however, naturally leads to a lack of consistency in how new entrants of DC schemes are treated compared with existing members (eg new entrants get more protection than existing members in some cases). It raises the prospect of people who move jobs suddenly finding themselves with a restriction.

*Members drawing all benefits from an arrangement before 6 April 2011*

4.20 By definition, the idea of the anti-forestalling rules is to prevent individuals bringing forward contributions to benefit from relief. A member who retires between now and 6 April 2011 may have been intending for many years to pay a large contribution near to retirement—this would clearly not be paid with the intention of bringing forward relief. It is very unfair that such a contribution should be caught by the special annual allowance, particularly as members in defined benefit schemes with at least 20 members would be unaffected if there was a final year augmentation of benefits. Once again, this is treating the two different types of scheme differently, as well as penalising members for genuine retirement planning.

*Non-UK schemes*

4.21 It is not clear how these proposals are to be implemented in relation to "currently-relieved non-UK pension schemes", as the draft legislation provides that this is to be specified in due course by way of statutory instrument. However, if the proposals are extended to cover such non-UK schemes, this will adversely impact many individuals who have come to the UK to work here, and who would otherwise have anticipated that the favoured tax treatment obtained for their local pension plan in their home country would have been respected in the UK (further to treaty, under migrant member relief, grandfathered corresponding approval, etc). If this is not to be the case, it will cause significant cost and/or administrative burden to both the individuals and their employers in seeking to work out what to do in these circumstances. This is not least in terms of any gross-up of tax cost that may be required where tax equalisation arrangements apply. Accordingly, we would urge that such non-UK plans should not be impacted by these proposals, and that this point be clarified at the earliest possible opportunity.

5. The Chartered Institute of Taxation

5.1 The Chartered Institute of Taxation (CIOT) is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it—taxpayers, advisers and the authorities.

The CIOT's comments and recommendations on tax issues are made solely in order to achieve its primary purpose: it is politically neutral in its work. The CIOT will seek to draw on its members' experience in private practice, Government, commerce and industry and academia to argue and explain how public policy objectives (to the extent that these are clearly stated or can be discerned) can most effectively be achieved.

The CIOT's 14,000 members have the practising title of "Chartered Tax Adviser".

*14 May 2009*

## Memorandum by the Association of Taxation Technicians

### Pensions—Clause 71 and Schedule 35

Your Lordships have asked us to consider the process leading to the restriction on relief for pensions and the anti-forestalling provisions in the Finance Bill, in the light of experience of the new pensions regime since its introduction in 2006.

### Executive Summary of Evidence

— This is yet another example of tinkering with the new pensions legislation, which has had no opportunity to "bed in". We believe Government should be urged to leave this legislation alone for at least two or three years, lest the constant uncertainty serves to undermine the original good intentions of the legislation.

— If the intention is not to restrict relief to basic rate until 2011, the anti-forestalling legislation is premature; if the true intention is to restrict relief with immediate effect, it is otiose. It would have been simpler and better to introduce new legislation with immediate effect, thus eliminating the need for Schedule 35 altogether.

— There is no genuine evidence that individuals would seek to "forestall" the proposed 2011 changes, or that there would be any real opportunity for many to do so. Schedule 35 reads as an exercise in paranoia.

— The definition of regular contributions (which escape the new special annual allowance charge) is defective, as it entirely fails to include patterns of regular contribution common among the self-employed. A better definition would permit any level of contributions which did not exceed those made in earlier years.

— Individuals intending to take pension benefits before 2011 will be put in an invidious position by Schedule 35. The strategy, hitherto positively encouraged by the legislation, of making a substantial one-off contribution in the year of retirement, will now be penalised.

— The inclusion of employer contributions within the scope of the charge will lead to some bizarre anomalies. If the intention is to deter high levels of employer contributions, the existing annual allowance should be the appropriate instrument.

— Basing the charge on income levels of the two prior tax years will lead to inequities, especially in the case of individuals who are currently out of work.

— 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.

— There will be practical difficulties in ensuring the individuals have sufficient information upon which to self assess the new charge.

— The current proposals would lead to difficulty in obtaining double tax relief in respect of the tax payable under the special annual allowance charge.

### Background

We should, perhaps, first point out that the proposals under consideration form part of a troubling trend within the new pensions regime which began even before the new rules had come into force, namely the progressive erosion of the clear advantages for which the new regime had been established.

The new regime, from the first of HM Treasury's consultative documents in December 2002, had been predicated upon two principles: firstly, that private pension provision should be actively encouraged; and secondly that the legislation should be made simple, permissive and easy to understand, as a means of facilitating that encouragement.

Perhaps inevitably, the high ambitions of the 2002 document (and of its successor in December 2003) failed to reach the statute books entirely undiminished. The legislation which emerged in Part 4 of the Finance Act of 2004 was still relatively complex compared to the hopes raised by the consultation process. Yet the general picture was still one of broad, easily-understood principles and a general lack of unnecessary micro-management. Certainly, at the time the 2004 Act was published, the mood among tax and pension practitioners and their clients was optimistic.

Some of that optimism was diminished, however, by the publication of the 2005 and 2006 Finance Acts, each of which amended the 2004 Act provisions (which had not yet, it must be remembered, come into effect) by introducing additional restrictions and complexity.

Elements of the system which had been proudly trailed in the consultation process as major liberalisations (the ability to invest in residential property, the alternatively secured pension which offered the over-75s an alternative to annuities, the right to commute "trivial" pension rights worth less than £15,000) were either reversed or emasculated—in each case accompanied by draconian tax levies which would do so much more than merely cancel out tax reliefs already granted.

The process continued in the 2007 Finance Act, which made further inroads on the alternatively secured pension, culminating in the bizarre situation whereby an individual who dies aged over 75 without having purchased an annuity will see up to 82% of his remaining pension fund seized as tax.

The fact that the 2008 Finance Act was largely devoid of such amendments gave hope that the pensions regime would finally be left alone to settle down, providing some degree of consistency and continuity to members and employers. Regrettably, the current Finance Bill shows that these hopes are again to be unfulfilled.

The Government agreed to a moratorium on further amendments to last year's non-domicile legislation in order to allow a degree of solidity and certainty to be established. Surely the pensions legislation is deserving of a similar moratorium?

## Restriction of Relief

Your Lordships have advised us that your Sub-Committee will not be considering the restriction of relief in principle, nor the level at which restriction is to be introduced.

The ATT sees no issue in principle with a general restriction of relief to the basic rate of income tax, nor with a targeted restriction based upon some level of income to be set by Parliament.

Unfortunately, other than the Budget press releases, we have had no opportunity to examine the Government's substantive approach to this issue. We are told that, with effect from 6 April 2011, tax relief will be available at the individual's highest marginal rate where adjusted income is below £150,000, that relief will be limited to 20% where income exceeds £180,000, and that the withdrawal of relief will be tapered between those income limits.

In principle, such an approach might well prove eminently workable. Yet that is not what the Finance Bill offers us. What is offered us is, by contrast, singularly unworkable. The devil lies not so much in the detail, but in the delay.

The Government could have chosen to introduce a restriction of relief, based upon income in excess of £150,000, with effect from 6 April 2009; had it done so, the 13 pages of draft legislation and 52 pages of technical guidance which now lie before us would not have been needed, nor would our evidence before Your Lordships.

The problems arise not because of the restriction of relief to individuals with incomes in excess of £150,000 (tapering so that full restriction is achieved at an income level of £180,000) which is proposed with effect from 6 April 2011. The problems arise solely because of the Government's desire to prevent "forestalling" of that restriction in the period between Budget Day and 5 April 2011.

## "Anti Forestalling"

The Government's position here is entirely without logic. If they wish to restrict relief to 20% only from 2011, why introduce provisions which in effect apply that restriction immediately? If they truly wish to restrict relief with immediate effect, why not simplify the legislative process by eliminating both the deferral to 2011 and the "anti forestalling" rules? On grounds of simplification alone, surely the post-A Day pensions regime has already suffered enough from needlessly over-complex legislation?

The Government apparently fears that individuals will in some manner accelerate pension contributions which might otherwise have been made after 5 April 2011 (and which would therefore only obtain tax relief at 20%) into earlier years, thus obtaining relief at 40%.

Where is the evidence for this? It must be remembered that tax relief is only available when a pension contribution is actually made—ie money must be spent. The Government appears fixated upon the tax relief, whereas we suspect most individuals would be more swayed by the cash-flow implications: why spend £60 today rather than £80 in two years' time—especially if that later expenditure is purely hypothetical?

Even if we accept that some individuals might be tempted to accelerate contributions, they are in any event limited in their scope for action by the existing legislative limits: tax relief is restricted to contributions which do not exceed 100% of relevant earned income for the tax year, or the annual allowance of £245,000 (whichever is lower).

With the best will in the world, an individual seeking to forestall the 2011 changes cannot accelerate contributions in excess of £500,000. This is made up of the 2009–10 annual allowance of £245,000 and the 2010–11 annual allowance of £255,000. These maxima assume that the individual:

— Has earned income (ie employment or self-employed income, but not dividend or savings income) in excess of those amounts in both years;

— Has made no other pension contributions in either year;

— Is capable of paying 80% of each year's annual allowance (ie £196,000 for 2009–10 and £204,000 for 2010–11) as a cash contribution into a pension.

Even if an individual were capable of satisfying all these criteria, the maximum higher rate tax relief he would be hoping to preserve would be £100,000. In realistic terms, the amount of relief which might be in question would be considerably lower, for a variety of reasons including:

— The individual's income might contain a relatively low level of earned income—this is particularly true of entrepreneurs who draw a relatively modest salary which is supplemented by dividends;

— The individual might already be making regular pension savings, which will reduce the amount of additional contribution possible;

— The individual might not either wish or be able to make substantial cash investment into a pension scheme at a time earlier than otherwise intended.

On balance, 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.

### Regular Contributions

Contributions during the 2009–10 and 2010–11 tax years are deducted from the individual's "total adjusted pension input", and therefore exempt from the special annual allowance charge, if they are deemed to be regular.

The definition given (for most money-purchase schemes, in paragraph 11) of such "protected pension input amounts" is that they were "paid, on a quarterly or more frequent basis since before 22 April 2009 … at a rate which has not increased … otherwise than in accordance with an agreement made before that date".

This definition causes us considerable concern, since it appears to be entirely divorced from reality. The pattern of regular monthly or quarterly contributions is, perhaps, congenial and familiar to Treasury officials, but it is far from the norm for most self-employed or entrepreneurial individuals. For those in business on their own account, the "regular" pension contribution is likely to be annual or six-monthly in nature, and the amount involved will be intimately tied up with questions of profit and cash-flow.

*Example:*

Alex is self-employed, making up his accounts each year to 31 December. Once he knows the profit for a given year, he pays 20% of that profit into a personal pension by the following 5 April. This has been his pattern of behaviour for many years.

If Alex is subject to the special annual allowance charge, his contribution in respect of the 2009 profits will not count as "protected pension input amounts", despite the fact that they are based upon a regular and unvarying pattern established well before 22 April 2009.

In addition, prior to the widespread availability of Self Invested Personal Pensions (SIPPs), some individuals would spread their annual contributions among a range of pension providers in order to spread risk and provide diversity. Thus, even if an individual was making quarterly contributions, each quarter's premium may have been paid to a different provider.

*Example:*

> Bridget is a company director. She makes contributions each January to an AXA pension scheme. She also contributes every April to a Skandia pension, each July to a Scottish Widows scheme, and every October to a Clerical Medical scheme. She has done this for a number of years, being reluctant to "put all her eggs in one basket".
>
> If Bridget is subject to the special annual allowance charge, her contributions will not qualify as "protected pension input amounts", even though she is in practical terms making quarterly contributions.

In such cases as these, it would be impossible for the individuals to benefit from "protected pension input amounts", even though their payment patterns were genuinely regular.

Similarly, the requirement that contributions should be "at a rate which has not increased during the period … otherwise than in accordance with an agreement made before that date" is unfair to those whose income is not regular. Individuals with fluctuating levels of income (the self-employed and small company proprietors) will generally make fluctuating levels of pension contribution, but this is not to say that they are not regular. Why should an individual who regularly contributes 10% of his net profits into a pension be penalised as against one who regularly contributes £250?

The drafter of Schedule 35 has perhaps forgotten Lightman J's judgement in *Bennett v IRC* (1995 STC 54), which confirmed that a settled pattern of expenditure could be evidenced by the assumption of a commitment which is thereafter complied with, or by an examination of the individual's expenditure over a period of time. To distil regularity into a simple mechanistic adherence to quarterly (or more frequent) payments lacks sophistication and will, as our examples have illustrated, lead to injustice.

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.

### Contributions Close to Retirement

One of the features of the Finance Act 2004 pension 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.

We see this as yet another instance of incentives offered by the original pensions legislation being suddenly withdrawn for no obvious reason. For individuals who intend to crystallise benefits before 2011, what alternatives do they have? If Schedule 35 exists to "forestall" avoidance, it should only prevent individuals making large contributions before 6 April 2011 where there is clear evidence of an avoidance motive; to trap individuals taking a perfectly reasonable retirement planning step is unacceptable.

### Employer Contributions

We are by no means convinced that Schedule 35 actually represents an attempt to prevent "forestalling". This is because of the inclusion, within the definition of "total adjusted pension input" at paragraph 3, of contributions made by the individual's employer.

The existing legislation (FA 2004 ss.229 to 237) already provides for an effective limit on employer pension contributions; where these, together with the aggregate of contributions made by the individual, exceed the annual allowance, there is an income tax charge. In the absence of such a charge, it is long-standing law that an employer's contribution to a registered pension scheme is not an emolument of the employee.

If the Government considers that the annual allowance is set too high, and that employer contributions above a given, lower, level should give rise to an income tax charge, the simple solution would be to reduce the annual allowance. The current approach, which effectively sets two different annual allowances, leads to anomalous results.

*Example:*

Clive and Desmond are both directors of small companies. Each company chooses to spend £250,000 on "compensation" for their services.

Clive's employer pays him director's fees of £5,000, and contributes £245,000 into a stakeholder pension.

Desmond's employer pays him a salary of £150,000, and contributes £100,000 into a stakeholder pension.

Clive pays no tax or National Insurance Contributions (NIC) on his director's fees, and is not subject to any tax charge on his pension, because the contributions fall below the annual allowance.

Desmond pays tax and NIC of around £55,200 on his salary, and will also suffer a tax charge of £16,000 ((£100,000—£20,000) @ 20%) on his pension contribution, because it exceeds the special annual allowance and is annual rather than quarterly or more frequent.

The Government has frequently—and laudably—stated that it wishes to impose a "level playing field" with regard to taxation. The proposed special annual allowance charge instead serves to make the playing field even less level!

In addition to generating anomalies such as that shown in the example, the inclusion of employer contributions gives the lie to the Budget press release's suggestion that the intention of the anti-forestalling legislation is merely to restore the level of tax relief to the basic rate of income tax.

Because employer contributions are not emoluments of the employment, the only genuine tax relief which has been obtained is that against corporation tax in the hands of the employer. Even if one assumes that the employer is paying the highest effective rate of corporation tax (the "taper" rate marginal rate of 29.75% suffered on profits between £300,000 and £1,500,000), the true tax relief received in respect of this contribution equates, after imposing the special annual allowance charge, to a mere 9.75%. Since the vast majority of employers pay corporation tax at the small companies' rate, the figure is more likely to be only 1%!

### Triggering The Charge

We are concerned that eligibility for the special annual allowance charge is triggered by having income of £150,000 in the year of the charge or in either of the two preceding years. This might, at first blush, appear to be a sensible approach, designed to prevent those who have hitherto been very high earners from accepting a lesser income in the current tax year and so escaping the charge. It is, however, a very blunt instrument which, in the current economic climate, may prove unduly harsh on individuals who have lost their former well-paid jobs.

*Example:*

Eric was a salesman. His basic salary was £40,000 and he received a sales-related bonus each May. His earnings for 2008/2009 were basic £40,000 plus May 2008 bonus £110,000 = £150,000.

In October 2009 he is wrongfully dismissed. After seeking legal advice, he obtains a compromise agreement from his former employer whereby £30,000 is paid into his pension scheme.

Although Eric's earnings for 2009–10 are only £20,000 (basic salary accrued to dismissal), his earnings for the previous year mean that he is subject to the special annual allowance charge. Because the £30,000 pension contribution was not made before 22 April 2009, an income tax charge of £2,000 will be due.

Since the income for 2010–11 will also be deemed to be £150,000, any pension provision he makes in that year in excess of £20,000 will be charged at 20%, regardless of his actual income level.

The provisions of paragraph 2(2), which look back to the previous two years' income levels, should be revised, not least because they are superfluous. Paragraph 2(3) provides that, where there is a scheme whose purpose "is to secure that the individual's relevant income for the tax year is less than £150,000", the tax charge shall apply. This is surely sufficient to cope with situations where individuals artificially reduce their income in 2009–10 or 2010–11, without bringing within the scope of the charge individuals who have, through no fault of their own, suffered a reduction in income.

### The Operation Of The Charge

One of our major concerns with the special annual allowance charge is that it is calculated solely by reference to the contributions in excess of the £20,000 allowance; no reference is made (other than in deciding whether or not the charge applies) to the individual's level of income.

This could lead to some ridiculously high marginal rates of tax. The following example is deliberately designed to be extreme but does, we hope, illustrate the principle.

*Example:*

> Felix owns a limited company of which he is sole director. The company makes up its accounts to 31 March each year, at which point Felix sets his annual bonus and pension scheme contribution.
>
> At 31 March 2010, Felix draws a bonus which brings his income to £149,999, and (confident that he will not be subject to the special annual allowance charge), arranges for the company to make a £100,000 pension contribution on his behalf.
>
> The weekend passes without event, until at midday on Monday 5 April 2010 Felix receives a telephone call from his accountant. Owing to an earlier rounding error, his bank interest had been understated by £1. Now his income is £150,000, and he is liable to the special annual allowance charge!
>
> In addition to the extra 40p of tax on this £1 of income, Felix is liable to a 20% tax charge on £80,000 of the pension contribution. The total tax due as a result of this £1 increase in income is £16,000.40—a marginal rate of 1,600,040%

While this example is admittedly extreme to the point of absurdity, it serves to highlight the problem. No tax can be considered entirely fair if it produces threshold effects with a marginal tax rate in excess of 100%—particularly when the tax charge is headlined as being at a rate of only 20%!

We suggest, at the very least, that the charge could be linked to the excess of income above £149,999 as well as to the excess of pension contributions over £20,000—perhaps a restriction to 50% of the excess income. The next example illustrates how this might work.

*Example:*

> Gerald's relevant income for 2009/10 is £160,000. His total adjusted pension input amount is £80,000.
>
> Under the current version of Schedule 35, Gerald is liable to a charge of £12,000. Since his income excess is only £10,001, this equates to a marginal rate of just under 120%.
>
> Under our proposed amendment, Gerald's tax charge is limited to 50% of the income excess, giving a charge of £5,000

### Practicalities

In order to self assess the special annual allowance charge, taxpayers will need to have prompt access to information from employers, third parties and pension scheme administrators regarding input amounts. This is especially the case where the inputs relate to defined benefit and hybrid schemes.

No consideration appears to have been given to ensuring that there are statutory rights for individuals to obtain this information in sufficient time to comply with their compliance obligations.

In addition, we note that the tax return for 2009–10 currently has no provision for the charge to be shown. Since we believe that the tax return design has now been finalised, this could prove to be a significant problem.

### Double Taxation

Paragraph 1 (11) of Schedule 35 states that the amount in respect of which the special annual allowance charge is charged is not to be treated as income for any purpose of the Tax Acts. This would preclude any availability of relief under most Double Taxation Agreements written under the OECD Model.

The expressed intention of the new legislation is to reduce relief which has been obtained at the higher rate down to 20 per cent. If that were achieved by the immediate introduction of a restriction on relief, then the individual would simply have a higher UK tax charge on his general income. This would then rank for relief under a Double Taxation Agreement in the normal way.

However the "anti-forestalling" provisions instead impose a free-standing charge on an amount which is not "income". This tax charge cannot therefore qualify for relief under any Double Taxation Agreement because it is clearly not a tax on income within the terms of Article 2 of the OECD Model Convention.

This may be a deliberate policy decision. If it is not, and having regard to the problems caused in last year's Finance Bill by similar issues relating to the £30,000 levy on non-domiciliaries, we consider that the Government should take urgent steps to rectify the situation.

*May 2009*

## Examination of Witnesses

Witnesses: Mr Andrew Hubbard, President, CIOT, Mr John Whiting, Tax Policy Director, CIOT, Mr Trevor Johnson, Past President and member of ATT Technical Committee and Mr Andrew Meeson, Chairman, ATT Technical Committee, examined.

**Q78** ***Chairman:*** Good afternoon and welcome to the Finance Bill Sub-Committee. Thank you for making time to be with us here this afternoon and thank you too for your written submissions. If I can ask you to speak reasonably slowly and clearly, that would be helpful for the stenographer as well as the Members. Perhaps you could introduce yourselves when you are first speaking, especially for the benefit of the web broadcast. Would you like to make any introductory remarks or shall we move straight to questions?
*Mr Hubbard:* I think we will move straight on.

**Q79** ***Chairman:*** Perhaps I could start by asking you how well you think the new rules for taxation of pensions worked in the three years from A day? Did they provide all the features which were billed at the time, that is, simplicity, certainty, flexibility, consistency, choice with reduced costs, and could they be readily understood?
*Mr Hubbard:* I will start that one. I am Andrew Hubbard and I am President of the Chartered Institute of Taxation. I think the answer to that is broadly yes. A huge amount of work went into that process leading up to A day and, given the enormous complexity of where we were before, I think people generally now do understand, subject to what we are about to talk about, how the new pension environment works. I think some transitional measures took people a little bit by surprise in getting up to speed there but, now everything is in place, my general perception is that it is now bedded down and we do have the advantage of a single set of rules to cover all pensions contributions, which must be an improvement on where we were. That would be my initial view on that point.
*Mr Whiting:* Just to add to that, if I may—John Whiting, Tax Policy Director of the Chartered Institute of Taxation—I would echo what Andrew has said and I think one of the great benefits of the new rules has been the flexibility for the individual to in many cases top up quite considerably their pension contributions when they have the money available. That reflects what happens in life, where incomes go up and down, and therefore contributions can be made to suit in many ways, particularly towards the end of a career, when very often more money is available than was the case earlier on.

**Q80** ***Chairman:*** Does the Association share that view?
*Mr Meeson:* If I might comment on that one—Andrew Meeson, Chairman of the Technical Committee of the ATT—I think that the rules which took effect from A day have worked as well as they have been allowed to. I think that is probably the answer. Broadly speaking, the simplicity and certainty that they offer has been very welcome and very effective. We must comment though that we feel it is a shame that what went into the Finance Act 2004, given that it followed two and a half years of solid and very good consultation, was not allowed to really settle down before being amended by successive Finance Acts. Probably virtually every Finance Act that we have had since then 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.

**Q81** ***Lord Griffiths of Fforestfach:*** I wonder if, first in the context of pensions but then more generally, you can say how you feel the changes in this Bill affect the competitiveness of UK business. Secondly, can you say something about clause 92, which imposes certain responsibilities on senior account officers in large companies.
*Mr Hubbard:* I will take the second one first, if I may. I think we have a lot of concerns about clause 92 as drafted. All of us are in favour of good governance within corporates. The issue is whether or not this is going to impose a huge additional burden on companies for no apparent advantage. HMRC has a signature on the tax return at the moment and we struggle a little bit to understand what additional comfort they will draw from a second signature. Clearly, giving the personal responsibility of an individual to sign off on the systems does concentrate the mind, but one would like to think that that mind is concentrated when the tax return is being signed in any case. We are very pleased that in the debate last

week the Government indicated some movement, and it is very important to acknowledge that. The first movement was in relation to defining the scope of these provisions to really the very largest companies rather than as defined, which would have been all large companies, which in effect would have included a huge number of unquoted companies, for whom this sort of governance structure really is not appropriate. I think the jury is still out as far as the profession is concerned, because we are still not quite certain what HMRC really wants out of this. The guidance is due in a few weeks' time and we are very pleased to see that the Government has pushed for the guidance to come out as early as possible. I think when we see the guidance we will probably be able to see much more clearly what is being driven at here and it will enable us to make more meaningful comments. I think there is an issue about whether we are talking here about a process matter; in other words, is the issue that the fixed asset register balance properly at all stages in a very long process to get to the accounts, or are we talking about the board of directors of the company having a proper oversight of the tax risk issues within the group? I think those two are not the same thing and at the moment we are, again, finding it quite difficult to decide which of those two is really driving these provisions.

**Q82** ***Lord Griffiths of Fforestfach:*** Can I just come back on that? If you go back to Sarbanes-Oxley, for example, when the CEO and CFO had to sign off the statements personally, my experience was that it did make a difference to the way they thought about it. With respect to the tax regime, I just wonder in another context, say, if you were a director of a bank, the risk management process, whether having to sign off specifically on something does, as you said yourself, maybe exercise the mind in a way which, if you do it generally, it is a little more comfortable?
*Mr Whiting:* I think that is a fair challenge, that it is going to concentrate the mind. The comparison with Sarbanes-Oxley is clearly something that has been in a lot of minds. We all know that that turned out to be a monumental exercise in documentation and working up systems, and it is questionable to what effect. It did have some effect but was it proportionate to the burden imposed? I think that comes back to what Andrew is getting at. We need to see what extra is really needed, because there is an impression being given by the Revenue that this is just signing off to say you are doing it anyway. Well, there is a difference between that and actually documenting everything, and it is the worry that there will have to be a great deal of documentation of what is being done to no real effect or advantage. It remains to be seen whether we can get it focused, as Andrew says, on risk rather than documentation.

**Q83** ***Lord Wakeham:*** Is that answer implying that a Finance Director would want a separate audit trail so that, if challenged, he could show himself capable of having done the work in order to be able to sign it off?
*Mr Whiting:* I think that is absolutely right, my Lord. It is exactly what we have envisaged, that there will need to be this separate audit trail to document what was going on already. Let us bear in mind that we are talking about all taxes that the company is involved with. There are over 20 that can affect a business in the UK; it is not just Corporation Tax, and it is to prove the documentation to a standard that says "I can sign off" and of course the documentation is there for HMRC.

**Q84** ***Lord Griffiths of Fforestfach:*** I was quite surprised when I read the Schedule that the maximum fine they were thinking of imposing was only £5,000.
*Mr Whiting:* It is the naming and shaming element. You will strive mightily to avoid what in monetary terms to a big plc might be a nominal thing but it is the black mark on your record.

**Q85** ***Lord Griffiths of Fforestfach:*** The more general question is about competitiveness.
*Mr Whiting:* It is a case of swings and roundabouts because foreign profits, which I know we will come to later, has been generally a good move and is good progress towards increasing competitiveness. On the other hand, the measure we have just talked about 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. The rate on trusts is going up and that is a signal that trusts are going to be somewhat more expensive if they are managed from here. So there is a strong element of swings and roundabouts, a strong element of two steps forward and one and a half back.
*Mr Johnson:* Trevor Johnson, Past President of the Association of Taxation Technicians, and a member of its Technical Committee. 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. The basic concept is you will get 20% relief when you put the money in, but you are going to pay 40% on the pension when you get it out; is that a good deal? Different people may have different opinions on that but initially it does not look very attractive from that point of view. You then have to look at the so-called high fliers, the executives who are now internationally mobile. Are we going to attract those kinds of people into the country to fill those places with a pension regime like that in place? We shall see.

*Mr Hubbard:* There are some quite technical issues about people coming into the UK in relation to overseas contributions that they already are making. The essence of the transitional provisions is that you can keep the level of contributions that you currently have, broadly speaking—and we will come on to the detail—but of course, if you have come in from a non-UK company, what is your equivalent level of pension contributions there? We are still awaiting some details on 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.

**Q86** ***Lord Wakeham:*** This Committee considers the question of consultation an important part of what we concern ourselves with. I wonder whether you have a view on whether the Treasury and HMRC could have consulted on substantive changes in the anti-forestalling provisions before Budget day and perhaps also tell us whether immediately afterwards everything you needed to know was available.
*Mr Hubbard:* On the first point, 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. HMRC have done a lot to try and explain the thinking behind this. There have been meetings both at official level and ministerial level. From that point of view, once this was out on the table, there has been a good discussion and it is pretty clear from comments that have been made publicly that some of the points that have been made are being considered. So I think in this context it has been all that one could expect.
*Mr Whiting:* The consultation shortcoming has been on other measures such as clause 92 and 93.

**Q87** ***Lord Eatwell:*** I would like to turn to Schedule 35, the irregular contributions issue. I wonder if you see that this has now been successfully covered. How do you see the issue of those who make irregular contributions being tackled?
*Mr Meeson:* That is a very difficult issue in practice, because the clear cut and dried methodology that has been brought in in Schedule 35, this concept of what you have done regularly, no less frequently than quarterly and not a penny more, does not really tie in with the real world, where people who have fluctuating incomes tend to have fluctuating contributions. People whose income is not known until quite late in the tax year will normally make fairly minimal regular, as in monthly or quarterly contributions, and do a top-up when results are known, which leaves us with two things. First of all, that the insistence on quarterly is inequitable because it does strike at many people who, for no motives whatsoever of forestalling, do not satisfy that particular test, and also, the concept that a single flat amount might be appropriate is also arguably inequitable because many of those with fluctuating profits will tend to have a regular pattern, by our lay definition of "regular", which is that each year they will contribute a given percentage of whatever their profits are, and if last year their profits were £10,000 and they contributed 10%, they will have put down £1,000; if suddenly this year, in one of these transitional years, their profit becomes £50,000, their regular pattern would be to contribute £5,000, but that additional £4,000 would somehow under Schedule 35 not count as regular and therefore not count as protected. So we feel that something needs to be done to give a little more fair reflection of what actually happens in these sorts of circumstances. 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.

**Q88** ***Lord Eatwell:*** How do you see defined benefits, including unfunded schemes, being covered under Schedule 35?
*Mr Meeson:* The problem with that is there is a conceptual issue in terms of what is attempting to be achieved. Certainly, the Budget headline was that we shall restrict relief upon pension contributions to the basic rate of income tax, which suggests that we are looking really at income tax relief, but of course, on defined benefits schemes, particularly unfunded schemes, the concept of income tax relief really does not come into it. We might be looking at perhaps variations on the annual allowance rules from the Finance Act 2004 but really we are trying to use apple laws to catch orange situations with Schedule 35 and the non-defined contributions schemes.
*Mr Hubbard:* Could I make just one more point which I think is important, which is this: the way the rules are defined, if you change your pension provider, those are not protected amounts. If somebody stuck in a poorly performing pension changes their pension provider and continues to pay exactly the same amount on a monthly or quarterly basis, as we read the rules at the moment, those are not protected amounts, and what that definition has done seems to be almost arbitrary,. I think we all accept that there is a classic trade-off here between fairness and simplicity because, to be fair you have to cater for situations about people who pay annually or twice a year, and then what happens if one year was a particularly bad year so they did not pay

contributions that year? Do you have an average of three or five years? We do not underestimate there that there are difficulties in trying to come up with a fair system, but at the moment I think the results are very arbitrary indeed. Again, we have had discussions already with HMRC on that and we are hopeful that perhaps something a little fairer will emerge.

**Q89** ***Lord MacGregor of Pulham Market:*** Can I just ask one question on that? In your own evidence from ATT you talk about individuals in their last year before retirement being put in an invidious position because up to now there has been an encouragement to put as much in as you can. I do not know whether you have had any discussions with HMRC about that or how that can be overcome.
*Mr Whiting:* We have certainly made the point to them, along with a number of others, and we are awaiting their further thoughts. It almost comes back to Lord Eatwell's point about trying to get some better measure of what is a regular pattern, because in many ways we have had a system since the 2004 rules that has encouraged putting a lot of money in in the last few years, and many people have established a pattern that that is what they will do. Whether that is correct or not, that is the reasonable expectation they had and, almost as a matter of fairness, it would seem invidious to force them not to do it that way.
*Mr Meeson:* Indeed, my Lord, it comes back to clause 139 of the 2004 Bill, with the intention that the new rules will allow for one to pay what they can afford when they can afford it. Anything which puts an artificial constraint upon the timing of a contribution is arguably backtracking on what were at the time very fine principles.

**Q90** ***Lord Barnett:*** Is the ATT alone, could I ask, in suggesting that anti-forestalling could have been avoided altogether if the simple measure had been introduced immediately to ensure that relief is only available to basic rate taxpayers?
*Mr Johnson:* I think that is a question for the COIT.
*Mr Meeson:* Your Lordship knows where we stand.
*Mr Whiting:* It could have been avoided because clearly it would have been within Parliament's "gift" if that is the right term—it probably is not—to bring in the cut immediately. So it is possible, if that was the decision, and naturally we would always argue that it is better to give a little prior warning but, that we can accept creates difficulties in the definition of fairness in running that transition.
*Mr Johnson:* Could I add, Lord Barnett, that we are a little puzzled as to why the proposed restriction on relief is being deferred two years. If this is a measure to increase tax revenues, and we know that the Government is in need of increased tax revenues, why is it not being increased as of now? That would, as we have said, do away with the need for any forestalling legislation, it would do away with 18 pages of legislation and many hours of advisers' time in trying to understand what it means.
*Mr Hubbard:* I suspect it is quite difficult to do it in-year but it may be next year. It may be as prosaic as the timescale of redesigning the tax return.

**Q91** ***Lord Barnett:*** Do you really want to do away with many hours of work? It would be highly paid, I hope.
*Mr Whiting:* It is very kind of you to think of our prospective pensions!

**Q92** ***Lord Sheppard of Didgemere:*** In the ATT evidence you have submitted you refer to other practical issues arising. Are there any that you want to raise with us that we have not covered during this conversation?
*Mr Meeson:* I think we would not want to perhaps take it any wider but we would wish to reassert the ones we mentioned specifically in our written evidence, namely the difficulty that some taxpayers may well have in obtaining sufficient information to prepare their tax return for the imposition of an income tax charge. Given that we understand from HMRC that there are no current proposals to give a statutory obligation upon anybody to provide them with that information, yet there is a 20% tax charge lurking there.
*Mr Whiting:* Yes. The other practical side is how the pension providers themselves are gearing up as to what information they will have to make available and what is their particular part in it. This almost comes back to Lord Barnett's point. One of the reasons for something of a transition is at least to give some chance of getting some of this sorted out before it comes into play.

**Q93** ***Lord Powell of Bayswater:*** I enjoyed the "Janet and John" examples in the ATT paper but I did note they did seem a bit sexist: Eric, Felix, Gerald, Clive and Desmond. That is beside the point. Obviously, one thing the Government has been trying to do is limit the cost of relieving pension contributions by high earners but surely there are other ways they could have done it rather than the way they have selected. Could they not have just restructured the annual or lifetime part?
*Mr Whiting:* That was our suggestion, being pragmatic.

**Q94** ***Lord Powell of Bayswater:*** What do you think their motive was for not doing it that way?

*Mr Whiting:* That is very difficult.

**Q95** ***Lord Powell of Bayswater:*** Would you like to speculate?
*Mr Whiting:* Too simple possibly?
*Mr Hubbard:* I think there is an element of saying that the Government took a decision that there was a difference between people who were higher rate taxpayers and those who are very high earners. I think, to be fair, it is trying to say "we are doing something about very high earners" rather than perhaps what might have been feared, which was that higher rate tax relief would be abolished in its entirety. It seems to me that this distinction is what has driven this really quite complicated set of rules; they are saying that for ordinary high earners, 40% tax payers will retain the status quo. I think probably the argument will be that if this does not go down very well, if there is too much kickback around this, there is a much simpler option, which is to only give relief at the basic rate for everybody. That is why I think they have done it this way.

**Q96** ***Lord Powell of Bayswater:*** One further aspect: in your earlier remarks you said that the system introduced in the 2004 Finance Bill was on the whole a pretty good one. The trouble was the Government has fiddled with it every year since and this year it seems to be having a maxi-fiddle. Do you think we can still actually get stability and certainty in the pension scheme with all that has happened or has it now gone beyond the point of no return in terms of complexity and uncertainty?
*Mr Hubbard:* I suppose now we have much more of an explicit decoupling of the pension rules from the tax rules, because in a sense, the pension rules continue as they were; your funding of the pension scheme, in theory at any rate, is unaffected; it just that you will not get tax relief on all of it. Whether in practice that will mean that people will still fund pension contributions with unrelieved contributions I do not know, but what I think you do have now is a division between the pension rules and the tax rules, where previously it was all wrapped up in one. It is inevitable, is it not, that year on year there are going to be tinkerings with the system as problems emerge, but what the government now has is a system where, if they wanted to, they could make further tax measures without actually affecting the structure of the pension scheme legislation.
*Mr Whiting:* I think that is one of the concerns, that certainly for the last three years we have had tinkerings. That is inevitable. Here we have had a major shift. Is this the beginning of major change? I know from clients that there is a complete reappraisal with some very wealthy people that clearly, as was said earlier, this set of measures shows that if pension investment is not worth it, they will consider something else. Typically, that is property, so there is an argument that this is a subtle means of encouraging investment in property and boosting the housing market.
***Chairman:*** A very good signal for our next inquiry.

**Q97** ***Lord MacGregor of Pulham Market:*** You have mentioned the reaction of your clients. What has been the reaction of your clients to the introduction of the principle of employer contributions being taxed, which presumably is causing some to rethink the whole position in relation to defined benefits schemes or defined contributions to them?
*Mr Whiting:* 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.
*Mr Hubbard:* It was inevitable that employer contributions had to be in these provisions once you decided that there were going to be anti-forestalling provisions, because otherwise the whole thing would never have worked in situations where people are able to determine whether or not they make personal pension contributions or whether their employer makes pension contributions on their behalf. So it was inevitable that that had to change. I suppose I should declare an interest because my employer pays pension contributions on my behalf. 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.
*Mr Meeson:* If I might add to that, again, I have to declare an interest because I am a pension scheme administrator and I have had a large number of contacts from clients wondering what on earth is going on with the Budget release on the anti-forestalling and then the Finance Bill on the anti-forestalling. A lot of the concern is that there was already a perfectly adequate provision, should one wish it, to tax employer contributions; it is called the annual allowance, set at £245,000, and if one wished to limit income tax relief, one could do it by limiting income tax relief rather than by allowing the income tax relief and then making a charge. One point I have to make here is that even were the anti-forestalling legislation to only do that, it would be defective because it is attempting to restore income tax relief to 20% by making a 20% charge, which assumes that higher rate relief on pension contributions is 40%. For a large number of people it is 42.5% so it does not even hit the target it alleges to hit.

***Chairman:*** Perhaps now we can move on to real estate investment trusts. Before we do that, if you feel content with an answer that one of your colleagues has made, do just nod. There is no need to elaborate too much on it.

**Q98** ***Lord MacGregor of Pulham Market:*** How far do you think REITs have been meeting their objectives so far, or is it too early to say? Some would argue that the falling short is attributable only to the economic downturn. That is one question. The other is, were they more successful in the USA and, if so, can you suggest any structural reason why this may have been so?
*Mr Whiting:* 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 we would be sitting here saying this is all 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. I think that explains why, arguably, the US is better than ours, simply because theirs have been launched longer and on the back of a longer property boom.
*Mr Hubbard:* Yes, I would agree with that. It was strong consultation but who at the moment wants to invest in property either directly or indirectly? It should be a very good time to do it, if one thinks the property market is going to move upwards rather than downwards, but I think people are just so nervous generally speaking that this has rather gone off people's horizons. But I do not think structurally there are any significant issues with REITs.

**Q99** ***Chairman:*** Do you think there are any changes that should be made, or should be considered, as indeed the property market revives, assuming it does revive?
*Mr Whiting:* We have pointed to a couple of technical ones to consider within our memorandum, and they are ones that we pointed out when REITs were first being set up: the de-grouping charge; if a property-rich group wishes to move property into a separate vehicle and it then hives off, it is faced with an immediate Capital Gains hit. It was said that is a price to pay and we might come back to that when we have seen how initially it is going. It is a difficult one as to what extent the group should have that potential charge relieved but it is something to look at. The other is this thing about if you are trying to assemble residential properties, the impact of Stamp Duty Land Tax and whether you automatically assemble at the 4% rate, if I can put it in those terms, or whether you are allowed to assemble individual properties at relatively small amounts. There are a couple of thoughts there that would be worth looking at but it really comes down to how much will or wish there is to push forward with these vehicles.

**Q100** ***Lord Wakeham:*** You have nearly answered this: have your members found any particular difficulties in dealing with the provisions?
*Mr Hubbard:* I think the reality is that there are so few of these REITS around that there are only a few members who are very specialised in dealing with them, and I think they have worked their way through the system.
*Mr Whiting:* Generally they are content.

**Q101** ***Lord Eatwell:*** Just finally, to wrap up on this, have you any specific comment on the removal of the barrier for tied premises to enter the scheme? Do you think that it will make any significant difference?
*Mr Whiting:* The ability for a pub group or whatever to move in?

**Q102** ***Lord Eatwell:*** Yes.
*Mr Whiting:* It is part of what I think would be useful to facilitate because it is really trying to move on from the initial REITs, which is where property groups re-launched themselves as REITs, to move to the situation where you have the operating retail or pub group or whatever that can effectively split their holdings and perhaps have tradeco and hive off a REIT. It is really moving into that what I think was always viewed as the second phase of REITs, but it comes up against some of the problems I tried to explain earlier.
***Chairman:*** If Members have no more questions on REITs perhaps we can move on to foreign profits.

**Q103** ***Lord Barnett:*** The CIOT regrets that an opportunity to move to a "proper territorial system" is being lost. Would you like to expand on that?
*Mr Whiting:* What we were 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 territorialit:. where would we be if we simply said profits made in the UK are taxed, and of course, the concomitant, that expenses attributable to the UK are allowed?' That gets at what, frankly, has to be termed a bit of a sacred cow of interest relief,

because you would naturally potentially restrict interest relief quite considerably. It would affect groups very differently. It would potentially raise a lot of money for the Treasury by 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. It is difficult to work out the numbers but you are potentially looking at an opportunity to bring the rate down quite markedly and pay for it with an interest restriction. It is a question we feel that should be looked at.

**Q104** ***Lord Barnett:*** You commend the Government for the consultation process.
*Mr Whiting:* Yes.

**Q105** ***Lord Barnett:*** Indeed, you congratulate HMRC that you did not manage to get this argument across.
*Mr Whiting:* No.
*Mr Hubbard:* I think HMRC have done a very good job on this and I think it has been a longstanding process. The Institute is always very clear that where HMRC has done a good job, we want to acknowledge that publicly. This has been a long debate on some very complex technical and economic issues and it has not been a rush to judgement. There have been various rethinks and still we have not got everything yet. I do not have a problem with that at one level because it gives a little bit more time to think some of these things through, and the Government has been very clear on that. There was a letter saying there are still bits to come. This is the direction of travel. All of that I think is fine. The only problem with it, of course, is that it does put you up against a real deadline of when the legislation actually starts to come into practice, and that is always an issue, but this has been good consultation. Yes, we did not get everything but we got a lot of what we wanted. There was genuine dialogue, which is the most important thing.

**Q106** ***Lord Barnett:*** You will get more next year.
*Mr Whiting:* Quite possibly.

**Q107** ***Chairman:*** You did have a particular concern, I think, about joint venture companies. Would you like to say how you think those should be handled and whether there has been any response from HMRC on that?
*Mr Hubbard:* There has been agreement in principle that there are some technical drafting problems with the way joint ventures are dealt with and HMRC have acknowledged that. We have been in discussion with them and we are led to believe that those changes will be made. But it looks all right at the moment.

**Q108** ***Lord Sheppard of Didgemere:*** The Chartered Institute in your paper say that the whole debt cap principle is misconceived and that legislation is both arbitrary and discriminatory. Would you like to amplify that, if it needs it?
*Mr Whiting:* It comes back to our overriding concern that the opportunity has been missed for a bigger, more radical move, and we really must emphasize that, within the constraints we have been given, we think the consultation has been good and we have made good progress, but when one stands back, we have a system which will require the group to do quite complex monitoring of its debt position within the UK and worldwide to apply a sum and to do this every year. It is one that will require effort. It is noticeable that the regulatory impact assessment predicted a cost of £8 or £9 million a year, which might not seem a lot but that still has to be done by a relatively small number of large UK-based multinationals and foreign-based ones. So the system we have has problems within it. We are hopeful, as Andrew alluded to, that the next iteration which we see will answer some of our concerns, and nothing would please us more than being able to take back that comment.

**Q109** ***Lord Sheppard of Didgemere:*** Can I just ask for the Institute's comments on mainly the BBA but also the 100 Group or whatever they call themselves, who raised the concern about the piece that has gone in about the personal tax accountability of senior accounting officers in large companies. Are any of your Institute's members concerned about that?
*Mr Whiting:* The personal nature of the liability? Yes, a number of them are, because obviously one or two of them . . .

**Q110** ***Lord Sheppard of Didgemere:*** They will be the first to be called on by the chief executive or the finance officers.
*Mr Whiting:* Yes, it is an interesting question as to who is going to be the senior accounting officer. It is a definition point by nature. It is presumably the CFO of the group, and he or she will rely on the tax director, which is often one of our members, to basically put the systems in place. So they are certainly being involved within companies in the discussions and in what is already, of course, preparatory work, because this system comes into play very quickly, in whatever shape it is, as a result of the Finance Bill debate.

**Q111** ***Chairman:*** Just one final shot before we close. How worrying do you find it that, on the day the Finance Bill was published, the Government had to announce that changes were already being proposed to provisions in the Bill?

*Mr Whiting:* If you are referring to the foreign profits, I think we were not worried because that was a continuation of the process of consultation. That was as understood.

**Q112** ***Chairman:*** Fair enough.
*Mr Hubbard:* Could I just say that we were worried though that on one or two of the other measures that we have already talked about, for instance, the duties of senior accounting officers or the naming and shaming, that there were changes or announcements of possible changes very soon after the publication, which suggests that these measures would have benefited from some consultation. I do not think there is any forestalling risk and I think the points that we brought out in the consultation would have informed better legislation in the first place.
***Chairman:*** Excellent. Thank you very much again for spending some time with us this afternoon and thank you for your very helpful answers to our questions.

## WEDNESDAY 20 MAY 2009

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**Memorandum by the British Property Federation**

*Real Estate Investment Trusts (REITs): Clause 65 and Schedule 34. In this case, the FBSC will be looking not only at the clauses but also at the experience of the legislation since its introduction in 2007 and how it compares with expectations then.*

### 1. Background—UK REITs Generally

1.1 *What are they?* UK REITs are a tax efficient, listed, UK based vehicle for collective investment in income-producing property, designed to allow investors to make an indirect, liquid and diversified investment in real estate in a way that attracts a similar tax treatment to direct investment in real estate. REITs avoid the double taxation experienced by other listed property companies. The Exchequer receives a minimum revenue each year because REITs are obliged to distribute to shareholders at least 90% of their profits from property investment, which are taxable in the hands of shareholders.

1.2 *Introduction of UK REITs* UK introduced REITs in January 2007. The consultation and stakeholder engagement that led up to that was handled very well, and the legislation is generally felt to be very good and to have been brought in very successfully.

1.3 *The PIA* On the back of an informal alliance between the BPF, IPF and RICS formed to promote the establishment of REITs, the industry has now created the Property Industry Alliance, bringing together the BPF, IPF, RICS and BCO (and, more recently, the BCSC). One of its principal objectives is the further development and expansion of the REIT regime.

1.4 *Take-up* Around 75% of the UK's listed property sector (some £30 billion in terms of market cap) converted to REIT status during 2007, generating substantial revenues for the Exchequer through the "entry charge". On the downside, there have been very few new REITs, and there are still no residential REITs.

1.5 *Practical experience since then* The administration of the UK REIT sector by HMRC is generally felt to be very good, with constructive attitudes and relationships facilitating the remarkably smooth operation of a wholly new part of the tax system.

1.6 *Market experience since then* Inevitably, the REITs have suffered from the financial crisis that began in late 2007 and from the economic crisis.

1.7 *Overall assessment* The introduction of REITs in the UK was very welcome and has been a success, but the timing was unfortunate, because soon after the REITs, like everyone else, became engulfed in a financial crisis. The economic crisis and the weak occupier market is emerging as the biggest challenge, but REITs are generally well placed to weather the downturn and more importantly support the recovery.

### 2. Current Issues and the Finance Bill

There are three areas of concern with the REIT legislation:

2.1 "*Snagging" items* Inevitably, there have been a number of areas where the REIT legislation does not work perfectly, or where it has problematic and unintended consequences. Many of these are points of technical detail, and some are more important than others.

(a) 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 they were all relatively low priority (and uncontroversial in policy terms).

(b) 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.

(c) The Government is currently rewriting the REIT legislation as part of the Tax Law Rewrite project. It will be disappointing if any of those "snagging" items, most of which were identified two years ago, are carried over into the rewritten legislation, in the absence of clear policy reasons.

2.2 *Flexibility during the current crisis* The REIT regime imposes tight constraints on REIT groups, some of which are particularly challenging in the current economic environment and may, if the recovery is slow, create real problems for a number of them.

(a) Well ahead of the Budget, BPF canvassed the views of the REITs and their advisers to identify any serious problems posed by the REIT rules in the current economic environment. A number of issues were identified as urgent or as likely to become urgent within a year or so on the basis of commercially prudent scenario planning.

(b) The most significant issues relate to the requirement that REITs distribute at least 90% of their property income annually, and the technical operation of the gearing restriction to which REITs are subject. This has become critical because REITs are the only listed vehicles required by law to distribute cash, which at a time of credit rationing by banks goes against the principles of good stewardship.

(c) Specifically, we would like REITs to be permitted to count distributions paid in the form of new shares to count towards the mandatory distribution requirement, and/or to defer the mandatory distribution for two or three years, to give them greater flexibility to balance the competing needs to maintain the strength and value of the business and to make distributions to shareholders.

(d) We would also like the gearing restriction to be changed. It was originally constructed to prevent REITs from taking on too much debt or using debt to extract profits in a tax free way, and breach gives rise to a tax charge. However, as currently configured, the restriction can be breached because of normal commercial matters such as fair value movements in a REIT's interest rate hedges, or because of break costs that have to be paid in connection with debt repayment. That is both unnecessary in policy terms and costly for businesses.

(e) The BPF 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.

(f) 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.

2.3 *Strategic vision* More generally, 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.

(a) 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.

(b) A fundamental problem which needs to be addressed in the UK is that 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.

(c) 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 vehicle for making such property assets available to true equity investors again. REITs were used in that way by the United States, Japan and other countries following previous recessions. We hope that the Government will engage with the industry to explore the possibilities.

(d) 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.

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.

*May 2009*

**Memorandum by the Royal Institution of Chartered Surveyors (RICS)**

RICS (Royal Institution of Chartered Surveyors) is the mark of property professionalism worldwide. It covers all aspects of property, construction and associated environmental issues. RICS has 86,000 chartered members (FRICS and MRICS) and 55,000 members in other categories of membership (TechRICS, trainees and students) globally. It represents, regulates and promotes the work of these property professionals throughout 146 countries. RICS is governed by a Royal Charter approved by Parliament which requires it to act in the public interest. It is also a professional regulatory body approved by Government (HM Treasury).

## Overview of the REITs Regime

In December 2007 the Property Industry Alliance of which RICS is a member, published an analysis of the impact of REITs. This document argued that the launch of REITs in the UK represented a very positive step forward for the UK property industry, which will bring long term benefits to the UK.

Market conditions will have reduced the potential impact that REITs could have had on the commercial property industry. It would be considered by many that REITs were introduced at the top of the market cycle and the commercial property market has continued to decline since then. These conditions have meant that share prices of REITs will almost certainly have fallen and it seems unfair to judge the success of the legislation against this background.

To help ensure the success of REITs they must continue to evolve and grow. The Government must work with the property industry to ensure that all companies that would be appropriate to become REITs are able to do so. Legislation will need to change to ensure that smaller companies are able to take advantage of the REIT mechanism. There is also the area of residential REITs which should help the creation of a dedicated build to let sector and boost overall housing supply.

## Finance Bill Issues

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.

### *Anti avoidance measures*

The key change was the introduction of anti-avoidance provisions which will prevent restructuring within groups enabling companies to meet the conditions to join the REIT regime. These provisions are a welcome improvement and mean that owner occupied properties are excluded from the tax exempt business of the REIT.

This anti-avoidance measure targets groups which are essentially trading groups that structure in a way that HMRC regards as artificial to satisfy the REIT conditions on a strict technical reading, rather than property investment groups. As such this seems to be a positive step which will ensure REITs are legitimate property investment vehicles rather than companies that own property, such as hotels or supermarkets, looking for a tax advantage.

Although requiring businesses to be fundamentally based in property investment, the changes are unlikely to increase significantly the number of REITs.

*Convertible preference shares*

Measures in the Finance Bill will allow a REIT to raise funds by issuing convertible preference shares. This is a welcome measure which was intended to be included within the original REIT structure. It will allow REITs to raise funds by offering convertible preference shares in addition to the non-voting fixed rate preference shares which are currently allowed. This is a positive step that will make it easier for REITs to operate effectively.

*Other changes*

Several other minor changes have been made to the operation of REITs which RICS believe will help the system function effectively:

— An accounting based definition for all REITs (applicable to groups and single companies) will be used to define "asset" when applying the "balance of business test".

— Where a REIT disposes of a property used in the property rental business the funds from the disposal that are awaiting reinvestment can be treated, for up to 24 months, as an asset of the property rental business for the balance of business test.

— Measures have been introduced to clarify the apportionment to be applied where the asset has been partly used for the purposes of the property rental business and partly for non-rental purposes.

## REITS and the Credit Crunch

As well as suffering in the same way as other companies during the credit crunch and the economic downturn, there will be a particular set of issues that affect REITs. RICS believe that the Government should be helping ensure the stability of the REIT market in the current climate and at the very least maintain it at its current size.

*Stock dividends*

Under the current rules, UK REITs are required to distribute 90% of their taxable income to shareholders in the form of cash payments. Other countries with a REIT regime, such as the USA, have taken steps to assist REITs during the current economic difficulties. In the US similar rules have been changed to allow REITs to make part of this distribution in the form of shares. The UK Government should change REITs legislation to allow the option of allowing stock to count towards the 90% distribution.

*Deferral of distribution*

The 90% distribution of taxable income currently has to take place within 12 months of the end of a REIT's accounting period. RICS believe that this period should be extended to help REITs which may be facing cash flow difficulties as a result of current economic conditions. A more sensible period may be 24 months rather than 12 months, giving much needed assistance to the sector.

*Financing costs ratio and the interest cover test*

Under the current regulations governing the financing costs ratio a REIT's gross profit (before financing costs and capital allowances) must be at least 1.25 times the interest payable on any debt. This interest cover test has caused particular problems in the current economic conditions where there have been difficulties accessing credit and banks have changed lending arrangements. In particular there have been difficulties with banks changing swap rates which has added extra costs.

At a time where profits are likely to be falling due to a declining market more REITs will run the risk of breaching the financing costs ratio. This will lead to action by HMRC and although the company will be able to stay in the REIT regime, they will have to pay tax that they would otherwise not be liable for. This simply adds an extra cost to companies that are already in difficulty and the Government should consider amending regulations to increase the ratio.

### Further Action needed on REITs

There was no change in the Budget to the flexibility of the system or real action to increase the use of REITs in either commercial or residential property. There are a number of steps the Government should consider taking if they are committed to increasing the use of REITs as a form of property investment in the UK.

*AIM listing*

Under the current arrangements property companies have to be listed on a recognised stock exchange before they can become a REIT. This means that companies listed on the Alternative Investment Market are not currently eligible for conversion. Allowing this would increase the pool of companies which could potentially be REITs as listing on the AIM is cheaper and more suitable for small companies. This 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.

*Using REITs to encourage institutional investment and a build to let sector*

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.*[1] Despite this desire from the Government there are currently no residential REITs in the UK.

The need to attract extra investment was also highlighted by the recent Rugg Review into the private rented sector. In their response to this review, the Government states that more work is needed on creating the right environment for institutional investment in new supply for specifically built to rent properties. Alongside changes to stamp duty and the planning system, REITS have an essential role to play in this process.

Reforms must be made to the REIT regime in order to encourage increased levels of investment. One of the barriers to the establishment of residential REITs is that in most cases the yield is to small for a company to operate effectively under the current REIT structure. To address this issue changes should be made to the gearing restriction to accommodate lower yields from residential property.

Any residential REIT would be more reliant on income from sales of properties than a commercial property REIT. As a result the gearing restriction which is imposed by the 1.25 interest cover test is harder to satisfy then with commercial property. This happens because the profits section of the interest cover test only includes income profits and not capital gains from property sales. There are three potential ways to achieve this:

— Allow residential REITs to include capital sale proceeds in the interest cover test.

— Provide a lower interest cover limit for residential REITs.

— Use a loan to value restriction rather than income restrictions.

RICS has been working as part of the Property Industry Alliance (PIA) to encourage the Government to reform UK REITs. Further action to encourage the entry of residential property investment companies into the REIT regime should include changes which:

— Reduce the cost of entry, including the 2% entry charge and listing costs.

— Remove the requirement for all REITs to be listed on a recognised stock exchange.

— Introduce some form of tax relief or deferral for those selling property to a REIT in exchange for shares in the REIT.

As well as encouraging entry into the system, changes must be made to the REIT system to accommodate the business model of residential investment companies. Reforms must be made to:

— Allow profits arising from portfolio "churn" to be treated as tax-exempt income of the REIT (provided properties are on average held for a sufficient period accepted as indicative of property investment activity);

— Allow residential REITs a notional capital allowance deduction for the purposes of computing the profits of which 90% is required to be distributed each period, in recognition of the fact that capital allowances, which make the distribution requirement easier to meet for commercial REITs, are not generally available in the residential context.

*May 2009*

[1] Recommendation 30, P80 http://www.hm-treasury.gov.uk/media/B/E/prb05_barker_553.pdf

**Examination of Witnesses**

Witnesses: MR GRAHAM ROBERTS, Finance Director of British Land on behalf of the British Property Federation and MS ROSALIND ROWE of the RICS Taxation Policy Panel, Royal Institution of Chartered Surveyors, examined.

**Q113** ***Chairman:*** This afternoon's hearing is the third in the Committee's inquiry into selective aspects of the Finance Bill 2009. May I welcome you to the Finance Bill Sub-Committee and thank you very much indeed for making some time to be here with us this afternoon? Perhaps I could ask you to speak reasonably slowly and clearly for the benefit both of the stenographer and Members. When you first speak could you briefly introduce yourselves especially for the benefit of the web broadcast. Do you want to make any introductory remarks or shall we move straight into questions?
*Mr Roberts:* I would very much like to make some introductory remarks and perhaps if I could kick off? My name is Graham Roberts; I am the Finance Director of British Land and to clarify I am representing the British Property Federation. Also, just to clarify that REITs essentially are a change of tax status and the existing REITs all converted from the existing property companies that were listed previously. So we were a FTSE 100 company prior and a FTSE 100 company after the conversion. There are three themes to the submissions from the BPF. Firstly, the snagging items, which is obviously the key discussion point for today; but also we talk about operational issues that arise out of the current environment; also a strategic vision for the role that REITs can play and some of the issues which the government and the banking system is facing at the moment. The reason for talking about those in the context of today is the relevance to the snagging items and actually getting the REIT regime to work correctly. REITs really were established in response to offshore unregulated property funds; that they bring in disciplines to property investment—lower gearing, plc standards of behaviour, offer an alternative asset class, which has heavily professionalised over the last ten years. In the context of the REITs as they were launched two years ago there has been a significant interest from overseas funds and our shareholder base grew dramatically. This is a potential opening for how to resolve some of the issues within the banks, through the re-equitisation potential through the REITs' access to global capital, particularly relevant to commercial property but also residential property, and that is the relevance of introducing that theme, which I hope we will come on to later.
*Ms Rowe:* Good afternoon; I am Rosalind Rowe and I am speaking here today on behalf of the RICS. 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.

**Q114** ***Chairman:*** Perhaps I can start with questions. Both of you seem to have been generally happy with the way in which REITs were introduced in the first place and if that is so we need not spend too much time discussing that. Clearly the timing of the introduction was a little unfortunate to say the least and I wonder how far you see the economic downturn as responsible for perhaps their failure fully to meet the original objectives; or do you think that there are structural weaknesses that have been responsible as well?
*Ms Rowe:* If I could pick up to begin with? I was part and parcel of the industry team that was meeting with government, Treasury and HMRC when REITs were introduced and what we did see after the REIT regime was introduced was one of the things that they were intended to achieve, which was mobility of property. Property is extremely lumpy—it is very difficult to go and buy a £100 million of property out of your back pocket—and I think it achieved quite a lot there and we certainly saw a large amount of partnerships opening up and property changing hands, certainly in the first year, and perhaps Graham would agree with that. Yes, there has been a downturn in the property market and therefore that has had a knock-on effect with REITs because REITs are an investment vehicle for property.
*Mr Roberts:* 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.

**Q115** ***Chairman:*** In your submission you mentioned snagging items with, I think, particular reference to the balance of business test. Why do you think that the Treasury and the HMRC declined to address these things when you identified them as of a higher priority than the issues that they did address?
*Mr Roberts:* It is hard to say for certain. I think that the prioritisation of issues for the Finance Bill meant that they were looking at key things that might affect headlines and moving forward other agendas not recognising, I think, the significance of getting the REIT regime to work and the potential that it could play within the actual solution or a part of the solution it can operate with the banking system.
*Ms Rowe:* I think that is right and, as Graham said, if you have an income distributing vehicle that has to give away 90% of its income it is quite a big hole to have to fill in, and if you go back to your bank and ask for cash and it is not there that is quite difficult. I would like to point out that what was being sought was actually merely a deferral of the obligation to distribute during these unforeseen terms—no one saw in 2007 that we would be where we were. So there were two things we were looking to help the cash position of companies: one was deferral of the distribution, 90%; and the second one was the stock dividend piece. I think maybe Treasury were a little concerned about the stock dividend—that is where people give shares away as opposed to cash—that they looked at what had happened in America and in America the IRS decided that stock dividends should be mandatory instead of cash dividends and I think that caused some concern—certainly a furore from the investors. This is only anecdotal but I offer it up anyway, there was the case of a discussion I had with a major investor in a REIT and I said, "You have a REIT and you want the cash out of it as a good investor?" He said yes and I said, "Supposing you found that you could not actually have the cash but you could have some additional shares?" and his view was he would rather prefer to actually preserve the cake and worry about the icing later on. So I think the key point is preservation of that investment vehicle is quite key.
*Mr Roberts:* Coming back to the balance of business tests specifically, the introduction of REITs, the way it actually worked was a good example of an industry and HMT working together to produce something—we were proud of such co-operation—but it was very much an engagement with the existing property companies and the legislation was aimed at making them convert, ensuring the conversion charge was paid, which was very good for HMT's receipts; but also achieve the objectives of the existing REITs. What is missing then is the evolution which was important in the US and in France, which encourages new entrants into the market, bringing new capital into the market. The balance of business test can be an obstacle to a newcomer coming in because if the cash itself that is on the balance sheet does not count, you cannot get past the first post. So it is those little snagging points that matter; because the REIT legislation was introduced quite fast we as an industry expected a continuous improvement to follow on, like we have seen in France, but actually it seems to have become set in stone.
*Ms Rowe:* I think the difficulty there is that there have been a number of teams from Treasury and from the Inland Revenue and because it was introduced quickly there were things that needed to be resolved. They were quite important at the time but as time has moved on I think maybe some of those messages have been slightly diluted. So I think the crucial thing is to address those issues. The point is at the moment, Graham mentioned earlier the need to retain cash so that if you have a rights issue and you cannot find a property that you want then it is going to sit on your balance sheet. I think you have done the right thing to preserve the business but if you want to grow it and you want to take advantage of the market then you need to have that commercial flexibility, and this is imposing a restriction on a commercial decision, which I think is unfortunate.

**Q116** ***Lord Best:*** You have talked about the things that are not in the Finance Bill and I am going to come to a couple of points that are and give a few comments. Staying with the sins of omission in the Finance Bill you draw attention to the absence of anything constructive and helpful on residential REITs, and since before REITs came along this was heralded as a huge and major breakthrough in terms of securing institutional investment into the rented sector. I wonder whether there is any chance realistically of introducing I think the eight measures which the RICS have helpfully listed as would be required to really make a go of residential REITs. Is this really banging one's head against a brick wall? There is very little sign that the government is expressing any interest in this, despite the access to global capital, as Mr Roberts put it, which could make a huge difference to investment in the residential sector. In your discussions with Treasury do you have any feeling that there is likely to be a move of any kind that would at last get the residential REIT on the road?
*Ms Rowe:* I am not sure we have heard that at the moment. I think there are some messages that we have been conveying for some time and those messages are around the fact that there were basically two barriers, I think, to investment in residential property. One was tax and the second one was the yield gap. If I can deal with tax, first of all, basically

taking tax out of the charge on income and gains is helpful. However, residential performs differently from commercial property and the RICS have asked me to say that if you want further detail we can provide any written evidence that you might find quite helpful. But in outline there is a yield gap and that is the difference between the return you get for investing in, say, residential property, compared with some alternative investment. The problem we have in the UK, unlike most other countries, is that there is a difference between the tax regime for commercial and residential property. There is a difficulty to recover more VAT; there is not the amount of capital allowances that we have in commercial property; and we also have competition from the vacant possession owner-occupied market, so that if your yield is 6% but your asset is going up phenomenally, as certainly housing prices were in the past, and your cost of debt is high, as it was two years ago, then you can see that there is not much left when you take 90%—there is not 90% of anything to actually take out. So there has to be some kind of help, recognising that the returns on commercial and residential are different and therefore what was being advocated by the Property Industry Alliance, of which both RICS and the BPF are members, was to enable some disposals of residential property that would generate income—trading income effectively—thus providing gains to be distributed as part of the income return. The government would not lose out because there would still be tax payable by the recipient of the distribution, which is the case for commercial property, and that would fix some of the fundamental structural differences between the two. But I am still not sure if that message has got through and I think that perhaps more discussion has to be done. The reason I say that, I have some statistics in front of me, with which the RICS have provided me, which show that the housing starts in 2007 were 170,000; the target for the government is 240,000 each year; for 2008 they are 80,000; and for 2009 maybe 60,000. I live near Stansted and where I live there are a lot of mothballed houses because people just cannot buy them, and the difficulty is how long are they going to sit there and how are we going to continue to meet the housing gaps that we need in the accommodation. So I would put it back to government that this is a major policy issue which the RICS does support but it does require some changes from a tax technical point of view.

***Chairman:*** We are happy to have additional written evidence if you would like to send that in.

**Q117** ***Lord Best:*** Just on the things that are in the Finance Bill, there is the provision affecting pubs. I do not know if you want to say anything about that? And there is the anti avoidance measures which, rather unusually, the representative bodies are in favour of—although that may be unkind. Could you explain why you think they are such a good thing?

*Mr Roberts:* Can I start? As a REIT as well I am in favour of them. I think we benefit from the tax advantages that come with the REITs and with that comes a responsibility not to engage in practices that are in the avoidance territory. I think structurally it was aimed at landowners and not at operators and therefore we are neutral and unaffected as we are not operators, but totally understand why that element of legislation was introduced.

*Ms Rowe:* I think there is a slight counter view and RICS has alluded to that, on page 2, which is that in other countries there are different business models. I think that RICS would take the view that they want an effective marketplace and therefore I think they feel the need to consider widening out how the REIT regime plays in the marketplace.

**Q118** ***Lord MacGregor of Pulham Market:*** I think this is my first question on REITs so perhaps I ought to repeat an interest in that I am Chairman of the Pension Fund Trustees of one REIT and I am also a very small shareholder in a REIT. Reading your evidence and also listening to you today, I think you are taking a very similar view as to recommendations outside of the Finance Bill. Could you put them in any order of priority?

*Mr Roberts:* From my perspective the one which deals with the inappropriate consequences in the credit crunch, which is the stock dividends that could be able to be paid out rather than the obligatory cash payments; and the relaxation of the distribution as an alternative deferred over a longer period of time so that companies are not forced to get themselves into a cash critical position. I think that is quite critical. Equally, the balance of business test point around cash, particularly for new companies that want to convert into a REIT, at a time when we do need to see equity capital come into the commercial property market, and I would argue the residential property market. To have a barrier to entry for this particular vehicle I think would be unhelpful.

*Ms Rowe:* I think certainly not requiring companies to distribute profits at this time is extremely important but there are companies who are restructuring debt and are facing problems with the definition of the finance cost ratio, which could easily be changed. That ratio basically says that you need 1.25 times income cover and the difficulty is that when it was thought about initially it was really concerns that the government had that offshore investors could actually gear up REITs and because they were not taxed on interest income they could actually gear it up with interest income and there would not be any rental income to distribute and therefore they would get their money out tax free. Then you could see why the government really would not like that. 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.

**Q119** ***Lord MacGregor of Pulham Market:*** Do you have any idea as to why the government are not listening to these recommendations or do you think that perhaps you are making some progress in getting them over?

*Ms Rowe:* Clearly at this stage because they are not in the Finance Bill I think it is a lot more difficult; but, as Graham said, I feel that these were not key priorities for the wider government, although they are clearly priorities for REITs and I would imagine that that is what lies behind it. However, we would like to encourage them to reconsider.

**Q120** ***Lord Sheppard of Didgemere:*** This question is more to the strategic side. What do you see as the priorities for action, both within and between new entrants, commercial property and residential property? One other parallel question: learning from foreign experience—generally we talk about the United States—you talk about the French experience. Do you want to pick that up?

*Mr Roberts:* Dealing with that first, 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 is I think missing. 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, as you are aware. 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.

*Ms Rowe:* Also from the institutions' point of view at the moment, 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. So, for example, in the US it is possible for an institution and indeed an investor with a large portfolio of property to be able to offer that into a partnership and only at the point that he sells the interest in the partnership is he subject to tax. Therefore, because of that deferral it is very attractive, and in the same way in France the change there is a discount on Capital Gains Tax that would be payable for somebody selling into a REIT. So that is actually helping those REITs to grow. I think REITs are good because they are regulated so it is good for investors; they are liquid; and I would venture—although it is not so provable—that some of the movements in the REIT shares, coming into the downturn in the property market, demonstrate that REITs indeed are very liquid because people wanting cash who could not get them out of certain investments were able to realise their cash by actually selling their shares on the stock market.

*Mr Roberts:* I am quite optimistic about capital coming into the residential sector and helping with the current housing issue in terms of the house builders that cannot get into turning over and passing on property quick enough, and actually there is equity capital that would be interested in residential. So encouraging residential REITs is one way to get there. We had a portfolio that we sold—in fact it was sold on to a company that then sold it on to Wellcome Trust and we still manage that portfolio for them. So there are serious investors who are interested in residential property. It was just that the timing of the REIT legislation was within that very strong bull market in housing, which meant that there was very low yields, which meant that the only way a professional investor would want to buy it would be if there was compound 6% growth in house prices from there in perpetuity, which was nonsense. In practice we are now moving to house price levels which I think will be very interesting for overseas investors.

*Ms Rowe:* 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. As you were saying, we came into the REITs maybe just at the wrong time. Why do we not get the residential REITs right now?

**Q121** ***Lord Blackwell:*** Could I add one question and, given the topic, I should declare my particular interest as director of a REIT. You have expressed some disappointment I guess that this Budget did not do more to address some of the issues you have raised. I think everyone was very complimentary about the level of effort that was put into the original of REITs and the discussion and involvement with the industry and I wonder whether behind this you sense that there has been a loss of interest. You would expect that having launched something like this that the Treasury would want to keep engaged to see what needed to be done. Do you sense that the eye has moved off it and there is no ongoing dialogue, or is it just that they did not think that this was the right time to deal with these issues?

*Mr Roberts:* I think it is fair to say that there were changes in personnel through the process as well as post the process. I agree with you; I think the interaction between the industry and HMT was exceptional and probably a model in how to get something to work. But it was not perfect and it is a shame that we missed the opportunity to actually hit a home run on something which I think would otherwise have demonstrated the good interaction.

**Q122** ***Lord Wakeham:*** What I think I am drawing from this is that you reckon you did a good job in explaining to the Treasury and the HMRC but they did not accept your arguments and therefore we would be entitled to ask them why did they not accept the arguments when they come and talk to us. Would that be reasonable? Not that they do not understand, that they understand your point of view but that they did not accept it; would that be the conclusion I ought to draw from what you have been saying to us?

*Mr Roberts:* I think it is fair to say that they have understood the technical points but it has not reached them, or at least the list of things to fix.

***Chairman:*** If there are no further questions thank you very much again for spending some time with us. Thank you for your answers to our questions and thank you too for your written submissions.

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## Supplementary memorandum by the Royal Institution of Chartered Surveyors

### Using REITs to Increase Investment in the Private Rented Sector

The private rented sector ("PRS") in England is expanding and its market share has grown from 9% in 1990 to 12% in 2007[2] and is increasingly important for those who cannot afford to buy a home but are ineligible for social housing. For many people private renting is becoming the tenure of choice. They can take advantage of increased levels of flexibility provided by the sector in terms of mobility of labour and lower transaction costs in moving to a more appropriately sized property. The sector must be encouraged to grow to provide choice both within the sector and also as an alternative to owner occupation. This will allow people to be more flexible in relocating to suit changes in the economic environment.

The private rented sector has been dominated in recent years by buy to let landlords and relatively small scale investors. The boom in buy to let properties in the early 2000s changed the make up of owners in the private rented sector. In 1994 50% of private rented sector properties were owned by companies and 47% were owned by individuals or couples.[3] By 2006 the proportions had changed to 16% owned by companies and 74% owned by individuals or couples.[4] In other countries, significant institutional investors (such as Grainger and Unite in the UK), play a bigger role in the provision of rented housing.

### State of the Housing Market and Role of Private Rented Sector

*The decline in housebuilding levels*

The levels of housebuilding have fallen significantly as a result of the declining property market and the reluctance of housebuilders to undertake developments if there is not sufficient demand. Housing completions in England have fallen from 174,530 in 2007 to 133,710 in the year to March 2009 and there were only 90,430 housing starts final three quarters of 2008 and the first quarter of 2009.[5] This is significantly below the Government's target of building at a rate of 240,000 homes per year by 2016 and below the level of new household formation which is around 220,000 per year. All steps should be considered to increase supply including council house building and also attracting capital investment from institutions to increase the number of homes in the private rented sector. This would also have the knock on effect of retaining skilled workers in the construction industry.

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[2] http://www.communities.gov.uk/documents/housing/pdf/HousinginEngland0506.pdf
[3] http://www.london.gov.uk/mayor/economic_unit/docs/current-issues-note-18.pdf
[4] Section 2.1 P3 http://www.communities.gov.uk/documents/housing/pdf/privatelandlordsurvey.pdf
[5] http://www.communities.gov.uk/documents/housing/xls/140894.xls

## Advantages of a Strong PRS

*Providing an alternative to owner occupation*

Significant price rises in the late 1990s and early 2000s saw the gap between household income and house prices increase significantly. This has led to the creation of a growing intermediate market in housing where households are not eligible for social housing but are unable to buy a home out right. There are a range of solutions to this issue including shared equity schemes but the private rented sector will always play a significant role. If the sector is to continue to fill this role it needs to become more professional and offer a better standard of service. Encouraging institutional investment can help achieve this.

*Increasing economic flexibility*

A thriving private rented sector can help assist labour mobility by providing flexible accommodation on a short to medium term basis. The standard tenancy in the sector can last for as little as 6 months and a person can chose to move with a relatively short notice period. This contrasts with the owner occupied sector where selling a home and buying a new one can take significantly longer, particularly when there is a lack of capital available. This fetter on mobility has become more acute as a result of current market conditions where the number of homes being sold has dropped significantly. Flexibility is particularly important for young professionals before they chose to live in a particular area.

*Assisting regeneration*

Most regeneration schemes will contain a significant residential element and in many cases houses will be inappropriate, for instance in a central urban area. Many schemes previously contained small flats which were aimed at first time buyers and the buy to let market. The recent downturn in the housing market has meant many of these flats remained empty as buyers were unable to obtain mortgages for them. Building properties specifically to let in a regeneration area means they can link in more effectively with ongoing management of affordable housing and commercial property, giving extra continuity to schemes. If developers have longer term interests in holding properties they have incentives to get the mix of properties balanced in a way which creates desirable communities.

*Improving housing quality and management*

Large investors are more able to provide higher quality housing standards and better levels of management than many buy to let investors. It is likely that an investor will own all the properties in a particular block, rather than a fragmented arrangement of owner occupiers and buy to let landlords, making management more efficient and reducing costs. Management should also be more professional than in many cases in the buy to let sector. Although some buy to let landlords employ professional managing agents there are still a significant number who will carry out management themselves in addition to their day job. The whole sector needs to become more professional, as recognised by the Government in its response to the Rugg Review, and increased levels of institutional investment can help encourage this.

## Changes to the REIT Regime to Encourage Investment

*Allow for portfolio churn*

The structure of tenancies and the levels of yield in the residential sector mean changes would be needed to allow access to a REIT regime which is largely designed for commercial property. For example, leases in the residential sector tend to be for six months rather than the five to 21 years in the commercial sector.

In the commercial sector valuations are based on yield and the income either from the lease in place or a potential lease. Difficulties arise in the residential sector where there is competition with the owner occupier sector where value is based on other factors such as desire to live in a particular area or a particular property. Decisions made this way will not take into account potential yields.

To overcome this, large residential companies will rely on regular sales of properties, or churn, to access capital and provide a better return to investors. This differs from the commercial sector where net income yields are large enough to provide new capital for investment and dividends for individual shareholders. Potential residential REITs need reassurance that HMRC will not treat this as trading activity which would be taxable and put the company's REIT status at risk.

Two steps can be taken to help address the need for portfolio churn:

- An acceptable level for turnover of residential stock which HMRC will not consider trading activity.
- Specific legislation and guidance regarding acceptable business models for residential REITs. This should ensure affordable housing activity such as shared equity and discounted rents are within the qualifying tax exempt activities for a REIT.

*Address problems with the distribution requirement between residential and commercial property companies*

Issues with costs of repair and maintenance of property impact on the ability of a residential REIT to meet the 90% distribution requirement as a result of lower net yields. This arises because under commercial tenancies the tenant is responsible for repairs but the landlord is responsible under residential tenancies. This additional cost reduces the average net yields, including management costs that are achievable by residential REITs.

A further problem is the lack of capital allowances in the residential sector. Capital allowances are available on certain plant and machinery in commercial property and are deductible when calculating taxable profits (or the profits to be distributed in the case of a REIT). Lack of capital allowances represents an additional risk in terms of a residential REIT breaching the 90% distribution requirement.

Two steps can be taken to address these issues:

- The introduction of a wear and tear allowance to reduce taxable profits to which the distribution requirement applies based on a percentage of rental income.
- A reduction in the distribution requirements for residential REITs from 90% to 80%

*Amend gearing restriction to accommodate lower net yield*

One of the barriers to the establishment of residential REITs is that is most cases the yield is too small for a company to operate effectively under the current REIT structure. To address this issue changes should be made to the gearing restriction to accommodate lower yields from residential property.

Any residential REIT would be more reliant on income from sales of properties than a commercial property REIT. As a result the gearing restriction which is imposed by the 1.25 interest cover test is harder to satisfy than with commercial property. This happens because the profits section of the interest cover test only includes income profits and not capital gains from property sales.

Three steps can be taken to address this issue:

- Allow residential REITs to include capital sale proceeds in the profits section of the interest cover test.
- Provide a lower interest cover limit for residential REITs.
- Use a loan to value restriction rather than income restrictions.

*Allow AIM and unlisted REITs*

Currently a company has to be listed on a recognised stock exchange before it can convert to REIT status. 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.

To address this issue, the following step should be taken:

- The REIT regime should be extended immediately to include AIM listed companies.

## Changes to the Tax System

*Stamp duty—creating a level playing field*

Under the present stamp duty system landlords buying property in bulk are charged stamp duty on the full cost of the purchase. For instance if they buy 20 flats worth £200,000 each they will be charged at the 4% rate as the total transaction is worth £4 million. Twenty buy to let investors buying the same properties individually would only be charged at the 1% rate.

This disadvantages the institutional investor as they will pay stamp duty on the bulk price when individual buy-to-let investors pay a lower rate. This is not a significant problem in the commercial sector where the typical value of a property tends to be above the highest threshold. Stamp duty should be calculated on average individual unit price rather than the full cost of the investment.

*VAT—reduce or exempt VAT on maintenance and refurbishment*

With commercial property VAT can be reclaimed on services and costs associated with the maintenance of properties. This is an additional cost to the landlord and as a result further reduces the potential yield of a residential REIT. To address this issue the Government should consider reducing VAT on residential maintenance and refurbishment undertaken by residential REITs. RICS has been one of a number of organisations campaigning for a reduction in VAT to 5% for all renovation and maintenance work carried out on buildings. Further details of the campaign are available at http://www.cutthevat.co.uk.

*Changes to the planning system*

Encouraging dedicated build to let housing development would also help boost institutional investment in the sector. One of the main barriers to investment is the lack of suitable property which will attract sufficient yields. One of the most successful listed residential property companies is Unite which offers blocks of student accommodation. As a result they are able to limit their management costs and increase profits.

Build to let properties could be encouraged through changes to the planning system requiring them to be retained for rent for a set period of time. This would ensure that (i) properties would not be split and be bought by owner occupiers and (ii) would maintain a significant base of properties for investors.

It may also be necessary to consider changes to the Section 106 system so the costs of development are further reduced. Section 106 payments are levied on developments over a certain size to pay for transport links, local facilities and to support affordable housing. Payments can be funded by a for sale developer through the costs of people purchasing homes when built. There is no equivalent significant payment if the properties are to be rented, potentially penalising investors.

*May 2009*

## Memorandum by the Association of British Insurers

The Association of British Insurers (ABI) is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. Through the ABI their voice is heard in Government and in public debate on insurance, savings and investment matters.

We welcome the opportunity to respond to the House of Lords Economic Affairs Committee, Sub-Committee on the Finance Bill 2009 on the issue of restricting tax relief on pensions contributions for people earning over £150,000.

### Overview

— The 2009 Budget is a mixed bag for the UK insurance industry.

— We recognise the Government faces exceptional challenges and has few easy answers.

— While only affecting a minority of pension savers we are disappointed with the Government's decision to curtail tax relief on pensions contributions for people earning over £150,000.

— To maintain consumer confidence in the pensions system, the Government must give a categorical assurance that the historic principle of pension savers receiving tax relief on their contributions will not be undermined any further.

### Restricting Tax Relief on Pensions Contributions for People Earning Over £150,000

1. The move announced in the Chancellor's budget will not directly affect the vast majority of people saving for retirement. Nevertheless, it is vital that the value of savings for the vast majority of people is reinforced. Going forward we need a strong message to ensure people understand that, for most, tax reliefs are unchanged. Further, we need to strongly encourage savings.

2. Although only affecting a small minority, we are concerned that the Chancellor's announcement sends a worrying message on pension savings that the Government is now breaking its contract on tax relief. Tax relief compensates responsible people who agree to defer some income by locking pension savings away until they retire. That principle was enshrined by Lord Turner in his Government-backed report on pensions in 2006.

3. We would welcome a commitment from the Government that it will not further erode tax relief on pension contributions for income groups below very high earners. The ABI's State of the Nations Survey from 2008 showed that 50% of the working population are either not saving in a pension at all, or are not saving enough.

4. The move announced in the Budget is likely to be expensive for the industry to implement. Although being done through self-assessment, communication changes, for example, will reintroduce complexity and change to the pension framework, just three years after the Government's "A-Day" reforms. The "A-Day" reforms were presented as the new simplified framework for pensions. Complexity confuses consumers and puts them off savings.

5. The ABI believes it is vital there is detailed and effective consultation on the implementation of these changes and we welcome the Treasury's commitment to this. This should minimise the implementation and ongoing costs that these complex measures will impose.

6. Pension providers, advisers and customers need urgent clarification from the Government on the anti-forestalling measures that took effect from 22 April.

*May 2009*

**Memorandum by the National Association of Pension Funds**

Executive Summary

The NAPF believes:

- These proposals break the long established principle of EET under UK tax law;
- The proposals are a break with the long term framework for tax simplification introduced in April 2006. The complexity and arbitrary nature of the proposals will add a further administrative burden on UK pension arrangements and plan sponsors;
- The inclusion of employer contributions as a taxable benefit will be a disincentive for high earners to save through registered pension arrangements;
- The changes could have a secondary effect as many high earners are key company decision makers regarding remuneration strategy (including pensions) If this group becomes disengaged from pension saving there is a risk that these proposals could destabilise pension saving for lower earners in the company;
- High earners will pay obtain relief at 20% marginal rate but will pay tax on pensionable income at 40%, or even 50%, in retirement which is double taxation;
- That high earners will disengage from pension saving and target more tax efficient savings options so HM Treasury(HMT) are unlikely to raise their anticipated revenue stream of £3.1 billion;
- That the process of "deeming" (valuing) employer contributions to DB schemes is likely to be complex for individuals—who must account for this through self assessment—and their employers;
- The proposals are insufficiently flexible. In particular the definition of "regular contributions" should be amended—both during the Anti-Forestalling regime and the post 2011 regime—to permit annual contributions, as this is the basis on which company directors and the self employed contribute to pension schemes.

Introduction

1. The National Association of Pension Funds (NAPF) welcomes the opportunity to submit written and oral evidence to the Economic Affairs Sub-Committee on the changes to pensions tax relief proposed in the 2009 Finance Bill ("the Bill").

2. In making our submission, we have focused our comments on the likely impact of these new proposals on future saving via registered pension arrangements in the UK.

3. In common with the Treasury Select Committee, the NAPF believes that a proper debate on these proposed changes is required to identify some valid alternative proposals.

About NAPF

4. The NAPF is the leading voice of workplace pension provision in the UK. We represent some 1,200 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. Ten million working people currently belong to NAPF member schemes, while around five million pensioners are receiving valuable retirement income from those schemes. NAPF member schemes hold assets of some £800 billion, and account for over one sixth of investment in the UK stock market. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

## Background

5. In his Budget speech on 22 April 2009 The Chancellor of the Exchequer set out the Government's proposals for changes to pension tax relief. In attempting to explain the rationale for the changes HMT reported that tax relief granted to UK individuals earning £150,000 or more had increased significantly since 2003 and now constituted some £6.1 billion with the result that around 230,000 individuals received c.25% of total tax relief on pension contributions in the UK. HMT believes this to be a disproportionate application of pension tax relief which is unfair to those on lower incomes. However, this argument ignores the fact that, in large measure, tax relief on pension contributions is in fact tax deferral—relief is given at 40% on the build up phase while tax will be paid at 40% when received as retirement income by the saver.

6. The NAPF believes that the UK pensions system should not be used to affect income redistribution. This is more properly the role of the direct taxation system. If the Government is concerned about incentivising saving by lower income groups it should use some of the projected £3.1 billion pensions windfall that will be generated by this change to improve incentives for lower income savers and scheme sponsors.

7. The NAPF acknowledges the arguments for change regarding pensions tax relief set out by HMT but seeks greater clarity regarding these proposals which as presently outlined are open to challenge for a number of principled and practical reasons which are described in paragraphs 9–24 below.

8. The NAPF believes that these proposals, if implemented, are unlikely to achieve HMT's objective of raising £3.1 billion in additional revenue by tax year end 2012–13 as many individuals within the target income group will choose to discontinue saving via a pension scheme and will probably also divert some of the pension saving foregone toward more tax efficient alternative solutions through advice from professional tax advisers and remuneration and benefit consultants.

## The Potential Impact on UK Pension Saving

*The Principle of EET*

9. Within the UK pensions system saving for retirement has always been regarded as deferred expenditure, ie saving from occupational income while employed (often for around 40 years) to provide an income for retirement. Deferred taxation is a practice which has been both encouraged and sustained by the principle of EET—Exempt (pension contributions both employee and employer where applicable) Exempt (investment growth and income) and Taxable (pension or retirement annuity is taxed at the relevant marginal rate of income tax being based on an individuals circumstances when retirement benefits come into payment).

10. The proposals within the Bill would erode this principle in two ways:

- — Tax relief for those earning £150,000 or more would no longer be given at their highest marginal rate but would be reduced on a tapered scale from 50% at £150,000 to 20% for those who earn £180,000 or more.
- — Secondly for those individuals earning in excess of £150,000 employer pension contributions payable on all "relevant income" (as defined by HMT) would lose their exempt status and be a taxable benefit in the hands of employees and become subject to a tax charge at the relevant marginal rate for that individuals' level of income. For Defined Benefit schemes, however, HMT have acknowledged that placing a "value" on the employer contribution element of benefit accrual will not be straightforward and to this end they have suggested an industry working group to formulate options on this key aspect of the proposed changes. These two aspects of the Budget changes are the most damaging and a big disincentive for high earners continuing to save via a pension scheme when potentially a significant additional tax bill, through self assessment, may be the outcome.

The NAPF has modelled a range of calculations which compare the existing treatment of pension tax relief for high earners with the treatment proposed under the new regime. This impact assessment table is appended to this evidence submission as Annex A.

*Administrative Complexity*

11. These proposals will impose another layer of administrative requirements onto pensions saving only three years on from the tax simplification ("A" Day) changes introduced on 6 April 2006 under Finance Act 2004. The NAPF calls on HMT to deliver a full cost benefit analysis (Regulatory Impact Assessment) of the introduction of these new proposals on pension scheme and payroll administration.

12. The "A" Day changes were intended to remove the multiplicity of eight different tax regimes for pensions since 1970 and establish a single long term framework for the assessment of tax on UK pension saving built upon the interaction of the Lifetime Allowance (LTA) and the Annual Allowance (AA) and the principle of EET.

*Anti—Forestalling Regulations*

13. The changes proposed in the Budget are intended to be effective from 6 April 2011 but interim Anti–Forestalling Regulations have been introduced from 22 April 2009 (Budget day) to restrict what Government would regard as over excessive use of existing tax reliefs by payment of significant pension contributions during the two year period before the new regime is in place. In effect all the extensive planning, consultation and significant expense of the "A" day changes will likely be lost within three years as tax simplification as envisaged under Finance Act 2004 has not even been maintained through its transitional period until 5 April 2011.

14. The Anti-Forestalling measures undo a cornerstone of the 2006 pension tax reforms by the introduction of a new restrictive special allowance which caps relief on pension contributions for each individual in tax years 2009–10 and 2010–11 to £20,000 per annum and thereby seriously dilutes the existing Annual Allowance (£245,000 for 2009–10 and £255,000 for 2010–11) permitted in each of those tax years. Whilst we acknowledge that most contributors do not pay pension contributions of £245,000, the average annual contribution from among the high earner group is c.£64,000 gross so the £20,000 per annum special allowance ceiling is a significant reduction in the amount that these individuals can save over the next two years.

*Impact on Lower Earners*

15. The fall out from the removal of the principle of EET (see paragraph 9 above) and yet more new regulation could well have the negative effect of disincentivising those key executives and senior managers who have responsibility for remuneration strategy within an organisation.

16. In sum if these decision makers are disengaged from company pension provision as a result of the Budget changes, pension provision for lower paid employees could start to be undermined. These decision makers may conclude that the proposals contained within the Bill are a starting point to significant further erosion of the tax advantages which underpin workplace pension provision.

17. Moreover, the impact of these new proposals—so soon after the "A" day changes of April 2006— may mean plan sponsors will decide that the constant "revolving door" of regulation means good workplace pension saving is simply too expensive and complex to maintain in the medium to longer term.

18. Similarly the introduction, or modification, of salary sacrifice schemes with regard to pension contributions which allow plan sponsors and employees to derive a benefit on National Insurance Contributions (NICs) and thus help keep the scheme affordable may be deferred or even abandoned as high earners will now be ineligible under the proposed new rules.

19. Some large UK listed corporates and the consultants who advise them have suggested a potential change in the remuneration packages for senior executives (eg 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.

20. The introduction of the special allowance of £20,000 contained within the Anti-Forestalling Regulations 2009 appears arbitrary largely because HMT have not adequately explained the rationale for this new pension tax relief limit (ie equivalent to only 8% of the extant 2009–10 AA and 7% of the AA for 2010–11).

21. The special allowance will remain static at £20,000 in 2010–11. The failure to uplift both this allowance and the £150,000 trigger point for relevant income in line with average earnings is likely to bring more individuals into scope each year. The NAPF would support an uplift in line with average earnings. A precedent for just such an uplift is being written into the Personal Accounts Scheme rules as the initial annual contribution limit of £3,600 is being annually uprated in line with average earnings under the Pensions Act 2008.

22. The impact on ordinary pension savers who do not follow the minimum requirement of quarterly pension contributions could be counter productive for individuals across a range of different circumstances (e.g the self employed or company employees upon redundancy) who through making additional or "one off" pension contributions seek to maximise tax efficiency and obtain the best outcome for themselves with regard to retirement income.

23. The NAPF believes that once interim measures designed to prevent overpayment by high earners also impact on other pension savers outside this target group this impact completely negates the notion of fairness which HMT have stated is one of the primary policy aims which underpin the proposals in the Bill.

*Unintended Consequences*

24. With specific reference to defined contribution schemes, if a high earner decides to pay higher employee pension contributions in order to receive a higher rate or matched contribution from their employer they may find that through being responsible and proactive with regard to pension saving their combined contribution inadvertently exceeds the new interim contribution limit of £20,000 per annum. As noted in paragraph 21 above the special allowance will remain static at £20,000 in 2010–11.

Alternative Proposals

25. For all the reasons stated above the NAPF believes that alternative proposals to the treatment of pension tax reliefs for higher earners should be sought. These proposals may want to consider:

- Maintaining the status quo.
- Reduction in the level of the Lifetime Allowance.
- Reduction in the level of the Annual Allowance.
- An increase in the level of the special allowance of £20,000 per annum.

The Treasury Select Committee reported on 6 May 2009 "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".

26. The NAPF proposes 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.

27. 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 sufficent incentive for high earners to continue pension saving through registered pension arrangements.

Conclusion

28. The NAPF believes that the proposals within the Bill while predicated on a notion of fairness and with a practical aim of policy consolidation on the tax relief on pensions are at best arbitrary in nature—particularly with regard to the interim Anti-Forestalling arrangements and will deliver unintended consequences which will damage pension saving in the UK.

29. Of greater long term significance the removal of the principle of EET leaves all workplace saving potentially vulnerable to the new, less tax-incentivised approach to all savers regardless of level of earnings a situation only likely to further discourage ongoing support for pension provision at a time when occupational schemes are under considerable pressure to survive.

30. Pension Managers, Finance Directors and HR professionals consistently request a reduction in complexity with regard to pensions. The NAPF have been foremost in arguing the case for a regime which offers good practical incentives and protection for savers but which allows employers respite from unnecessary regulation.

31. It is our view that the pension tax relief proposals set out in the Bill are designed as a short term policy fix to maximise revenues and reduce the public sector finance gap but are flawed in terms of meeting that financial objective as most high earners will disengage from future pension saving. In the longer term the proposals may be detrimental to the behaviour of all those responsible individuals who want to make adequate provision for their retirement. Moreover, they are likely to have the negative effect of destabilising pension provision for lower paid employees.

32. The Government (HMT) has promised to consult on these proposals and consequently the NAPF believes that we should enter that consultation process with a view that these proposals are ill conceived, will fail to meet their primary objective and should be fundamentally rethought and revised accordingly.

*18 May 2009*

**Annex A**

IMPACT OF PENSION TAX RELIEF REFORM: EXAMPLES

| *Example* | *Gross income* | *Pension contribution rates (%)* | | *Gift Aid (£)* | *Trading losses (£)* | *Extra pensions tax (£)* |
|---|---|---|---|---|---|---|
| | | *Employee* | *Employer* | | | |
| 1 | 155,000 | 8 | 10 | 0 | 0 | 0 |
| 2 | 170,000 | 8 | 10 | 0 | 0 | 476 |
| 3 | 180,000 | 12 | 8 | 500 | 0 | 1,080 |
| 4 | 220,000 | 10 | 8 | 1,000 | 1,500 | 9,680 |
| E.gs. 5&6 show how an employee can reduce his tax liability by accepting reduced employer contributions and replacing them from his own pocket. | | | | | | |
| 5 | 220,000 | 8 | 10 | 0 | 0 | 10,120 |
| 6 | 220,000 | 10 | 8 | 0 | 0 | 9,680 |
| 7 | 175,000 | 10 | 15 | 0 | 0 | 1,937.5 |
| 8 | 175,000 | 0 | 0 | 0 | 0 | 0 |
| E.gs. 7 & 8 are identical, but no. 8 makes no pension contributions. No.7 saves in a pension, but pays £1,937.50 in extra tax as a consequence. | | | | | | |
| E.gs. 9 & 10 compare the same person. He receives a £5k pay rise, which means an extra £1,350 pension contributions—but £1,882 extra pensions tax. | | | | | | |
| 9 | 175,000 | 7 | 20 | 0 | 0 | 4,774 |
| 10 | 180,000 | 7 | 20 | 0 | 0 | 6656 |

In e.gs 7, 8, 9 and 10, the gross pay includes a £20k non-pensionable bonus

In every case, these individuals will also pay an extra £3,237.50 Income Tax due to the loss of the personal allowance above £100,000.

**Examination of Witnesses**

Witnesses: Ms Maggie Craig, Director of Life and Savings, Association of British Insurers and Ms Joanne Segars, Chief Executive, National Association of Pension Funds, examined.

**Q123** ***Chairman:*** Welcome to the Finance Bill Sub-Committee. Thank you for making time to be here. If I could ask you to speak reasonably slowly and clearly that would be very helpful both for the stenographer and for Members; and if you could introduce yourselves when you first speak that would also be helpful, particularly for the web broadcast. Do you want to make any introductory remarks or shall we move straight into questions?
*Ms Segars:* I think we are both happy to move straight on to questions.

**Q124** ***Chairman:*** Let me start. How well did the new rules for the taxation of pensions work in the three years from A day? Did they provide all the features that were intended at the time: that is, simplicity, certainty, flexibility, consistency, choice with reduced costs, and could they be readily understood?
*Ms Segars:* I will start. My name is Joanne Segars; I am the Chief Executive of the National Association of Pension Funds. We represent around 1200 pension schemes in the UK and 400 businesses providing services to those pension schemes. From our perspective we would say that the 2004 Finance Act changes are now working well and I think that is largely because of the huge effort that pension schemes and employers who provide pension schemes, working with HMRC together with the insurance industry, put into making those proposals work well. I think that merging eight different tax regimes into one tax regime and having a consistent tax regime across different types of pension arrangements was something which was welcomed and was something which was pushed for by the industry and has now bedded down, and our concern, as you know from our evidence, is that that has now been significantly disrupted.
*Ms Craig:* My name is Maggie Craig; I am the Director of Life and Savings at the Association of British Insurers. We represent about 90% plus of the insurance market in the UK, so a great deal of pensions business within that. I would pretty much echo Joanne's comments; we think that the rules that were brought in to simplify were pushed for by everybody and worked pretty well. The simplicity, which matters a lot because everyone knows that complexity confuses people who go in for pensions, whether it is complexity around their own particular situation or the subject in general, so I think the simplicity did work. It also helped quite a bit in putting in a degree of stability because there was a backdrop of change upon change upon change in pensions' legislation, so A day kind of drew a line in the sand and said, "That is it; we have stability now" and I think that that simplicity and stability has now been jeopardised.
*Ms Segars:* It is probably worth adding that the reason we put in so much effort and so much time and cost was that trade-off because we knew that we were signing up to something which was there for—we cannot say in perpetuity because nothing in pensions is there in perpetuity—certainly longer than three years. I think it was that sort of trade-off that has now been disrupted too.

**Q125** ***Chairman:*** So you both feel that the measures now proposed really run counter to the earlier changes. How significant an issue is this really? Or is it simply an attempt to persuade the government to water down the current proposals in some way or another?
*Ms Segars:* From our perspective, thinking about employers who offer pension schemes and the employees who belong to those schemes, simplicity is absolutely essential. As I said, that was the spirit in which we entered into the simplification exercise. Simplification sounds very good but it was a very, very complex process getting to the simple regime in which we now find ourselves. 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 currently—if I can use the word—"flipping" around.
*Ms Craig:* I think we would agree with that. 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 that means it can be very difficult to get the employers to engage with pensions; we know that workplace pensions are very important and a very valuable conduit for pensions schemes for ordinary people. So it is that undermining of confidence there. The other thing is, as I said, there is a backdrop of change going on here so 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.

**Q126** ***Chairman:*** One specific point. One effect of the 2004 Finance Act changes was to bring the legislation on the taxation of pensions closer to that of pension

legislation. Has this now been lost and, if so, does that matter?
*Ms Segars:* One of the things that we certainly welcomed was the fact that DB and DC pensions would be treated consistently, and that was certainly one of the very important simplifications to come out of this regime. I think it is unclear to us, certainly—maybe the ABI have a different view—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.
*Ms Craig:* I think that is true. Again, because pensions tend to be very complex and people are not necessarily very interested in them. The simpler you can make it and the more level the playing field you can make it the easier it is for everyone. It is not clear to us, as it is not clear to Joanne's organisation, exactly where we have ended up here, whether DB and DC are on exactly the same level playing field. 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 gaming 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. Once you start introducing complexity, whichever clever person thinks up the complex arrangement there will be another clever person who will be finding a way around that complex arrangement, and it is impossible to say at this stage what they will be but pensions history is full of complexities that somebody else finds a way around, to be honest.

**Q127** ***Chairman:*** Not just pensions!
*Ms Craig:* Not just pensions, no!

**Q128** ***Lord Wakeham:*** You make a very good point about complexity and simplicity and the uncertainties that these changes might make that might bring other changes. I have to say that you are less convincing when if you are going to have any complexity at all that it is probably the high earners over £150,000 or whatever it is, if there has to be complexity perhaps that is the best place for it to be and not for everybody else. But leave that on one side. What I want to ask you is this. You think that the employer contributions as a taxable benefit will be a disincentive to high earners—and I can see that as well—but what I would really like to ask you is what do you think the effect of all of this will be on the competitiveness of UK business?
*Ms Craig:* I think that is a very difficult one to quantify. 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. The other point there is also about having disincentives to save for the long term in retirement. At the moment a high earner would have a disincentive to save. They might then think, "I have this higher tax rate as well." They are also thinking about what does that mean in terms of how they structure their business, what do they do with their business? If you look a small entrepreneur who is trying to build up his business it may not be UK global but it can be very important for the way that people bring their business through and they may just decide that they are going to go somewhere else. It is very difficult to quantify, I am sorry.
*Ms Segars:* I think I would agree with that. It is very difficult to estimate that at the moment, certainly in the absence of any real detail around the proposals. I think, as Maggie has said and we would agree with it very much, that 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. If I may comment on your comment about if anybody could understand the complexity it is the high earners. We have been looking at this and the impact it will have on high earners many of whom will need tax advice about whether or not they should save in their company pension scheme and that seems to us to be daft—saving in the company pension scheme should frankly be a no-brainer. If you have to go to a tax adviser about whether it is best to save in a pension or take shares because you are only paying CGT at 18%—that is not what pensions were set up for.

**Q129** ***Lord Wakeham:*** What I was really getting at was the idea that changes upset people's view, I can understand that completely. If it is necessary for the complications to be as they are is another matter, but it is probably easier to deal with it on the high earners than it is across the population.
*Ms Segars:* I accept that.

**Q130** ***Lord Wakeham:*** Can I ask another question and that is that there is some doubt, in your views as I understand it, whether these measures will raise the projected tax take of £3.1 billion by 2012 and that savers will use alternative more tax efficient savings solutions. Do you think that that is a pretty serious problem?
*Ms Segars:* I think it is a serious problem and as we have been looking at these proposals and as we have been talking to our members and to advisers who are advising companies and individuals they are certainly suggesting to us—and Maggie, your comments

echoed this too—that new ways of remunerating this group of individuals will be sought. It might involve, as I have just mentioned, paying them with more share options on which they may just pay Capital Gains Tax at 18%. So the Treasury may well be disappointed with the tax take that will accrue to them. We would be very interested to see the Treasury's modelling on this as we have not seen that so far; we will be interested to see that because I think that will be helpful in our assessing the impact of these proposals because clearly we want as many people to save in pensions as possible.

**Q131** ***Lord Blackwell:*** Can I just draw attention again to my interests as a director of a Life and Pensions Society, which is indeed a member of the ABI. Before I go on to the next question can I just pick up one point about this tax on the higher earners? When it was originally announced in the budget there was quite a lot of uncertainty in the press reports as to how this would impact on DB schemes, and in particular whether it would just apply to contributions or whether the incremental benefit arising from somebody having a salary rise, for example, would be subject to this high rate of tax. Has that now been clarified in subsequent discussions or is that still a point of uncertainty?

*Ms Segars:* We need to distinguish between the two regimes—the anti-forestalling regime which came in immediately on April 22 and which runs until 2011 and the subsequent regime, the post-2012 regime. Our understanding is that salary increases or job changes will fall within the normal definition of earnings and contributions during that anti-forestalling period, so I hope that answers your question. Again, it is the sort of information on which we need more information and more clarity from Treasury as soon as possible because advisers are out there trying to advise their clients and they are finding the absence of firm information quite difficult in this area.

*Ms Craig:* As Joanne said, we need to be careful to distinguish between the imposition of 2011 proposals and the forestalling. A few comments there. Originally, even in terms of what was happening with the proposals from 2011 we were quite confused by exactly what was proposed, particularly in terms of how the slicing effect on tax earnings above £150,000 would actually pan out. In fact I had two colleagues who went to two separate meetings where officials explained and they each came back with a different interpretation of how it was going to work.

*Ms Segars:* And we probably had a third!

*Ms Craig:* I think you probably did! I think we are getting there with that, but in the anti-forestalling there is still quite a bit that we feel we are not absolutely sure that it is going to work. We are also quite concerned in terms of this idea of if you have an established pattern of contributions—what exactly is a pattern? Also particular cases where people might lose out. If someone, say, is taking ill health early retirement or is made redundant or sells their business with a view to putting in a very large contribution in the last couple of years before retirement how exactly that will work, because you do not have that pattern of contribution. I would be happy to provide more written evidence on some of these particular cases if you thought that would be of interest. But at the moment we are trying to work through. We appreciate that you cannot write legislation that picks up every single individual scenario but we do think that there are some wrinkles in there that do need to be ironed out.

**Q132** ***Chairman:*** We would be happy to take further written evidence.

*Ms Segars:* We very much echo that view that the definition of normal contributions for a quarterly pattern is far too rigid and it does not take account of the flexibility that the new tax regime that you described earlier has encouraged and sought to encourage quite deliberately, particularly where self-employed people are concerned where it would be normal—although not the normal pattern of contributions—for them to use the proceeds of the sale of their business to augment their pension; likewise for tax reasons with redundancy payments. So all of these are issues that need to be looked at, but looked at very urgently indeed in our view.

**Q133** ***Lord Blackwell:*** Can I move on to ask about what you describe as the EET principle and the way in which in your submission you say that you believe that has been broken. But there is of course still relief on the pension contribution, albeit at a reduced rate. Could you first explain what the EET principle is and why you believe it has been broken and whether that is a fair criticism?

*Ms Segars:* The EET principle has been enshrined in UK pensions' legislation for decades; it is a very long established principle where the contributions are exempt, the investment roll-up is exempt, and the proceeds of the pension are taxed on the way out as income. That principle was established in order to encourage long term saving, to encourage people to lock their savings away for 40 years and that is why it is a very different regime to short term savings such as for ISAs, for example. I think these proposals break that very important principle for two reasons: first of all, because there is now a significant element of taxation on employee contributions that were previously completely tax free at somebody's marginal rate; secondly, because there is now a completely new tax on employer contributions. So whereas previously one might have got relief at 40% but paid 40% tax as income on the way out that position has now changed quite significantly. So, for example, for somebody who earns £155,000, who receives a bonus of £20,000, who has an employer contribution of about 20%, an employee contribution of 8%, they will face a new tax bill of £3,800 as a result of these changes. I think it is also worth pointing out that the changes effectively mean that there is now double taxation in the pensions tax system because somebody who is earning over £180,000 will receive relief from their own contributions at 20%; they will pay a tax on their employer contributions of 30%, but they are likely to be taxed at 40% on that pension when they receive it. Notwithstanding the tax free lump sum they are still likely to pay tax at 40%. In fact in 2007/8 over 210,000 pensioners did pay tax at 40%, at the current higher rate, which is almost the same number of people who will be affected by these changes. So we do think that it does break that very, very important principle. It is not an arch point, if you like, but it is a very important point and it goes back to the very central point that Maggie talked about earlier on, which is that if these individuals are disincentivised from saving in a pension they may disengage from pensions altogether. The affected group are the company pension's decision-makers, and we know certainly where DB pensions are concerned scheme are under enormous pressure and we are seeing announcements today about another Defined Benefit pension scheme closing for example. We have in the private sector only 28% of Defined Benefit pension schemes still open to new members. 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.

*Ms Craig:* Could I add a little to that, just to build on Joanne's points? The other thing that concerns me here is the overall message it sends because having broken the principle you have taken that watershed, the Rubicon's crossed, whichever way you want to phrase it, and that then raises questions in people's minds that it has only affected very, very high income people at the moment but what happens next time? Does it come down the income bracket? That is my thin end of the wedge concern, that having started with the higher income bracket it then comes down and down and down. That was why we would really like some statement that says that that is not the intention. I think that is particularly important as we are moving forward to 2012 with significant pension reforms coming in, and at the moment—although I hope very much that that will change over the next few years—we do not have a clear government message that says it is a brilliant idea to save for your pension. So we do not have that message at the moment; we have significant reforms coming down the line. I know that one or two of my member companies have actually had customers on the phone saying, "I gather that tax relief has been cut" and they then have to explain to the customer that actually no, it does not affect them because they are well below that level. So there is something there about setting a precedent that people will fear will be applied lower down the income bracket and just the kind of general perception that it is no longer as good to save in a pension scheme.

**Q134** ***Lord MacGregor of Pulham Market:*** Could I just follow up on the change in the employer contributions because am I right in thinking that this is a new principle that has been introduced into the pension legislation, so that not only has it changed the certainty of the A day and all the rest of it, but it has actually created a new principle which might be followed up as a precedent in later finance bills. Is this a worry that some of your members have and, if so, will it be a further disincentive to carry on with Defined Benefit schemes, or the other way around and would it be a further incentive to keep closing it to new employees?

*Ms Segars:* I think it is an enormous worry and you are right, it will be a disincentive for employers to contribute particularly to DB schemes but to Defined Contribution schemes as well. We have very well established principles and employer contributions are made tax free of corporation tax so it is an incentive for employers to make that contribution. I think the thin end of the wedge point which Maggie made is of enormous concern. There is 'form' here in terms of pensions, if you like. One can point to the abolition of Advance Corporation Tax, which Norman Lamont first restricted and then Gordon Brown abolished altogether when he was Chancellor. We have seen an increase in the number of individuals who are now covered by the current annual allowance and lifetime allowance. I think the HMRC originally estimated it would be 5,000 people and it is now something like 22,000. So you can see how there is a creeping expansion of the coverage of what are supposed to be targeted measures but actually become much more widespread, and which have very significantly undermined pensions. So that would be a very considerable concern of ours.

**Q135** ***Lord Sheppard of Didgemere:*** If we can come to the subject of consultation, which one did think had come a long way the last time but I wonder if it still has. Would it have been possible and HMRC to have consulted on the substantive changes that have taken place but also the anti-forestalling provisions before the Budget day? The next point is, from what you have said I gather that what has happened since

has not been very satisfactory in terms of the explanation building up if you could not do it before the event, and even after the event it has not been perfect. Am I right?
*Ms Craig:* I think so. We appreciate, obviously, the sensitivities around this, but we do think that there could have been proper consultation on the substantive changes, particularly as they could have brought the anti-forestalling in. Even beyond that, we do try to work very responsibly with government. 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. We do accept, and it is actually perhaps a function of the complexity, the annualised adjusted net income, whatever it is, I have not got my head round it yet, that there are a lot of difficulties there, so I think the consultation could have been better and I think that the explanations could have been better. Again, that just creates a feeling of uneasiness, and it goes back to the stability point, where, as you say, having got to a position where there were good consultation arrangements, we seem to have gone off the track.
*Ms Segars:* I very much agree with that. 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. All the parties worked together on the detail to arrive at something which may not have been the simplest solution, but was one which, nonetheless, everybody was brought into and understood, and a collective understanding was important, given the complexity. 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. In terms of what has happened since April 22, we have had a number of meetings with the Treasury, they have been available to answer our questions and, I think as Maggie hinted earlier, the more we know about this, the more questions we have about it. They are now going to start the formal consultation process, we understand, where they will involve representatives of the industry, from the ABI and the NAPF in particular. We will be very active participants in that, I am sure both organisations will be. It is very important that that process starts and starts quickly. But these are such significant changes, because of the precedent that it sets and because of the wider implications that we have talked about, that we really do feel that it would have been better if the Treasury had been able to talk to us beforehand, as Maggie said, not necessarily with all of the stakeholders, but certainly with those stakeholders whose members are most affected by this.

**Q136** ***Lord Sheppard of Didgemere:*** If I may ask my final question which, Chairman, you may want to rule out of order before it is answered, you cannot decide who the next Government is, although you have got more votes than I have got in deciding what the next Government will be or whatever happens, but do you attempt to consult with potential other parties, the Conservatives, Liberals, whatever?
*Ms Segars:* We will certainly be having discussions with the major opposition parties, yes, and we have scheduled meetings with them to ascertain their views and to discuss the issues with them and to discuss the pitfalls with them, yes.

**Q137** ***Lord Wakeham:*** Would you think that an explanation as to why there was no consultation, and you cannot think of any good reason why there should not have been and there have been consultations before, is there one explanation, that the HMRC were required to bring the proposals forward in rather a hurry and that it just did not have the time to do it? That would be logical, would it not?
*Ms Segars:* It would be logical. There is not very much detail in the proposals, as we have talked about, but there has clearly been a lot of thought that has gone into the proposals, certainly in some of the ways that it blocks off salary sacrifice arrangements, for example. I am not sure these were quite made up on the back of a Whitehall fag packet, but it seems to me that there has been some thought that has gone into them and, therefore, we would have been, at very short notice, very pleased to have contributed to the consultation.

**Q138** ***Lord Wakeham:*** So what is your explanation of why there was no proper consultation?
*Ms Craig:* I do not know. I do not know whether it was felt to be too sensitive, which may have been the case, although I think anti-forestalling would have picked that up. I honestly do not know, but it is the only explanation I can think of.

**Q139** ***Chairman:*** There is just one other item on consultation. To what extent do the issues on which consultation will take place on the substantive change arise on the anti-forestalling schedule and need to be resolved now?

*Ms Segars:* They absolutely do need to be resolved now. There are individuals who need advice on what they should be doing with their pension arrangements and they need that advice now.
*Ms Craig:* I think the other thing is that sometimes in conversation one gets the impression that they say that this is not really a problem for the employer, the provider, the adviser or anybody else because all this will be done through the individual's tax return self-assessment, so there is no cost or hassle for my members. Well, actually, there is a bit. All the literature that our member companies provide to customers explaining tax relief will have to be looked at because it will no longer be correct for some customers, and that will have to be done for the anti-forestalling and it will have to be done for 2011. If we are training staff to answer customer queries, if the firm is giving advice, all of these things do change. I am not suggesting that that is a mammoth systems cost or anything, but the idea that this is being done through self-assessment and, therefore, it is only the individual who has to make a change, I think, just does need a little bit of correction.
*Ms Segars:* I would agree with that.

**Q140** ***Lord Blackwell:*** Is there a risk then that there could be mis-selling claims arising out of this, that people carry on buying products where there is inadequate literature and the advice is wrong?
*Ms Craig:* Put it this way: it is very difficult to know how to advise someone when you do not understand, and you do not have a proper handle on, what the arrangements actually are. I fully accept that these are people at the top end of the income bracket and they are more likely to have advisers, but those advisers need the information with which to work, so yes, and I think it goes to Jo's point earlier. It used to be an absolute no-brainer, that your employer runs a pension scheme, pays a contribution into that and, if you go into it, it is bound to be good for you, but that is just no longer certain. In particular, on the anti-forestalling, if you are self-employed or you are someone whose earnings include a large piece of bonus or whatever, you might not know what your earnings are going to be until very late in the day, so how are you supposed to go to your adviser and get advice when he will not know, because you do not know what your earnings are, what your tax relief is going to be, so it will be very difficult to advise.

**Q141** ***Lord MacGregor of Pulham Market:*** One of the possible explanations for the lack of consultation is that the Government may have felt that they needed the extra revenue, irrespective of the criticism that it may not be there, and realised that there would be this tremendous criticism, which you are now putting forward, of the proposals, so they may have thought that it was better not to consult in advance, but simply introduce the legislation.
*Ms Segars:* I certainly think that that may be a large part of what lies behind the lack of consultation, absolutely. In that regard, I think that the Treasury and the Government need to be very clear about what is driving these changes. Is it the need for the £3.1 billion, regardless of whether we think they are going to get that £3.1 billion? Is the primary driver an issue around fairness of individuals receiving tax relief at 50%, or is it the need for, primarily, £3.1 billion in tax-take? I think that, if it is the issue of fairness, that perhaps takes you down a different route or a different set of options in terms of policy prescriptions and ways in which one might tackle this issue. If it is, "Well, actually we just need to get our hands on £3.1 billion", it takes you down a different set of options. I think it is very important that we, as stakeholders, understand actually what is the primary driver here for the Treasury.

**Q142** ***Lord MacGregor of Pulham Market:*** Following on from the earlier discussion, the very recent one, are there any significant problems with Schedule 35 or matters which are not properly covered? Now, the NAPF questioned the special allowance figure of £20,000, but what figure would you have felt happier with, given the approach of the Schedule, and does the figure of £20,000 include employers' contributions and, if so, was the importance of this reflected in the Budget's explanatory material?
*Ms Segars:* Perhaps I can take those questions in reverse order, if I may. In terms of the £20,000, this again is a figure where, I think, we need to distinguish between the anti-forestalling regime and the post-2011 regime. We certainly have been told by the Treasury that post-2011 the £20,000 figure for establishing somebody's adjusted net adjusted income, on which the individual's pension tax relief figure will be calculated, is just the employee contributions. We believe that also to be the case in terms of the anti-forestalling measures, but again we are not clear, we have had slightly conflicting messages from the Treasury on that, so clarity on that is something which we need urgently. In terms of our questioning of the £20,000 figure, that really related to the post-2011 regime for establishing somebody's snappily titled 'adjusted net adjusted income' figure. I think again that part of our questioning was to do with the fact that we cannot understand how the figure of £20,000 was arrived at; it seems slightly arbitrary to us. It is less than 10% of the annual allowance, which is currently £245,000, it is about a third of the amount, on average, that people in this income group are saving, so we cannot quite understand how the figure of £20,000 was arrived at, and maybe that was one of the figures that was

arrived at in haste at HMRC or the Treasury, we are not quite sure, so we would certainly like to see the analysis which led the Treasury to arrive at this £20,000 figure. I think that, without that, we cannot then answer your more substantive question about what would we like it to be. I think there is certainly a case that could be made for pushing that higher because it does quite significantly reduce the amount that individuals can take into account in terms of their tax relief, but also the amount of contributions which they can, in effect, make to their own pension scheme. Therefore, it has a significant impact on the amount that they are likely to save in a pension and their ultimate retirement income. I think there is a case for saying, "Well, as we look to refine these proposals and as that consultation process is considered and as we, perhaps, consider a range of alternative options, actually one of those alternative options could be increasing, for the post-2011 regime, the figure of £20,000 for ANAI purposes". 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:* Particularly in view of the fact that we are not quite clear exactly what is going to constitute a pattern of normal contributions, so 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.

**Q143** ***Lord Best:*** How do you see the issue of protecting those who made irregular or annual contributions being tackled? How would you improve the flexibility of the provisions? Then, linked to that, how do you see defined benefit, including unfunded schemes, being covered, particularly, as the NAPF say, with regard to employers' contributions?
*Ms Craig:* I talked a little bit about this earlier, and I think what we need to do is to come up with a rather better list of those people who do make irregular or annual contributions, whether it is people who are self-employed or whoever. If your pattern, for example, is that you get a bonus and every year you put in half of your bonus, but your bonus varies from year to year, that is a pattern in one sense, but it is not necessarily a figure that turns up the same every year, so it is that kind of thing. We are working through that at the moment, and I think that there are two types in my head. One is a pattern of somebody who is continuing in work, for whatever reason, whether they are paying in bonuses or whatever, and the other is what happens to those people who have been using the current allowances to kind of make a last push for their pension, whether it is because they are about to be made redundant, ill-health, early retirement or the self-employed. Unfortunately, I have not got all of that yet because we are still trying to work a bit with shifting sands, but I would be happy, once we get a bit more on that, to put that in as written evidence. I think those would be the main things, but, Jo, do you want to pick up on that?
*Ms Segars:* In terms of dealing with defined benefit pension schemes, this is clearly a very important issue and it is clear that, whatever the outcome, it needs to be simple both for the individual to understand in order to put it on their own self-assessment form, because again the Treasury has said somewhat sweepingly, it seems to me, that this will not involve employers at all and it will all be for the individual to deal with in their self-assessment form. Well, the employee has got to have the number from somewhere and it can only come from their employer in the case of defined benefit pension schemes, so it needs to be simple for the individual, but also for the employer. Just picking up your point on unfunded schemes, clearly the largest unfunded scheme in the country is the one in the public sector, the Principal Civil Service Pension Scheme, and so on, so it is absolutely essential that the regime is consistent across funded and unfunded pension schemes, the public sector and the private sector, and that it works for both, but also that the public sector is not excluded from these arrangements; I think that really would cause uproar. We have asked the Treasury about that and it is their intention that the public sector is included in the same way. Exactly how one deems DB contributions, employer contributions, is, as I said, very, very difficult and the Treasury recognise that. Our principal view on this is that it would obviously be better to exclude employer contributions altogether, but, if the Treasury's motivation is a tax take of £3.1 billion, then clearly the lion's share of that comes from employer contributions. The simplest option, we think, at this stage is that which is set out in HMRC guidance, which was published after the Budget, where the simple formula would be used to calculate the value of pension saving at the end of each year and the individual would be taxed on the difference. We are clearly looking at different options of how one might do this. The Treasury has just established a working group on that and in fact, just as I left the office, I had an email inviting us to join that working group. We are pleased that they are putting work in on that very quickly indeed because it is going to be very complex and it will involve employers making some changes to the way in which they communicate with their scheme members on this very important issue. We both talked about the level playing field earlier on and we think that the regime needs to be as level as possible between DB and DC and the deeming of DB

contributions needs to be actuarially fair, so there are a number of principal points on which we will enter the consultation phase with the Treasury. But we will be looking at other options and obviously we would be very happy to provide further information once we have done that.

**Q144** ***Chairman:*** Could there have been any other way of achieving the same objective of limiting the cost of relieving pension contributions by high earners and raising similar sums, perhaps by restricting the annual or the lifetime limits, and, if so, why not?
*Ms Segars:* I think there are four options that spring to our minds. One would be limiting the annual allowance, and a number of organisations have suggested that, including a number of consultancies, 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 those and again we will be looking at the pros and cons of each of them, in particular. I know that the Treasury raised this when they gave evidence to the Treasury Select Committee, and the impact it could have lower down the income scale and ensuring that these proposals stay targeted. Another option, as I have mentioned, would be raising from £20,000 to a higher figure the amount that is included for assessing somebody's adjusted net adjusted 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-enrolment and mandatory employer contributions coming on stream in 2012, these things could be tied up, so I think there are other ways of doing it. If the consultation process, to go back to your earlier questions, had started earlier, I think we in the industry would have put our heads together and come up with some of those more innovative solutions.
*Ms Craig:* I was just going to say that. At the risk of sounding irritated, if we had had the chance to consult, then we would not be sitting here, thinking, "Oh, we've got this. What do we do with it?" Obviously, this would not have been a welcome proposal, but we do always want to respond and to be consulted, but I think Joanne has outlined some options there. The proposals to do it through either the annual allowance or the lifetime allowance, I would echo the point that there is a real danger that that would take it further down the income scale and it would have a wider effect, so I think we need to work that through. Also, I think that could, conceivably, hit the special groups that I was talking about earlier, people in redundancy, ill-health, early retirement and so on, but we will try to think this through to see if there is a more innovative way to do it.
*Ms Segars:* Again, if we have access to some of the Treasury's modelling, I think that would help us in thinking this through, as an industry because, as you have heard today, NAPF and ABI stand together on these issues. It would help us in really trying to work through alternative proposals, thinking about the issues from an employer perspective, a scheme sponsor perspective or a pension provider perspective and coming up with solutions which encourage pension provision, because that is what we want to see in this country, and which do not discourage it.

**Q145** ***Lord Wakeham:*** I know you cannot be absolutely sure, but would you think that your alternatives would raise as much money, from the Revenue's point of view?
*Ms Segars:* Well, they may not, but, in a sense, that is not necessarily the issue for NAPF.

**Q146** ***Lord Wakeham:*** Well, that was the question really: was there an alternative? If they are going to have to raise that amount of money, the question is: is there a better way of doing it? If there are better ways of doing it which raise less money—
*Ms Segars:* Again, I think that is why we want to see the Treasury's modelling and why we also want to know if the primary motivation is fairness, as I said to Lord MacGregor earlier, or if it is achieving a tax yield of £3.1 billion.

**Q147** ***Lord MacGregor of Pulham Market:*** Just on the question of about how far down the income scale it goes and the issue of some of your alternatives, particularly the annual allowance, whilst I recognise that, if you bring the annual allowance down, it does destroy some of the objectives of clause 139 of the 2004 Finance Bill, it clearly destroys some of those, it would not have the same impact on lower income earners, would it, if there were a modest adjustment to the annual allowance?
*Ms Craig:* I am sorry, I was not trying to imply it was necessarily lower incomes, but it is how far down the bracket you would take it and also how it would affect those in special circumstances, redundancy, ill-health, that kind of thing, but, as I say, we have not had the time to actually work through the alternative modelling on this.

**Q148** ***Chairman:*** Finally, are any other issues with the Government's longer-term proposals which you have not mentioned so far and which you want to raise with us this afternoon?

*Ms Craig:* I think I would just like to reiterate the points around could we please not have any more change. It would be really helpful if somebody would say that this is not the thin end of the wedge and we are not going to have more change. I also think that it really is important that the Government sends out the message that, particularly having made a change, albeit it only for very, very high earners, it does actively and actually want to support pension savings because, having sent out the message that is negative to some extent, even only for some people, it would be very, very helpful to have that counterbalance which was positive.

*Ms Segars:* From my perspective, I would echo those comments and I would say that the Government needs to be absolutely certain that there are no unintended consequences in this piece of legislation and that we do not see a further undermining of pension provision in the UK as a result of this, a measure which is, on the face of it, aimed at 230,000 individuals, but which actually impacts many, many more people. We are not convinced that the Government has taken that risk fully on board.

***Chairman:*** Well, thank you very much indeed again for spending some time with us and thank you for your answers to our questions.

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## Supplementary memorandum by the Association of British Insurers

The Association of British Insurers (ABI) is the voice of the insurance and investment industry. Its members constitute over 90% of the insurance market in the UK and 20% across the EU. They control assets equivalent to a quarter of the UK's capital. Through the ABI their voice is heard in Government and in public debate on insurance, savings and investment matters.

### Supplementary Evidence

In response to Question 131, Maggie Craig offered to submit further supplementary written evidence on specific cases that will be affected by anti-forestalling rules. The Committee indicated that they would welcome such further evidence.

Our concern focuses on the definition of established patterns of contributions. In oral evidence we expressed the difficulty about defining what exactly is a pattern. A pattern is currently defined in terms of regular amounts of contribution. There would be particular cases where people might lose out. Below are three case studies.

From 22 April 2009 new anti-forestalling rules were introduced to restrict higher tax relief on pensions contributions for individuals. The restrictions apply to people:

(a) whose income is £150,000, or higher (or has been in the last two years);

(b) who increase their normal ongoing regular pensions savings; or

(c) whose total annual pension contribution exceeds £20,000.

*Case Study 1: Use of small business to finance retirement*

For some successful small business owners, it is common to leave profits in the business and fund a pension from the ultimate sale proceeds. In this case, the lump sum resulting from the sale of their business would be placed into a pensions pot for retirement. This lump sum would be caught under the anti-forestalling measure if, in any of the two years preceding the sale, the owner has had income of £150,000 or more (including bonuses and dividends from the business), as the amount is likely to be in excess of £20,000 and not recognised by a normal contribution pattern. In this case it would be caught by restrictions (b) and (c).

For example, an individual received a salary of £150,000 in 2008. However, he received a reduced salary of £70,000 in 2009 because his business has suffered due to the economic downturn. He then decides to sell the business for £250,000 in 2009—likely to be less than the business was worth prior to the downturn—and pays £200,000 into his pension. Even though this individual has suffered a reduction in his earnings and has been forced to sell the business he will still not be able to gain full relief for their contributions. This is because his salary was in excess of £150,000 in the previous year.

There is no forestalling of the future changes in tax relief here. The large pension contribution is not driven by the future changes but by the availability of funds when the business is sold.

*Case study 2: Annual contributions*

In 2008 an individual earned an annual salary of £110,000. That person makes no monthly or quarterly contributions to their pensions but instead opts to make an annual contribution to their pension from their bonus, which is wholly dependent on performance.

If in 2008, this individual had received a bonus of £60,000 and paid the entire amount into their pension, they would receive full relief for the whole contribution.

However under the new anti-forestalling rules, if this same individual receives a bonus of £50,000 in 2009 and pays the entire £50,000 into their pension, they would only receive full tax relief on £20,000 of the contribution. The remaining £30,000 would be caught by the restriction outlined in (b), as this individual does not make monthly or quarterly pension savings. Therefore their "normal contribution pattern" is zero. In addition, the restriction (c) applies as the total pension contribution exceeds £20,000.

If in 2010 the individual still earns £110,000 and receives a bonus of £30,000 and pays the entire £30,000 into their pension, they would still receive full tax relief on only £20,000 of the contribution. This is because they still have no regular level of contribution. Although their income in 2010 is below £150,000, it was above £150,000 in the previous year.

There is no question here of the individual taking advantage before 2011. The individual is making annual contributions as they always have. Furthermore, the level of contribution is declining not rising as the impact of the recession reduces their bonus.

*Case Study 3: Approaching retirement*

When an individual is nearing retirement, it is not unusual for them to consider the income they will be entitled to during retirement. As a result they will consider topping up their pension pot.

In many cases this will spur an individual into looking to boost their pension by lump sums as frequently as possible in the run-up to their retirement. Again, anything over £20,000 would be caught by restrictions (b) and (c).

There is no forestalling of the future changes in tax relief here. This is part of the normal pattern of individual's pension contributions.

## MONDAY 1 JUNE 2009

| Present | | |
|---|---|---|
| Present | Barnett, L | Paul, L |
| | Best, L | Powell of Bayswater, L |
| | Blackwell, L | Vallance of Tummel, L (Chairman) |
| | Griffiths of Fforestfach, L | |

### Memorandum by HM Treasury and HM Revenue & Customs

Corporate Taxation of Foreign Profits: Clauses 34–37 and Schedules 14–17

The foreign profits package consists of four elements:

- dividends and other distributions received from foreign companies will largely be exempt from corporation tax and UK distributions will be exempt to the same extent;
- an interest debt cap, which limits the tax deduction for interest and other finance expense available for the UK members of a group to the group's consolidated gross finance expenses;
- certain exemptions are removed from the controlled foreign company (CFC) regime as a consequence of the introduction of dividend exemption—these are the superior and non-local holding company exemptions, and the acceptable distribution policy exemption; and
- the Treasury Consents rules (that require approval from HM Treasury before certain transactions are undertaken) are repealed and replaced by a post-transaction information-reporting requirement.

The changes introduced by this package affect companies only, and result from a long period of consultation. The HM Treasury and HM Revenue & Customs websites provide copies of the relevant consultation documents and responses, of the draft legislation, and of draft and final impact assessments. The links are:

http://www.hm-treasury.gov.uk/consult_foreign_profits.htm

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb = true&_page Label = pageLibrary_ConsultationDocuments&propertyType = document&columns = 1&id = HMCE_ PROD1_029074

Dividend exemption applies to all companies receiving foreign or UK dividends and other company distributions. Corporate groups consisting entirely of small and medium sized companies are unaffected by the finance expense restriction. The existing CFC legislation and the changes being made now do not apply to companies with profits of £50,000 or less. The post-transaction information-reporting requirement applies to companies that undertake transactions of £100 million or more involving foreign investments.

Real Estate Investment Trusts: Clause 65 and Schedule 34

The Real Estate Investment Trusts (REITs) regime was introduced to level the playing field between direct and indirect investment in property and to reduce inefficiencies in the property market. The regime achieves this by exempting companies and groups of companies, whose business is property rental, from corporation tax on that part of their profits and gains arising from the property rental business and requiring them to make distributions out of those profits to shareholders.

To ensure that the exemption is restricted to property rental profits and does not exempt other profits the companies are required to meet a number of conditions. It was not intended that companies who held property assets from which they carry out their own business would benefit from the regime.

The 2008 Pre-Budget Report announced changes to the Real Estate Investment Trust legislation to stop the existing legislation being circumvented by businesses that did not meet the conditions of the regime and to exclude owner occupied properties from the regime.

Clause 65 and Schedule 34 introduce these changes. The Schedule provides a power to make regulations to prevent restructuring within groups enabling companies to meet the REIT conditions and tests when, without the restructuring, they would not.

The Schedule also removes an obstacle that would stop potential REITs with 'tied premises', such as tenanted pubs from entering the regime. Current legislation taxes owners of tied premises as though all their income including rental income, is trading income. This provision will not apply for the purposes of the REIT regime.

The Schedule also makes minor technical amendments to parts of the existing legislation to make it clearer and more consistent following discussions with the industry.

PENSIONS: CLAUSE 71 AND SCHEDULE 35

The Chancellor announced at Budget 2009 that tax relief for pensions savings would be restricted for high income individuals with effect from 2011–12. The restriction is to apply to those with incomes of £150,000 or more. Relief above basic rate will gradually be withdrawn as income increases above that threshold, and for those with incomes over £180,000 tax relief on all pension savings will be at basic rate only. There will be a period of consultation on this starting before the 2009 Pre-Budget Report.

To prevent individuals taking undue advantage of higher rates of relief before April 2011, the Government also announced at Budget anti-forestalling legislation. The detailed proposals for this are in clause 71 and Schedule 35 of the Finance Bill. The aim of this legislation is to restrict tax relief to basic rate on additional savings over and above normal, regular ongoing pension savings. The anti-forestalling rules apply to people earning £150,000 or more, but they do not apply if an individual's total pension savings (including employer contributions) are less than £20,000 a year (the special annual allowance introduced by Schedule 35).

Tax relief for pension contributions affected by the anti-forestalling measure will be restricted by recovering relief above basic rate by a charge (the Special Annual Allowance Charge) applied to the additional savings as the final step in the Self Assessment tax calculation.

*May 2009*

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**Examination of Witnesses**

Witnesses: MR MARK NEALE, Managing Director for Budget, Tax & Welfare, HM Treasury, MR JIM HARRA, Director, CT & VAT, MS JUDITH KNOTT, Director, Business International, and MR DAVID RICHARDSON, Director, Charity, Assets and Residence, HMRC, examined.

**Q149** ***Chairman:*** This afternoon's hearing is the fourth and last of the Committee's inquiry into aspects of the Finance Bill 2009. Some Members have declared an interest at previous meetings. I welcome you to the Finance Bill Sub Committee and thank you for making the time to be here. If you can speak reasonably slowly and clearly that would be extremely good both for the stenographer and for Members. I probably ought to tell you that there are a lot of questions we want to get through. We will ask them as quickly as we can, and if you can be reasonably concise in your replies, that would be very much appreciated. If you could introduce yourselves before you first speak, that would be helpful. Do you want to make any introductory remarks?
*Mr Neale:* I do not think so. I think we will proceed straight with the questions.

**Q150** ***Chairman:*** Excellent. We will start with consultation. First the good news! It was generally acknowledged that the consultation on foreign profits was a big improvement on the consultation on Capital Gains Tax and Residence and Domicile that concerned the Committee last year. However, there are still some worrying comments this year, in particular that consultation on one or two important issues such as the exclusion from the debt cap rules for financial services has got underway only recently. Our overall impression is that the consultation was a little leisurely in its early stages—between September 2007 and July 2008—and that it has been fairly frantic since the publication of the draft clauses at PBR. Is that a fair assessment; and, if so, why is that the case? Why has the consultation since the end of last year been frantic?
*Mr Neale:* Perhaps I can kick off with that question. I am Mark Neale; I am the Treasury's Managing Director for the Budget, Tax and Welfare. I am very pleased that many of your previous witnesses have been positive about the consultation process on foreign profits. I think it was a successful consultation. I think it was successful because it led us to an outcome which balances competitiveness gains for business with protection for the Revenue. I think it was successful because it consolidated the good relationship which the Treasury and HM Revenue and Customs have with business generally in addressing issues of common concern. I am not sure I would recognise the word "frantic" in relation to any parts of the consultation. As we discussed this time last year, there is always a balance to be struck in any consultation between getting to the right answer on the one hand, and ending uncertainty as quickly as possible on the other. On this occasion I think it struck a good balance throughout. Some parts of the consultation were more intense than others, but the end outcome is what matters, and I think there has been strong support for the outcome.

**Q151** ***Chairman:*** Is that view shared by HMRC?
*Ms Knott:* Maybe I could add a comment. I am Judith Knott, Director of Business International in HMRC. I think we would very much think that overall our consultation process has been very positive. I think we have been recognised as having listened to the concerns expressed. I would also point out that the early part of the consultation, which was described as "leisurely", 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. If I could just comment finally on the financial services exemption which you specifically mentioned, we did recognise the need for financial services exemption some time ago, when the draft clauses were published back at PBR. They did contain a form of exclusion for financial services, but we then discussed with industry about ways to improve the design, because there were some aspects that were of concern to the industry; so we did make some changes. That did take time in discussion with the financial services industry, but we are actually publishing draft legislation on that aspect today, to be tabled at Committee stage in the other House.

**Q152** ***Lord Barnett:*** Did I hear you say you are publishing something today on the Net?
*Ms Knott:* It is the financial services exclusion that is being published on the website. It is actually out today, yes.

**Q153** ***Lord Barnett:*** As I am sure you are aware, there is a lot of discontent about the debt cap schedule. Although there was a lot of consultation, the impression is that you were not really listening; you had made your mind up in advance, and that was that. Would that be a fair view?
*Ms Knott:* In response to that I would make a number of points. Firstly, as Mark has said, the debt cap is part of an overall package that is designed to improve UK competitiveness, which includes the widely welcomed dividend exemption, which is a big step forward in UK tax policy, and we should not lose sight of that. Within the overall package, the debt cap is the element which is designed to protect the tax base and reduce the risk to the Exchequer and to make the package affordable, so I think it is quite natural, and would be expected, that it is that element of the package that gives rise to the areas of discontent and concern, because it is the area that naturally is not going to be quite as welcome to business as the elements that are reducing their tax. It is important to recognise that overall the package has been welcomed. For example, Julian Heslop, who appeared before your Lordships in a previous hearing of this Committee, said that The Hundred Group had welcomed the overall package and thought it would help UK competitiveness. We do feel it is right to have some form of interest restriction. Many countries have introduced a form of interest restriction, and we think that the one we have proposed is appropriate and much simpler than some of the systems that other countries have. For example, some countries require the allocation of expense around group companies in quite a complex way; so we feel that on balance the current approach was the right one to take. I should also mention that during the process of consultation the proposals did change significantly; so we did listen, and this was recognised by a number of comments from rep bodies. For instance, the Chartered Institute of Taxation said that HMRC was to be congratulated on listening to the concerns of advisors and business. The Hundred Group also acknowledged that we had made many changes as a result of the consultation; so overall we would say we have listened to the concerns and changed things as a result.

**Q154** ***Lord Blackwell:*** Before moving to pensions, I should just declare my particular interest as a director of a life and pensions Company and also, when we come to it, as a director of a REIT. On the taxation of pensions, again our witnesses have been very complimentary about the consultation that took place before the 2004 Finance Act. Obviously, the changes in the current Bill—there was less consultation and a number of people have said that despite the issues that were brought forward, there could have been the opportunity for informal confidential discussions with a few experts. Was that considered and rejected, or why was there less consultation?
*Mr Neale:* The first thing to say is 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; but, 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. As Andrew Hubbard of the Chartered Institute of Taxation said when he gave evidence to you, that is quite well accepted and understood among key stakeholders and practitioners that we do not tend to consult on

measures that are subject to, or potentially subject to forestalling.

**Q155** ***Lord Blackwell:*** You are not concerned that the timetable for implementation on something as complex as this is going to be difficult to achieve without prior knowledge?
*Mr Neale:* There are two elements here. There is the measure itself, which will come into effect from 2011. That gives us a good run-in to ensure that we get the design of the measure right, in consultation with the industry; and then there are the forestalling measures that are in the Finance Bill on which we are talking to stakeholders, and very much listening to their views.

**Q156** ***Lord Best:*** On other aspects of the Bill there has been criticism that you have not consulted enough, and in particular in relation to clauses 92 and 93. Would it have been better to have deferred these provisions to allow time so that there could have been some proper consultation on these clauses?
*Mr Harra:* If I can pick that up—Jim Harra, Director of Corporation Tax and VAT, Revenue and Customs. If I take the two clauses separately, in the case of clause 92 the Minister said in the Committee of the other House that the Government had to take very difficult and urgent decisions on fiscal consolidation, and part and parcel of that is our decisions around maintaining tax revenues and tax compliance. That is why this decision was taken at the same time as the fiscal consolidation measures. The measure is aimed at a relatively small number of large groups, most of whom, the Government believes, will not be significantly impacted by it; but some that do not have adequate systems will be; and it was felt right not to delay action for those companies. The Government has, however, kicked off consultation on practical implementation of that clause, and that is now underway with interested parties, with a view to producing common guidance. The Government has shown that it is listening to those views. Going on to clause 93, that clause, which is the naming of evaders and the publication of those names, 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. To that extent I am satisfied that we understand the views of people on the definition that that is based on. During that consultation and also in a recent survey of debtors there has been a quite clear demand for greater action in relation to evaders, and this is our response to that. 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.
***Chairman:*** Moving on to our second theme, which is competitiveness—Lord Paul.

**Q157** ***Lord Paul:*** The overall impression of the foreign affairs package is that the problems on the debt cap schedule have to be resolved before the Government's objectives "to enhance the competitiveness and attractiveness of the UK as a location for multinational business" are likely to be met. How confident can you be that the problems can be thrashed out and the necessary changes made in time?
*Mr Neale:* We are very confident that we have a good package. As Judith 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 competitiveness gain. The debt cap helps to protect the Exchequer. The measures on the debt cap which will come in in 2010 do reflect, as Judith said, a great deal of discussion with business, and we have on that front made a major change, setting the net financing costs of UK business against the gross worldwide costs of the overall business. I think that provides a sensible outcome which gets that balance between competitiveness and the protection of revenue in the right place.

**Q158** ***Lord Paul:*** Why can we not remove this impression that Britain is becoming uncompetitive?
*Mr Neale:* 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. In surveys of the kind run by PWC and the World Bank we score very well indeed for ease of tax administration, again scoring top among the G7 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.

**Q159** ***Lord Griffiths of Fforestfach:*** I would like to carry on with competitiveness, and particularly with the details of Schedule 35 about which there seems to be quite a lot of work to be done still. How confident are you that the private sector representatives that you reach agreement with were reasonably content, or not?
*Mr Richardson:* I will pick that up, if I may. I am David Richardson, Director of Charity, Assets and Residence in HMRC. I should start by saying that I did not entirely recognise the premise of the question that much needs to be done in relation to Schedule 35 as opposed to the substantive changes from 2011. What I would agree with though is it is really

important that we get a clarity of understanding around the measures. We have done an awful lot on that score already. On Budget Day we published guidance for individuals, guidance for pension providers, a big document analysing the provisions from a technical point of view and the draft legislation. We pre-briefed our pensions helpline so that they were ready to answer questions as soon as the Chancellor sat down. We provided in the Budget documentation details of a member of the policy team to answer more detailed questions that people had. We have held seven seminars with interested groups so far. What we have found from all of those contacts is that the questions that people have are pretty well all answered in the documentation we put out at Budget time, and it is a question of people getting up to speed and understanding what is there. We have found some different questions have come up, which we have provided the answers to, and we will update the guidance as we go along. We will do that in consultation with pension providers. The short answer to your question in terms of the clarity is that, yes, we are confident that we can provide the clarity that people want and that people need. In terms of the competitiveness, I do not recognise that Schedule 35 will 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. What we have recognised, of course, is that there are some people whose pension savings are less regular than a quarterly basis, and the Financial Secretary therefore on Budget Day said that he was interested in receiving views on how those people might be dealt with. We are taking representations on that as we go along, and obviously ministers will take a view on what action they may or may not take in respect of that.

***Chairman:*** Moving on to foreign profits, Lord Powell.

**Q160** ***Lord Powell of Bayswater:*** I think we will skip question 7 because it has been answered in earlier questions. On foreign profits, why was it not possible to do all the necessary drafting before the Bill was published? This rather reflects what we experienced last year with the residence and domicile changes. Is the Treasury or HMRC short of staff, or is life just too complicated; or is there a better reason?

*Ms Knott:* I would not recognise those reasons. 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. 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 which we referred to earlier, that process of dialogue extended beyond the publication of the Finance Bill. As I mentioned, we published that legislation on the website today. Generally speaking, I would say that this is not part of an increasing trend 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 sometimes extends beyond the time.

**Q161** ***Lord Powell of Bayswater:*** It is a fairly obvious supplementary: why not start earlier?

*Ms Knott:* On this particular point 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. On final analysis these things do take a long time to get right. The signal we have had from business all along is that it is important to get it right and continue our dialogue.

**Q162** ***Lord Powell of Bayswater:*** You do not think it is going to become an increasing feature of finance bills that they come out with great gaps in them!

*Ms Knott:* No, I do not think so.

**Q163** ***Chairman:*** Some of our private sector witnesses felt this was something of a missed opportunity to move to a "pure" territorial system. Is that something you have considered? If not, why not; and if you did why was it rejected? Would not a movement in that direction raise sufficient tax to fund a substantial reduction in the main Corporation Tax rate?

*Ms Knott:* Yes, I have seen that comment made. Firstly, I would say that no country has a pure territorial system, and there is some debate as to exactly what that means. It can become a rather theoretical debate. There were discussions between Government and business as a part of the Business Government Forum on Tax and Globalisation, run by the Financial Secretary. They considered this issue last year, and as a result of that discussion an announcement was made by the Financial Secretary that we would move closer towards a territorial system. The introduction of a dividend exemption does do that and moves in that direction. We are now embarking on reform of our Controlled Foreign Companies Rules over the next year or so, again in dialogue with business. We are aiming to design rules that will be consistent with that direction of travel towards a more territorial system. If we come back to the more pure territorial system, that would require us to look at the rules for giving relief for expenses, including interest. 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, and it was something I was involved in when I was in the Treasury. It was very clear at that stage that businesses would not have welcomed that kind of system. It could prove to be very complex, and it would have restricted interest quite significantly, much more so than the debt cap. Broadly speaking, we felt that the debt cap was a more balanced measure to introduce at this stage, along with the dividend exemption.

**Q164** ***Chairman:*** Was it strictly complexity that put business off the idea, or did they recognise that it could be self-funding with a significant reduction in the Corporation Tax rate and might have taken a different view if they recognised that possibility?
*Ms Knott:* It is true it was not discussed in that context, and of course 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. The concern was twofold: business regarded our currently very generous rules for relieving interest, and they continue to be generous in international terms even after the introduction of the debt cap—so those things were very positive features of our tax regime, which business did not want to lose, to maintain the competitiveness of the UK. There were also significant complexity issues as well, and we did look at a number of ways in which we might have approached it, and they all looked incredibly complex.

**Q165** ***Lord Barnett:*** Turning to dividend exemption, many of our private sector witnesses, as you know, commented adversely on the way Schedule 14 was drafted as, say, a charge with exemptions with anti-avoidance rather than an exemption with anti-avoidance. Why was it drafted in this way? Is it because there is a difference between smaller and larger companies? Is there a percentage of smaller companies rather than larger ones or vice versa where there is more avoidance, do you find?
*Ms Knott:* I can say a number of things in response to that. First, it is worth emphasising that the dividend exemption that was introduced in Schedule 14 is extremely wide and generous in international terms. A lot of countries have a participation exemption for dividends, but it only applies to certain kinds of dividends; whereas we have produced something that is very, very broad. 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. The point about the way it is drafted was put to us during the consultation process. We seriously considered alternative approaches. There were people in my team back at the office who applied wet towels to their heads and tried to do it 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 around—I realise it is quite a technical point, but if we had done it the other way around, essentially companies would have had to satisfy themselves that they were not caught by any of the exclusions. As it is, if, for example, a dividend is paid by a subsidiary to its parent that represents over 90% by value of dividends, it will be exempt; so they can come within the exemption in a number of ways. Turning to the small company point that you raised, we do have different sets of rules for small companies and large companies; but 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. For example, small companies generally do not have such complex offshore structures so they do not need the details of the large company provisions. At the same time, there are less complex provisions elsewhere in the system for small companies, which means that there are not the defences in place in the tax system, so we do need a broad anti-avoidance component for small companies in this legislation. Another point in terms of the small companies is that it was important to dovetail this measure with a measure elsewhere in the Finance Bill on the exemption of personal dividends, because a lot of these small companies will be owned by entrepreneurs for whom the personal dividend taxation is quite important. It was important to get that right. 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.

**Q166** ***Lord Barnett:*** Does not all of this introduce boundary issues and add to the compliance costs? If I may make this additional point, looking at some of the press over the weekend and the guidance you have given about allowing or not allowing accountancy charges to prepare tax returns, would you be disallowing the compliance costs and employ accountants to deal with it?
*Ms Knott:* In the case of corporate computations they would generally be allowable—but I need to confirm that. In terms of the complexity and the compliance burden of these rules and the boundary issue, generally speaking companies will know whether they are a small company or a large company. It is a distinction that is used quite frequently in the taxes rules now. I think they will be pretty clear which side of the line they fall on. The small company rules are somewhat simpler than the large company rules.
**Lord Barnett:** I will pursue that on some other occasion!

**Q167** ***Lord Blackwell:*** You have made the point that many extensions in Schedule 14 are overlapping. The Law Society in evidence said it concluded it would be possible to simplify that without a significant degree of risk. Do you want to comment on that?
*Ms Knott:* It is essentially the point I have made in that we looked at that alternative way of doing it that was suggested by the Law Society. I did see the comment from the Law Society, but I should also note that Peter Cussons, when he was sitting before your Lordships, actually described it as "a pretty decent bit of drafting". There are different views on this. We did try to look it at from the other end of the telescope, as it were, but concluded that this was a better way.

**Q168** ***Lord Best:*** Why were foreign branches not tackled as part of this package, and are they likely to be tackled on a timescale that would satisfy the BBA? In particular, will any of these issues be addressed before the Committee or Report stage for changes at that time, that is the treatment of capital distributions, joint ventures and split shareholdings in subsidiaries?
*Ms Knott:* There were two sets of points there really, all of which were raised by the BBA. On the foreign branches point, 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 are two sides to the story, as with a lot of things in tax policy; so while the banks would welcome it, 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; so there is that issue to take into account. There are also various tax risks which we need to take into account in looking at foreign branches. In terms of the package for this Finance Bill, we felt it was right to focus on something that was manageable—the dividend exemption and the debt cap and the various other things that accompany that—and to leave the question of foreign branches for a later date. We are likely to return to it 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. There is a danger that if we also take on the issue of foreign branches, we lose focus on these other issues of great importance. We are aware of the issue but it will take some time to come to that. On the other specific issues you mentioned—capital distributions, joint ventures, split shareholdings—we have looked at all of these issues. We are aware that they have been raised by commentators, but we do not feel that they are ones that need to be addressed in the Finance Bill. Maybe I can explain in each of the cases why that is the case. In the case of capital distributions, this is quite a technical point and a very difficult area of law. Having looked at it and got legal advice, we do not feel that Schedule 14 changes the scope of the chargeable gains legislation at all. The new Part 9A specifically excludes distribution of a capital nature, and the previous exemptions for UK dividends have no application to the chargeable gains legislation, so we do not, having looked at it, feel that there is a change to be made there. In the case of joint ventures and split shareholdings, which are very similar points, it is true that there is no exemption specific to them, so that whereas there is a general exemption for dividends paid from a subsidiary to a parent, there is not a general exemption for joint ventures. Even if dividends and joint ventures do not fall within the ordinary shares exemption, they will be exempt provided they are not paid out of profits and transactions designed to avoid tax. That is a very broad exemption—as long as they are not for an avoidance purpose. We feel that that should not be any kind of obstacle to joint ventures that operate for genuine commercial purposes. They will be able to get certainty also by applying for clearance to HMRC if they have any concerns about whether a particular dividend is exempt. 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 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.

**Q169** ***Lord Paul***: Some of our witnesses saw the approach of this Schedule as fundamentally flawed, chiefly because it moves away from the arm's length principle and can lead to arbitrary and discriminatory results. How would you answer this criticism?

*Ms Knott:* I begin by saying something I have already mentioned, which is 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 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. If I can give your Lordships an example, about six or seven years ago I did some work as part of a project on tax laws and I went and looked at the files of multinationals in our Large Business Service. I looked at a number of these and one particular file that stuck in my mind was of a large multinational getting relief in the UK for two and a half times their worldwide interest charge which seemed inappropriate. There is something wrong in the tax system if you are giving relief in the UK for two and a half times the overall worldwide interest. 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. The arm's length test, which we do have in our legislation, is essentially a subjective one and looks at how much would or could an investor at arm's length invest in a subsidiary. In practice it mainly applies to inward investment situations; it does not tend to apply in outbound situations where potentially you might get a loan from a subsidiary to the UK which drains profit out of the UK, and it is those kinds of situation that we are trying to address here with an objective test. If I could also address the point about the debt cap being 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.

**Q170** ***Lord Griffiths of Fforestfach:*** I think you saw some of the worked-out examples we were given regarding this subject, and the outcomes seemed to be not what was intended by policy-makers. Can you comment on this, for example in the way cash-rich groups and so on would be discriminated against?
*Ms Knott:* Would you like me to go through the examples one by one?

**Q171** ***Lord Griffiths of Fforestfach:*** We could, yes.
*Ms Knott:* The first two are pretty straightforward and not contentious and just show how the debt cap is meant to be applied, although it is worth pointing out in example 1 one of the ways in which we have changed the debt cap in response to consultation so that it applies with respect to the gross amount of interest expense of the worldwide group rather than the net expense, and that is rather nicely illustrated by example 1. Turning to example 3, the debt cap does not apply in the restriction and there is no intention for it to apply in that kind of situation. This 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 order to take account of some of the issues in example 3, such as the market value of different members of the group, you would have to have a much more complex system than the debt cap, so the straightforward nature of the debt cap means that it is not something that would be caught in this case. In example 4, again there is no restriction, and this shows how the debt cap will not catch every example of an upstream 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.

**Q172** ***Lord Griffiths of Fforestfach:*** You go for something which is fairly simple, in which you recognise there are I's to be dotted and T's to be crossed and so on. Do you feel that there would be any companies that would have some legitimate criticism of the way this was implemented?
*Ms Knott:* In terms of the administrative burdens, 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, so they have to go through the rules but they amount to nothing. 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.

**Q173** ***Lord Powell of Bayswater:*** My role this afternoon seems to be to shorten the list of questions because I think you have answered effectively 15 and 16, so skipping on to 17, it was put to us that it would be better to have avoided a lot of this complexity and instead tightened up the existing rules on thin capitalisation and introduced a target measure to address upstream loans. Did you consider doing this? If so, why did you reject it?

*Ms Knott:* I think I have probably answered this one in some ways.

**Q174** ***Lord Powell of Bayswater:*** In that case, I did not understand the answer.
*Ms Knott:* In a sense, the thin capitalisation rules rely on the arm's length principle. As I mentioned in the example I gave, it would not be possible to tackle that kind of thing 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 looked at but it would have raised a number of problems. In fact, what we would have ended up with was a targeted measure that would have to be quite broad in its application and it would have had to have had a number of exclusions and would have been quite complex.

**Q175** ***Lord Powell of Bayswater:*** To round it off, would it not have been better to delay the implementation of Schedule 15 until the next year?
*Mr Neale:* This brings us back to the fact that 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.

**Q176** ***Lord Powell of Bayswater:*** Business cannot have the lollipop unless it also has the cod liver oil?
*Mr Neale:* That is one way of putting it.

**Q177** ***Chairman:*** As the Treasury has the floor, perhaps we can move on to Treasury Consents. The repeal of the existing legislation is welcome but some of our witnesses felt that the absence of General Consents in the new rules and the failure to address simplified arrangements for transactions of a recurring nature would lead to excessive reporting. Is there any substance in that view? If so, is there anything you intend to do about it?
*Ms Knott:* Perhaps I could answer that one. Firstly, I would mention that there is a threshold of £100 million in terms of the transactions that will be reported under the new reporting arrangements, so that should actually mean that it is very much kept to a minimum in terms of the number of transactions. On General Consents, which were raised by a number of witnesses, I can confirm that we are intending 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. So we will be doing that, and, specifically, we will also be including a new exclusion for cash pooling arrangements, so that should address any concerns about recurring arrangements.

**Q178** ***Lord Barnett:*** On REITs—I am not sure who is answering—how far have REITs met your expectations in the two years or so since they were launched? In so far as they have fallen short, how far do you put this down to economic circumstances, which can change—hopefully will in the not too distant future—or is it a structural weakness in the regime?
*Mr Harra:* I think they have been a marked success in this initial phase. The regime was introduced about two and a half years ago within the context of Exchequer cost and state aid constraints and after extensive consultation. In that period, to date 21 companies and groups have announced that they have become REITs and that includes most of the large quoted public companies. Going forward, I think we do expect that more companies and groups will become REITs in the coming years. 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, and indeed, many of the witnesses before your Lordships have said they do not see major structural problems with the regime.

**Q179** ***Lord Blackwell:*** Can I ask you then to comment on the specific measures in Schedule 34? There has been quite a long list of suggestions from the industry of other items which might have been covered. What was the thinking behind the priority given to these ones rather than other measures which were not covered?
*Mr Harra:* Schedule 34 and the regulations to be introduced under that Schedule will stop the existing regime from being circumvented by businesses that do not meet the conditions that need to be met for the regime. In particular, it prevents groups from entering the regime unless they receive at least 75% of their income from rented property, from tenants, and in addition there are regulations to be made under existing legislation which will exclude owner occupied properties from the regime. I know that that tightening up has been welcomed by other witnesses and I would expect it to be effective in making sure that the regime remains targeted on what it is intended for. Schedule 34 also removes an arbitrary barrier on access to REITs for pub companies. This has been introduced following interest that has been expressed by several pub companies in taking advantage of the REITs regime. This change will mean that they will be able to use the regime provided they satisfy all the other conditions in the same way as any other group. That is an important part of the Government's principled approach to the design of

REITs, that there are no arbitrary barriers that were not intended. Beyond that, Schedule 34 makes a number of minor adjustments to the regime. These have been developed in consultation with the industry. They are designed to clarify the way the regime works and to ensure it is consistent and they meet some of the concerns that the industry has expressed in its snagging list, and I expect them to be welcome to the industry and to be uncontroversial. The Government attaches a high priority to the provisions in Schedule 34 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.

**Q180** ***Lord Best:*** The industry has put to you a number of measures to help REITs in the current economic circumstances, in particular to allow dividends to be paid in shares, to defer the requirement to distribute and to ease the gearing restrictions. Have Ministers had a look at this? Is there any chance that they might move on it? The industry would certainly like them to do so.
*Mr Neale:* We certainly recognise that REITs are facing many of the same challenges as other businesses during the recession and they will reap benefit from the measures which the Government took in the Budget and in the Pre-Budget Report to support businesses through the downturn. Some of the changes that you mentioned 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.

**Q181** ***Lord Best:*** So that is a "no"?
*Mr Neale:* As I said, these are fundamental to the REITs design.

**Q182** ***Lord Paul:*** We noted that REITs were introduced as a response to Kate Barker's reports into housing supply but there are no residential REITs today. Why do you think this is? It has been put to us that there are particular issues with residential REITs which need to be addressed: the structure of leases and lower net yields, amongst others. Do you see it as important to address these?
*Mr Harra:* It is true that today there is no REIT that is purely invested in residential property, and there are only two that contain residential property as part of their portfolio. Many reasons have been advanced for why that is the case. One commonly cited reason 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 has said, that each and every one of those features is there for an important reason. They were introduced to this regime less than three years ago, after extensive consultation with the industry. For example, the requirements that a UK REIT make at least 75% of its gross profit from rental property is important to make sure that the regime is targeted at inefficiencies in the property rental market and does not provide a tax break for property dealing, which I think is one of the areas that others have looked at. The rules of the regime, as well as being devised after careful consultation, have also been devised against EU state aid rules and against the context of Exchequer costs that have to be managed. So we would need to look carefully at any representations to change them.

**Q183** ***Lord Best:*** Can I press the witnesses on that, Chairman? When REITs were introduced, this element within the new opportunities that they brought of boosting the residential sector and getting the institutions to invest in it was highlighted by Ministers, by everybody. Were you all just wrong in making the case that REITs would lead to institutional investment in private renting, which is very badly needed? Was this just a mistake? It has not happened, and it seems there is very little likelihood of it happening now. Within HMRC did you just not understand the market? Why was it that we were told that REITs was the salvation for getting institutional investment and nothing has happened?
*Mr Harra:* 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.

**Q184** ***Lord Griffiths of Fforestfach:*** Can I just carry on from there for a minute? If property prices had not fallen, would you say they would have been much

more successful? As one looks at, say, the UK and the US, it does seem to have been much more successful in America.
*Mr Harra:* I think in the US REITs have had a much, much longer time to settle in. They were introduced there in the 1960s and there was significant reform of them in the 1980s, so they have had a much longer period to mature than they have here. In addition, in the US they encompass not just property but also mortgages and mortgage-backed securities, which is not an area that the UK has gone into.

**Q185** ***Lord Griffiths of Fforestfach:*** Can I just ask one other question? Do you think REITs could play a role in recapitalising the banking system, as the industry has suggested?
*Mr Neale:* We have yet to receive a formal proposal from the industry on that. I do not want to comment on a proposal that we have not yet seen or had a chance to consider but we would certainly be very pleased to look at any suggestions the industry has on that front.

**Q186** ***Lord Griffiths of Fforestfach:*** Thank you, but do you see potential for that?
*Mr Neale:* I think that is a hard question to answer hypothetically.

**Q187** ***Lord Powell of Bayswater:*** Just help me understand something: do you actually want to see new entrant REITs or just the conversion of existing companies? Is it an aim of policy? If so, we were told that the costs are rather a deterrent.
*Mr Neale:* 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 has said, it is early days in the context of a fairly turbulent market.

**Q188** ***Lord Powell of Bayswater:*** You do not see any scope for reducing the charges to encourage that to happen?
*Mr Neale:* The charges are set at the level they are partly to reflect the inherent capital gain in the property and partly to protect the Exchequer interest.

**Q189** ***Lord Griffiths of Fforestfach:*** Can I just say one thing? I think the real question is whether, in a sense, you are protecting the Exchequer's interest so much that if you were entrepreneurs for the REIT industry, if you were trying to encourage the growth of this industry, are you really doing enough or are you being just a trifle too cautious?
*Mr Neale:* 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.

**Q190** ***Chairman:*** Perhaps we can move on to taxation of pensions, but with just one parting shot at REITs, and that is, we understand from you that changing legislation in the REITs context after a few years is a bad thing but it seems that it is not necessarily a bad thing, at least from your point of view, in the context of pensions. Pensions are essentially a longer-term business and the taxation changes made in 2004 were indeed well thought out, well consulted and so on, and introduced a coherent system that the private sector was content with and believed would last. To announce major changes only three years later in this context is seen by them as damaging to savings, especially as it could be the thin end of the wedge, with further reductions in relief for people with lower incomes. Perhaps you might tell us how you can reassure the industry in that regard. In framing the changes, what weight was given to the fact that the relief is a tax deferral in this case, since when the pensions come to be paid, these recipients are likely to be liable at their marginal rate?
*Mr Neale:* 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% 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.

**Q191** ***Chairman:*** Can I stop you there? Is that you confirming that this is not the thin end of the wedge?
*Mr Neale:* I am simply setting out what the effect of the changes announced by the Government is, and they do not alter the pensions tax relief regime for over 98% of savers.

**Q192** ***Chairman:*** So we do not know whether it is the thin end of the wedge or not potentially?
*Mr Neale:* All I can set out for you are the changes that the Government has announced.

**Q193** ***Chairman:*** Carry on then.
*Mr Neale:* As I said, 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.

**Q194** ***Lord Barnett:*** I imagine you will not have been too surprised to see a headline referring to a Treasury bungle—it happens very frequently, as you know, but this one related to a Treasury bungle on pension fat cats, and it is talking about the numbers. The number of savers who would be caught out by the Government's £1.75 million cap on pensions is nearly five times higher than the Treasury initially predicted. If you had got it right—and assuming that article is right, which is not an assumption I normally make—would you have still come out with the same policy?
*Mr Neale:* I am confident that the numbers I have given you are right and the policy is the policy announced by the Government.

**Q195** ***Lord Barnett:*** I am not sure what you mean by that answer.
*Mr Neale:* I am confident that the numbers we have given you are the correct numbers.

**Q196** ***Lord Barnett:*** I see. Could I turn to something else that our private sector witnesses reported, namely, that the inclusion of employers' contributions as a taxable benefit may well lead to a switching of pensions into other forms of remuneration. As you know, tax advisers come up with a legion of proposals for how to avoid tax. I am just wondering whether you have given any thought to this relief as a tax deferral, since when the pensions come to be paid, the recipients are likely to be liable at their marginal rate. That is one way of putting it. Is there any other way? Perhaps you could tell us.
*Mr Neale:* I think the first point to make is, as several of your earlier witnesses said, not to have included employer contributions would have opened up an avenue of avoidance through salary sacrifice. I think, however, that under the proposals contributions to pensions by people with incomes over £150,000 will continue to attract tax 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.

**Q197** ***Lord Barnett:*** Given the numbers we are now talking about, assuming they are not quite what they were when you started, do you think it might lead to lower tax revenues than you had originally estimated?
*Mr Neale:* I do not think I have accepted your premise that the numbers on which the policy is based are the wrong numbers.

**Q198** ***Lord Barnett:*** Can I just ask one brief question on taxable benefits? You have issued guidance frequently on benefits in kind. Do you think it is time you issued some new ones?
*Mr Richardson:* We keep all our guidance under review. I am not aware that there is a problem with the guidance on taxable benefits. If you have a specific point you want us to look at, I will be happy to look at it but I am not aware that there is a generalised issue.

**Q199** ***Lord Barnett:*** You do not think there is any problem with the broad charge of taxable benefits, whether from employers' contributions or in any other area?
*Mr Richardson:* Obviously, taxing benefits is important because if you do not, you open a way to avoidance, and we have seen various attempts to get round that over the years and have tried to tighten it up. It is an area we keep under review but I am not aware of a fundamental need to revisit it at the moment.

**Q200** ***Lord Blackwell:*** Our evidence has suggested there is particular concern about the impact that these changes might have on defined benefit schemes, and in fact a fair amount of confusion as well, despite the attempts you mentioned earlier to explain all of this. Could you comment on how you see the changes impacting on the balance between defined benefit/defined contribution schemes and whether you are confident that a level playing field has been maintained? Since there is confusion, maybe you could take this opportunity to clarify whether the higher rate tax, when it is applied for DB schemes, will apply to increases in contribution from an employer, or whether there would be some attempt to levy it on the increasing imputed benefits? I think that is one point that was not clear to people.
*Mr Richardson:* Certainly, the intention is to be even-handed between 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.

**Q201** ***Lord Blackwell:*** So that point has not yet been decided?
*Mr Richardson:* No, that point has not been decided. That is a key point to consult on for the 2011 changes, the way to value the benefits in DB schemes.

**Q202** ***Lord Blackwell:*** Does that not make it quite difficult for people running these schemes, if there is going to be quite a long period where that is not clear and people are making choices? It goes back to the issue of how much of this could have been consulted on before.

*Mr Richardson:* 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 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 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.

**Q203** ***Lord Best:*** Do you think there is a danger of disincentives to pension savings for high earners having an impact on those lower down the income scale, not least because the higher earners are the people within the organisation most likely to be setting the pensions policy?

*Mr Neale:* 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.

**Q204** ***Lord Paul:*** There were concerns, both in the context of the substantive changes and with the application of Schedule 35, that there could be massively high marginal rates of tax, including a cliff edge at £150,000. Have you considered this aspect and are you going to do anything to limit these high marginal rates?

*Mr Richardson:* Yes, we have looked at this very carefully, as you would expect. If you look at the substantive changes for 2011, where in effect anybody earning over £150,000 making pension contributions will be caught by the provisions, so it is essentially a universal provision, it is clearly important to avoid having a cliff edge. Therefore the proposals announced on Budget day make clear that 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. As far as Schedule 35 is concerned, I think 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 Schedule 35 are those people who have decided in some way or another to change their contribution rate, which, as I say, is essential 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. If though there are people that find themselves somehow or other inadvertently getting into Schedule 35—and I know there is an example that the Association of Tax Technicians gave you of a circumstance where somebody whose income was below £150,000 and there was an error in their bank interest details which took them over, if in those exceptional circumstances people found themselves inadvertently caught by the provisions in Schedule 35, we have built in there the ability to have a refund of any pension contributions made that were triggering Schedule 35. We think that is the fair way of dealing with the cliff edge point in relation to Schedule 35.

**Q205** ***Chairman:*** Would there not have been a simpler alternative to all this, and that is just to reduce the annual or lifetime allowance? Did you look at that?

*Mr Richardson:* Yes, we did look at the possibility of, instead of the 2011 changes, reducing the annual allowance or reducing the lifetime allowance, because they looked seductively attractive and simpler, but they deliver a quite different policy outcome. The objective was to restrict the higher rate relief in terms of people earning over £150,000. That relief has gone up from 10% of the total pensions relief in 2006 to something like 25% now, and that was the target that the measures are aimed at. If you were to restrict the annual amount, you would have to restrict it by such an extent that it would have an effect really quite low down the income scale at much less than the £150,000 limit. If you restricted the lifetime allowance, again you would have an impact lower down the scale and, of course, it would take some time to take effect in terms of the revenue. 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.

**Q206** ***Lord Griffiths of Fforestfach:*** In the Finance Act 2004 and given what the Minister said at the time, the impression was given that the annual allowance was pretty generous and that people would be allowed to make top-up payments later, maybe as their income increased and so on. The question is, should not taxpayers be given more time to arrange their affairs before these proposed changes come in?
*Mr Neale:* 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. As David has explained, the forestalling measure does allow regular contributions to continue without any tax penalty, and it does allow people to put in one-off contributions of up to £20,000 without penalty, and indeed, people can put in more, subject, clearly, to the 20% relief on amounts over that. So it strikes as good a balance as we can under the circumstances.

**Q207** ***Lord Powell of Bayswater:*** We have probably flogged forestalling as far as we are going to get anywhere at all with it. Moving on to the written ministerial statement of 22 April by the Financial Secretary and his statement that to introduce the changes before 2011 would risk administrative disruption for savers, pension schemes and HMRC, it is not clear to me how Schedule 35 overcomes that. If you are going to have two sets of rules in the space of two years, are you not making matters worse for pension contributors and possibly for HMRC?
*Mr Richardson:* Happily, I think not. What Schedule 35 does is to provide a window, if you like, to develop and prepare for the 2011 changes. Most importantly, it provides a window for the consultations we were talking about earlier on, which are essential, I think, for getting the substantive changes in 2011 correct. It will also provide a period for financial advisers to prepare themselves and advise their clients on how to respond. It will give individuals the opportunity to assess their own personal position and, from HMRC's point of view, it gives us the opportunity to get our computer systems in line for the new arrangements and amend the self-assessment return. Schedule 35, by stopping forestalling, gives us the window to be able to safely do all of that in. I think moving to 2011 without all of that would be an extremely unattractive position. I suspect if we had done that, we would be here before your Lordships being criticised for doing so. You are quite right though, of course, that it means we have two sets of rules rather than one change but I think, as we tried to illustrate earlier on, 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.

**Q208** ***Chairman:*** In that same ministerial statement the Financial Secretary said that the Government would welcome views on how pension contributions made by those with less regular patterns might be protected. Could you tell us how those discussions are going and whether you will be able to meet the concerns of our various witnesses, particularly about the self-employed and one-off cases like people who are retiring or are indeed made redundant? Would not one solution have been to raise the £20,000 annual allowance to, say, £50,000, which would not be particularly expensive?
*Mr Neale:* 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 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.

**Q209** ***Chairman:*** So we can expect some positive response?
*Mr Neale:* Ministers are considering the representations they have received.

**Q210** ***Lord Barnett:*** One further point on this issue of Schedule 35: you referred to it before as an option. In that case, why not just drop it?
*Mr Richardson:* 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 would 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.

**Q211** ***Lord Blackwell:*** May I pick up one comment made earlier, that one reason for these changes was the discovery that the amount of tax relief going to high earners had risen to 25%. When this was all introduced in 2004, after a huge amount of discussion and consultation, I would have thought it would have been clear that one of the indications implications of increasing the limit on annual contributions would be

that those people who took advantage of that would tend to be higher earners and one consequence would be more tax relief going to people on higher incomes. Was this just missed at the time or have the Treasury had second thoughts?
*Mr Neale:* 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.

**Q212** ***Lord Blackwell:*** So it is a knock-on effect of that 50% tax rate?
*Mr Neale:* Clearly, the 50% tax rate causes you to look very carefully at whether the existing structure of incentives should continue and whether that is sustainable.
***Chairman:*** Are there any other questions anyone wants to ask?

**Q213** ***Lord Griffiths of Fforestfach:*** On a practical issue, how can you best ensure with a minimum of administrative and compliance costs that, in particular in relation to DB schemes, an individual has all the information he or she needs in good time to complete a self-assessment return?
*Mr Richardson:* Clearly, in relation to Schedule 35, coming back to my point, if people stick to their ongoing regular savings, they do not get into the whole issue of how Schedule 35 impacts. If people do change their saving pattern, then clearly they need to do two things. First, they need to understand whether or not their income is over the £150,000 threshold and secondly, they have to value the change in their savings pattern. The £150,000 threshold, in order to calculate whether you are over that, essentially requires you to look at the information that you would have to hand in any case to fill in your Self Assessment return. You do not have to include in that the employer's contribution or benefit provided by the employer unless you have entered into a new salary sacrifice arrangement. In terms of valuing the benefit to be assessed under Schedule 35, I think it is not unreasonable to suggest that the population targeted here of high-earning individuals, many of whom will have advisers, are quite likely to be fairly well appraised of their contractual rights under their pension scheme and benefits, but if it turns out that they are not, there are already provisions in regulation which allow you to ask and receive a reply from your pension provider to the pension rights that you have 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.
**Lord Powell of Bayswater:** Given the expectations raised by the Finance Act 2004 and what was said at the time about the risk to pension savings, the comparatively low risk of forestalling in practice, the complexities of three different regimes in five years, the need to take account of special cases, the administrative difficulties and compliance costs, why not drop Schedule 35 altogether?
***Lord Barnett:*** I have already asked that.
***Lord Powell of Bayswater:*** There is probably not much more you would wish to add on that.

**Q214** ***Chairman:*** There are no further responses on that?
*Mr Richardson:* No. I tried to answer that point in relation to Lord Barnett's question.

**Q215** ***Lord Barnett:*** There are a lot of obsessions at the moment in the media, as you know, about the whole question of benefits in kind. On this question of a Self Assessment return, which a taxpayer might find difficult to do himself or herself, perhaps because they are too busy running a business and they use an accountant, would that be a benefit in kind? I have no interest personally any more.
*Mr Richardson:* If the employer was paying for the person to have an accountant—is that your question, whether that would be a benefit in kind?

**Q216** ***Lord Barnett:*** Yes.
*Mr Richardson:* Yes, it would be, under the normal taxation provisions.

**Q217** ***Lord Barnett:*** It would be classed as a benefit in kind?
*Mr Richardson:* If your employer is paying for you to receive a service from a third party, that would normally fall under the benefit in kind rules, yes.

**Q218** ***Lord Barnett:*** Do you do an analysis of all accountancy charges by companies as to how much of it is benefit in kind?
*Mr Richardson:* You are slightly outside my area of expertise in relation to how we police that. We do obviously have auditors who look at companies operation of the Pay As You Earn system and taxation of benefits, so in principle, yes. I could not give you a detailed answer now in terms of how many companies we look at or on what basis but it is certainly an area of the tax system that we police, as other areas.
*Ms Knott:* Employers are required to make a return of benefits in kind that they pay to their employees annually, so we look at those returns and make enquiries as necessary.
*Mr Richardson:* It is the form P11D.

**Q219** ***Lord Blackwell:*** I just have two quick follow-on questions on the pensions issue we have been talking about. One is, there are obviously thousands of financial advisers out there trying to give the best advice to people on these long-term financial

investments they are making. Given that the consultation is happening now and therefore there is a period of uncertainty, do you have any concerns or representations that advisers may be finding it difficult to give advice or may be giving advice that they later have to come back and say was the wrong advice, or are telling people to sit on their hands for a while? Is that this is an issue that concerns you?
*Mr Richardson:* If it were a destabilising problem, I think it would be an issue but I do not think that is the case. In essence, what people need to decide at the moment is what they do in 2009-2010, where Schedule 35 sets out very clearly the consequences of acting in one way or another. As to what you do in two years' time, I would have thought the responsible position is to wait and see the outcome of the consultation before deciding on how to do that.

**Q220** ***Lord Blackwell:*** That might mean you would defer taking a decision about a long-term plan.
*Mr Richardson:* I imagine that one may want to consider what the longer term rules are before deciding what to do in those years that are still far off. If you take the view that it is impossible to get into an area where there might be changes in the pension regime, what in effect you are saying is that the pension regime is fossilised for ever and can never change, which does not in policy terms give a particularly sensible position.

**Q221** ***Lord Blackwell:*** Secondly, very quickly—and this may be a mischievous thought but I wondered whether the fact that this is in part driven by the need to align the pension regime around the decision to have a 50% tax rate might not be an explanation for why there was not an earlier consultation on it.
*Mr Richardson:* No, I do not think so. There was in effect no reason to have consultation in advance of the Budget in relation to the 2011 changes. As Mark explained earlier on, the Government is committed to consultation but we do not generally consult on tax rates and rates of relief, therefore consulting on the possibility of reducing the rate of relief is not an area that we would normally consult on. What we have done, having announced that that change is going to take place, is to consult on the detail, and that is the well-trodden route in terms of consultation. Consulting on the anti-forestalling provisions would be extremely difficult and largely self-defeating.
***Chairman:*** If there are no further questions, all that remains is for me to thank you for spending some time with us this afternoon and thank you for answering our questions.

## Supplementary memorandum by HM Revenue & Customs (HMRC)

Corporate Taxation of Foreign Profits: Clause 35 and Schedule 15

*Tax treatment of financing costs and income*

The Law Society of England and Wales (LSEW) provided examples of various scenarios to the Committee that show how the debt cap rules works, and that in their view demonstrates that the policy behind the debt cap is fundamentally flawed.

Some of these examples were referred to by members of the LSEW in their oral evidence. Copies of the examples were subsequently provided by the Committee to the HMRC and HM Treasury witnesses. The witnesses were asked to comment on some of the examples when giving oral evidence on 1 June 2009. Not all the examples were discussed and HMRC takes this opportunity to provide brief written comments on all the examples provided by the LSEW.

All of the examples are correct in terms of the effect of the debt cap rules. In other words they correctly show when there will and won't be a disallowance.

The first two examples illustrate how the debt cap rules are supposed to work. Neither example is contentious. It is worth pointing out however that the first example neatly illustrates one of the significant changes made to the draft debt cap clauses as a result of consultation. The £5 million interest received from the bank in the example is not netted off against the £50 million interest expense in arriving at the available amount. The available amount is now the gross consolidated finance expenses of the group. This simplifies the debt cap rules, making them easier to apply. The change also reduces the number of groups affected by the rules—in particular it reduces the number of inbound investors that will be affected.

The third example does not result in a restriction and there is no intention that there should be one. The example does demonstrate that the UK still retains a very generous regime for interest relief even when the debt cap rules are taken into account. The example also demonstrates how the debt cap rules are designed to be as straightforward as possible. Rules to specifically target this type of scenario would very likely require either complex tracing rules for debt or some form of interest allocation rule.

The fourth example again results in no restriction and is presumably intended to demonstrate that the debt cap rules will not catch every upstream loan. However the example does again illustrate how debt cap rules are designed to be as straightforward as possible. There is a need to strike a balance between catching every conceivable case and designing rules that can be applied in practice. A set of rules designed to catch every upstream loan would in all likelihood require more complex rules and this no doubt would have raised even more concerns. We did discuss alternative kinds of interest restriction at an earlier stage of consultation, but these were very unwelcome to business.

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 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. In practice our analysis suggests that the main impact of the debt cap rules will not be in this kind of example with inbound investment—particularly now that the available amount is the gross consolidated finance expense of the group. The main impact of the debt cap rules will be on UK headed groups unwinding their upstream loans.

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. This would include considering how much debt the UK would borrow if both parties were independent.

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 the 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 is unlikely that groups will base their financing decisions solely based on the impact of the debt cap rules.

# Written Evidence

**Memorandum by the Association of Chartered Certified Accountants (ACCA)**

Introduction

1.1 ACCA is the global body for professional accountants with 131,500 members and 362,000 students who we support throughout their careers, providing services through a network of 82 offices and centres around the world.

1.2 The expertise of our senior members and in-house technical experts allows ACCA to provide informed opinion on a range of financial, regulatory, public sector and business areas, including: taxation (business and personal); small business; pensions; education; and corporate governance and corporate social responsibility.

1.3 Our staff around the world have been working with members and others in the financial services sector to develop the network necessary to understand the credit crisis from the perspectives of governance, remuneration, regulatory and accounting stances.

Our comments on the Finance Bill

2.1 *Foreign profits clause 34 and schedule 14*

— ACCA acknowledges that the Treasury has listened to the profession and it is evident from this piece of legislation.

— The dividend exemption is welcomed and reflects commerciality.

— Consistency is essential to maintain business in the UK and this is a step forward.

— We are concerned that, once enacted, outside influences may cause this legislation to be abandoned and it may be necessary to abolish an acceptable distribution policy, which would be disastrous.

— We believe that small and medium-sized companies' definition could be aligned with companies legislation for consistency.

— We hope that the Treasury continues to consult with the profession.

2.2 *Interest cap clause 35 and schedule 15*

— These provisions introduce a restricted deduction for interest to the extent that UK debt costs exceed 75% of worldwide interest deductions, with a *de minimis* level of £3 million.

— We are 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.

2.3 *Changes to tax relief on pension schemes clause 71 and schedule 35*

— ACCA remains 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 income in excess of £150,000, the implications will be felt far more widely.

- The higher-paid director may feel that, along with the loss of personal allowance, giving him a marginal tax rate of about 60%, he will also lose pension entitlement, it is not worth continuing to bother with the administrative problems of running a pension scheme for himself or for his employees. Perhaps the band between £100,000 and £112,950 (where the allowance disappears) could be widened to give a slower progression.
- It is not only those with income of £150,000 that are affected; those with income of £150,000 in either of the last two years will be within the charge; retrospective taxation is unacceptable.
- Will this be the last rites for pension schemes?
- 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.
- There will be a charge under the benefit-in–kind provisions in respect of excess contributions:
  - Will this lead to wage inflation?
  - How will it be valued?
- The Special Annual Allowance Charge—20% for 2009–10, 30% for 2010–11 and 50% thereafter—applies to pension savings in excess of the Special Annual Allowance. Protection from this is, however, available to civil servants.
- It is also available to other schemes, where weekly or monthly payments are made.
- This appears disadvantageous to the many small businesses that make annual contributions, based on the annual accounts.
- The extra compliance would be unlikely to benefit either the economy or our members, as the business owners may decide not to bother.

*May 2009*

## Memorandum by the Institute of Chartered Accountants of Scotland

Evidence Concerning Pensions: Clause 71 and Schedule 15: Finance Bill 2009

The Institute of Chartered Accountants of Scotland welcomes the opportunity to give evidence to the House of Lords Economic Affairs Committee, which is considering the Finance Bill 2009.

The Institute of Chartered Accountants of Scotland received its Royal Charter in 1854. It is the world's first chartered and professional body of accountants and it continues to play a leading role in the accountancy profession. The Institute has approximately 17,000 members who retain the exclusive privilege in the UK of using the designatory letters "CA". Its members hold key positions in commerce and industry, the public sector and private practice. Its members work throughout the world.

In all of its responses, the Institute aims to act in the best interests of society whilst upholding the integrity and standing of the profession of chartered accountancy.

We understand that the Finance Bill Sub Committee has decided in advance to restrict itself to reviewing:

1. Foreign Profits: Clauses 34 to 37 and associated schedules on which we do not wish to comment.
2. Real Estate Investment Trusts (REITS): Clause 65 and schedule 34 on which we do not wish to comment.
3. Pensions: Clause 71 and schedule 15.

The Institute wishes to raise the following points in relation to pensions clause 71 and schedule 15. The provision of financial security in old age is a major concern for individuals, their dependents and the State. In the United Kingdom, the State pension is relatively modest compared to many of our European neighbours so it is essential citizens should be encouraged to make responsible and sensible savings throughout their working life. By definition, planning for old age is a long term investment decision and it is essential that there should be stability and certainty. Government should not change the regime with too great a frequency nor should the regime be unduly complicated. We have recommended that the fiscal regime should be simplified as far as it is possible.

From 6 April 2006, a single unified tax regime applied for pensions replacing the eight previous regimes. At that time, the Government made it clear there were to be no limits on the amount that an individual could save in a registered pension scheme although there were limits on the amount of pension savings that qualified for tax relief. An individual who is a UK taxpayer was entitled to tax relief on contributions of up to 100% of UK earnings. Non taxpayers were encouraged to contribute to a pension fund and the Government would augment their savings by allowing a non taxpayer to receive £20 for each £100 they contributed personally subject to a maximum of £3,600 a year. Employers are entitled to tax relief on contributions that they make to a pension scheme for the benefit of employees.

It is common for working persons to have little surplus money available to fund a pension during the early period of their working life. This is especially true for the self employed who, in the early years of their business, may reinvest into their business all available profits to try to grow the business. Later in life, they may have more free cash which can then be invested into a pension scheme and the old regime recognised this when it allowed people of aged 60 or more to obtain full tax relief if they were able to invest up to 40% of their taxable income. This compared to a limit of 17.5% of their relevant earnings for those aged 35 or less.

From 2006, the new reformed pension regime retained two controls on an individual's tax relief pension savings. The first of these controls was the annual allowance and the second control is the lifetime allowance which has been explained in an earlier paragraph. In the fiscal year which has just ended, the annual allowance for 2008/2009 was £235,000 with a lifetime allowance within the fund of £1.65 million.

### 1. Those with Fluctuating Income will be Disadvantaged

For many self employed individuals, their income fluctuates markedly from year to year and in a good year they will be able to make a substantial contribution to their pension fund but in a bad year there may be no surplus cash available to make such a contribution. A self employed individual who has suffered a poor year but then enjoys a good year could find their tax relief on a responsible pension contribution being restricted unexpectedly. This problem might be addressed by taking as the base measure an average of five years contributions to establish what is the normal pattern of contributions.

### 2. Long-term Plans Disrupted

There will be individuals who have planned to make a large one off pension contribution in their year of retirement. Their planning may have included a plan to realise capital assets of their business to achieve that large single pension contribution in the year of retirement but this change will therefore undermine their planning which may have existed for many years. Such destabilisation of pension investment and planning is not in the public interest.

### 3. Unnecessary Complexity

Introducing a restriction on tax relief for higher earners introduces an administration complication although, as the BN47 press release highlights, this will not apply to the vast majority of individuals. This raises questions as to 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. If enacted, anyone who has an income of more that £150,000 and pays a one off contribution in excess of £20,000 to a personal pension scheme will only be entitled to tax relief at the basic rate on the contribution in excess of £20,000.

### 4. No Consultation—too soon after April 2006

Saving for a pension is a long term investment decision that should be encouraged. It needs stability to give people the confidence to invest for the longer term. We recommend that the clause and schedule should be removed from the Bill. There should then be extensive consultation before any further changes to the pensions law is enacted.

Circumstances have not changed so dramatically since the new pension legislation was introduced in 2006 that such a change can be justified. 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.

### 5. Self Assessment should be simple

Within the UK, we have now had a self assessment regime for personal tax for approximately 12 years. These new provisions contained within the Finance Bill 2009 intend that where an investor has their tax relief restricted to the basic rate on their additional savings, a tax charge will be collected through the self assessment tax return. Such a complication is wrong in principle and inappropriate for a self assessment regime especially in those cases where income fluctuates because of unusual circumstances perhaps arising on the exercise of an option or a one off bonus or a balancing charge on the disposal of a capital asset.

Increasing complexity is likely to lead to error or mistake. In addition, frustration of lifelong pension planning is likely to lead to a feeling of unfairness and ultimately the loss of confidence in the stability of pension regimes and pension planning. This must be contrary to the policy intention of encouraging responsible pension investment. This may lead to a loss of financial security as well as confidence in the regime.

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.

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